

The SEC Regulation of Takeovers: Some Doubts from a Game Theory Perspective and a Proposal for Reform

Sharon Hannes & Omri Yadlin[†]

This Article shows that in cases where shareholders subject to partial takeover bids lack information about the tendering decisions of their peers, such shareholders might accept detrimental tender offers. This outcome could be improved by way of a slight change in the rules of the game. We suggest a simple reordering of the tender offer and proxy contest procedures in hostile partial bids that would ameliorate the problem to a significant extent. The decisionmaking problem faced by shareholders in partial bids could be substantially alleviated by the following procedure: first, the tendering period should close prior to the shareholder vote on the bid; second, the final tally of the tender should be made public; and finally, shareholders should vote on the bid. Shareholders would thus be free from the burden of guessing the tendering choices of their peers. When voting for or against the bid, shareholders will know exactly what fraction of shares were tendered, allowing them to have a better sense of the value they will receive for their shares if the bid is approved. This simple procedure overcomes an important challenge at virtually no cost, making shareholders less likely to approve a bid that they will later regret. If this proposal were to be adopted, judicial hostility to partial tender offers might abate. Partial bids sometimes make much sense from an economic point of view, as they allow M&A activity without any necessity for raising funds to acquire the firm in its entirety.

[†] Tel Aviv University Faculty of Law. For their helpful comments and conversations, we wish to thank Oren Bar-Gill, Lucian A. Bebchuk, David Gilo, Alon Klement, Roy Kreitner, Yoav Kremer, Ariel Porat, Avi Tabbach, Edward Iacobucci and the participants in the Law & Economics Seminar at Tel Aviv University and at the ILEA Annual Meeting and at the Siena/Toronto/Tel Aviv Workshop on Law and Economics (Siena, June 2007). Our thanks also to the Cegla Center for Interdisciplinary Research of the Law at Tel Aviv University Law Faculty for financial support.

Introduction.....	36
I. Tender Offers and a Shareholder Referendum on a Bid's Outcome	39
A. The Shortcomings of the Tender Offer Mechanism	41
1. Asymmetric Information and Pressurizing Tactics.....	41
2. Collective Action Problems (Free-Riding and the Pressure to Tender).....	43
B. The Scholarly Literature's Proposed Solution for Coercive Bids.....	46
C. Market Developments and Regulation.....	50
D. Securities Regulation and Its Official Interpretation	54
II. The Problem of Uninformed Votes and a Proposal for Reform	56
A. The Operation of the Proposed Arrangement when Shareholders Suffer from Asymmetrical Information	58
1. The Shareholder Body	59
2. The Bid and Shareholders' Estimations of the Bid's Value	59
3. Explanations for the Shareholders' Decision Tree	60
4. Shareholders' Payoffs for Any Combination of Tendering Decisions.....	61
5. The Solution of the Game (and Shareholders' Decision Problem)	63
6. The Reform Proposal	64
7. Discussing Group Behavior	64
B. The Operation of the Proposed Arrangement if Shareholders Diverge in Ability to Cope with a Controlling Shareholder	66
1. The Shareholder Body	67
2. The Bid and Shareholders' Estimation of the Bid's Value	68
3. Explanations for the Shareholders' Decision Tree	69
4. Shareholders' Payoffs for any Combination of Tendering Decisions.....	70
5. The Solution of the Game (and Shareholders' Decision Problem)	72
6. Our Reform Proposal	73
III. Concluding Remarks	73

Introduction

This Article deals with the hurdles of a heterogeneous shareholders body, with different tastes or beliefs, when facing a takeover bid. The literature already recognizes that a hostile tender offer poses a threat to the target shareholders who, for strategic reasons,¹ may tender their shares in response to

¹ By strategic reasons we mean that each shareholder takes into account not only her own view of the purchase offer but also the actions and tastes of her peer shareholders, and the interaction between the actions of all shareholders. Specifically, a shareholder may tender her shares out of the fear

an inferior bid.² It has therefore been suggested that the decision to tender be made separately from the shareholder vote on the actual merits of the bid.³ While the legislature has never adopted this proposal, market forces in the poison pill era did generate a mechanism with a similar effect.⁴ To overcome a poison pill (a mechanism implemented by managers to thwart bids),⁵ the bidder must win the shareholders' vote in a proxy contest that is aimed at redeeming the poison pill, and only thereafter can the tender offer be consummated.⁶ Thus, a coercive bid, which is inimical to the target shareholders as a group, would be rejected in the shareholder vote, even if the majority of the shareholders were willing to tender their shares for strategic reasons.

Neither the literature nor this mechanism when operated in practice contends, however, with the hurdles set by the non-transparency of the tendering preferences of the shareholders' peers. Consider, for instance, a partial bid for 50% of the target corporation's stock. With such a bid, there is no guarantee that all tendered shares will be purchased. If shareholders holding more than 50% of the target's outstanding capital decide to tender their shares, the bidder will purchase a prorated share from each. The more shareholders who tender their shares, the fewer shares purchased from each tendering shareholder. This feature of partial bids complicates the decision for target shareholders. Not only do they have to consider the stand-alone value of the target, the bid price, and the post-acquisition value of non-tendered shares, but they also have to guess what fraction of the target stock is going to be tendered. Put differently, unlike in an any-or-all-shares bid, the shareholders in a partial bid can only guess at the value per share they will receive for any given fraction of tendered shares.

that other shareholders would tender their shares and she may thus be left with a small minority in a firm governed by a problematic or questionable controlling shareholder.

2 "Hostile takeovers" is the term used for unsolicited control transactions that are imposed on the management of the target. This type of transaction became prominent in the 1980s, and after a short decline in frequency regained its position as one of the major routes of M&A transactions. *See generally* Marcel Kahan & Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 874 (2002) (discussing the trends and shifts in hostile takeover activity).

3 Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985) (describing the problem of coercive bids and suggesting a reform proposal).

4 John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1307 (2001); Sharon Hannes, *The Determinants and Consequences of Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51, 63-64 (2004).

5 Coates refers to the poison pill as "the most common, controversial, and distinctive type of defense." John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 277 (2000); *see also* ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW 70-71* (1993) (reporting on the effects of takeover defenses, particularly the poison pill).

6 One of the authors has engaged in a broad analysis of incumbents' ability to thwart bids and the corresponding outcomes. *See* Sharon Hannes, *A Demand-Side Theory of Antitakeover Defenses*, 35 J. LEGAL STUD. 475 (2006) (supplementing existing theories of anti-takeover defenses); Sharon Hannes, *The Market for Takeover Defenses*, 101 NW. U. L. REV. 125 (2007) (presenting a unified theory and framework for the motivation behind using defenses) [hereinafter Hannes, *Takeover Defenses*].

Interestingly, a mild change in procedure could significantly simplify the decision for shareholders in partial bids. If the tendering period were to culminate prior to when the shareholder vote on the bid is conducted and the final tally of the tender then made public, shareholders would not be forced to guess the tendering preferences of their peers. When voting for or against the bid, they would know exactly what fraction of shares have been tendered, giving them a better sense of the value they will receive for their tendered shares if the bid is approved in the shareholder vote. This simple procedure would overcome an important challenge inherent to partial bids at virtually no cost, making shareholders less likely to approve a bid that they will later regret. Moreover, as we shall illustrate in this Article, the revealed preferences of informed shareholders could, at times, signal bidder quality to uninformed shareholders, which would enable the latter to thwart indiscernibly harmful bidders.⁷

Currently, however, the Securities and Exchange Commission's (SEC) interpretation of the existing securities regulations hampers adoption of our proposed solution for the peer-preference-guessing problem in partial bids.⁸ The SEC's interpretation of the so-called prompt-payment-or-return rule requires bidders to conclude the purchase of the tendered shares soon after the tender period is over.⁹ Given this requirement, bidders cannot presently close the tendering period before shareholders have voted in the proxy contest aimed at redeeming the poison pill, since any purchase of shares before such a vote would activate the poison pill. Since the SEC's interpretation of the rule does not take into consideration the importance of revealing other shareholders' preferences, we propose in this Article a reevaluation of the SEC's stance. Based on our analysis, we point to the need for a reform that would allow or even require bidders to follow the simplifying procedure described above.

Perhaps this matter has evaded discussion so far because the takeover literature has, by and large, assumed shareholders to be homogenous and informed.¹⁰ In reality, however, shareholders are heterogeneous and have different beliefs and tastes and, as noted elsewhere, "a target's shareholders might well differ in their judgments of how the offered acquisition price

7 See *infra* Section II.A.

8 17 C.F.R. § 240.14e-1(c) (2007) (requiring the bidder to pay the consideration offered for the securities accepted under the offer, as well as to return securities not accepted, promptly after termination of the tendering period).

9 For example:

[I]nformal positions taken by the SEC staff suggest that the staff does not interpret the prompt-payment-or-return requirement as permitting a bidder to let its offer expire and continue to retain the tendered shares while it waits to see whether conditions it has *chosen*, as a business matter, to impose . . . are met (*e.g.*, the subject company's redemption of a poison pill rights plan . . .).

5-72 Securities Law Techniques § 72.05(6)(c) (2007).

10 See, *e.g.*, Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

compares with the independent target's value."¹¹ It is, therefore, helpful for each shareholder to be informed of the final tendering decisions of her peers, before the vote on the bid itself. Recall that if the number of tendered shares exceeds the number of shares requested, then the bidder will purchase only a pro rata share of each tendered parcel of stock from each tendering shareholder.¹² Hence, the total amount of shares tendered should be a central factor in each shareholder's decision on whether to tender. In fact, the broader corporate governance literature and corporate finance literature recognize that the shareholder body is split into informed shareholders (such as institutional shareholders) and uninformed shareholders (such as the general public). We build on this distinction to show the importance of our proposed mechanism. Interesting results obtain from our analysis. We show that our proposal could sometimes assist uninformed shareholders in identifying and fending off indiscernibly harmful bids, while simultaneously preventing shareholder opportunism ("free riding") from thwarting beneficial bids.

The Article progresses as follows. Part I begins with a discussion of the shortcomings of tender offers as a means of wresting control. Information problems and collective action problems (both the pressure to tender and free-riding) are considered in this context. This Part then briefly discusses the solution that has emerged in scholarly writings to certain elements of these problems and the market developments that led to the adoption of a similar solution. It then presents the relevant securities regulation requirements that both limit and ground the solution adopted in practice. Part II expands on this discussion, incorporating the factors of shareholder heterogeneity and uninformed votes. It then proceeds to explain and demonstrate the benefits of our proposal. Part III concludes.

I. Tender Offers and a Shareholder Referendum on a Bid's Outcome

Unlike their counterparts in foreign countries, most large American firms enjoy a dispersed ownership structure with multiple passive investors.¹³ While

11 Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911, 916 (1987). Bebchuk points to this fact in advocating a majority vote on the outcome of a takeover bid. We argue that this diversity also requires the final tally of the tender offer be revealed so that shareholders will not be required to guess the tendering decisions of their peers—a crucial consideration in voting on the bid.

12 15 U.S.C. § 78n(d)(6) (2000). The pro rata purchase requirement means that if the number of shares tendered exceeds the number of shares requested by the bidder, then the bidder is required to purchase only a fraction of the tendered shares from each tendering shareholder. That fraction is calculated by dividing the number of requested shares by the number of tendered shares. To demonstrate, if the number of tendered shares is twice the number of requested shares, the bidder should purchase from each tendering shareholder only half of the shares tendered by that shareholder.

13 See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 496 (1999) (reporting that most developed financial markets, with the exception of the U.S. and British markets, suffer from concentrated ownership); see also ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (considered one of the first treatments to emphasize the de-facto separation between ownership and control in large American corporations).

there are ample benefits to the American ownership structure,¹⁴ there is also a fear that, in the absence of close monitoring by distant owners, managers will divert or destroy much of the value of the firm.¹⁵ Job shirking, self-dealing transactions,¹⁶ insider trading, perks consumption, investment in “pet projects,” and unjustified expansion and diversification are just some of the detrimental practices that exist.¹⁷ Managerial wrongdoing in the WorldCom, Enron, and Tyco scandals are strong reminders of the possible materialization of this fear.¹⁸

In his celebrated article *Mergers and the Market for Corporate Control*, Henry Manne argued that corporate takeovers may cure distant shareholders’ joint action problem in monitoring management.¹⁹ Small shareholders have no incentive to invest time and effort in monitoring, but will gladly tender their shares to a bidder for the right price. Hence, if managers shirk their duties or otherwise engage in wasteful activities, the market value of the corporation will decrease and an opportunity will arise for a hostile bidder to buy the company cheaply and reap the benefits of its improvement after firing the incumbent managers. Alert to this possibility, corporate managers will limit diversion of

14 See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (indicating that markets in which dispersed ownership is the norm are deeper and more liquid and that this financial development translates into economic growth).

15 MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994) (discussing the causes and consequences of the common American ownership and control structure).

16 An important subset of the self-dealing transactions relate to managers’ pay, which recently has received much attention. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE PAY* (2004) (discussing at length flaws in the design of manager pay practices), Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003) (same); Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 761-63 (2002) (same). One of the authors contests part of this literature. See Sharon Hanes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421 (2007).

17 See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986) (discussing managers’ waste, which is aggravated by the fact that many corporations have ample resources); Michael C. Jensen, *The Free Cash Flow Theory of Takeovers: A Financial Perspective on Mergers and Acquisitions and the Economy*, in *THE MERGER BOOM 102* (Lynn E. Browne & Eric Rosengren eds., 1988), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=350422 (same).

18 John C. Coffee, *A Theory of Corporate Scandals: Why the U.S and Europe Differ* (Columbia Law & Econ. Working Paper No. 274, 2005), available at <http://ssrn.com/abstract=694581> (discussing the corporate crises of the early twenty-first century, their causes, and consequences); John C. Coffee, *Understanding Enron: It’s About the Gatekeepers, Stupid* (Columbia Law & Econ. Working Paper No. 207, 2002), available at <http://ssrn.com/abstract=325240> (same); John C. Coffee, *What Caused Enron?: A Capsule Social and Economic History of the 1990’s* (Columbia Law & Econ. Working Paper No. 214, 2003), available at <http://ssrn.com/abstract=373581> (same).

19 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (initiating the discussion of the market for corporate control). The first formal models arrived much later. See Grossman & Hart, *supra* note 10; David Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185 (1988) (modeling the argument that the fear of takeovers disciplines managers from the outset).

corporate resources and do their best to maximize firm value.²⁰ Thus, takeover prospects, in a sense, replace the monitoring function that owners perform in a concentrated ownership structure.²¹

Since its first usage in the United States in the 1960s, the tender offer mechanism has flourished and gained popularity as a means of seizing control of a firm from the hands of the incumbent managers.²² Nevertheless, and notwithstanding its beneficial role in corporate governance and in moving assets into the hands of their best users, a takeover bid entails several threats to the welfare of the shareholders of the target corporation. These threats can be divided into two types: information-based problems and strategic or collective-action problems. Understanding both categories of problems is essential to the thesis of this Article, which questions the SEC's interpretation of the existing takeover regulation. We will later show how careful design of takeover regulation may alleviate in some circumstances both sets of challenges, which are especially acute in partial bid settings.

A. *The Shortcomings of the Tender Offer Mechanism*

1. Asymmetric Information and Pressurizing Tactics

Most unsolicited control contests for public corporations involve a tender offer, which may be broadly defined as a publicized attempt to solicit shares at a fixed price.²³ Until the 1960s, however, when the mechanism was imported from Great Britain, control contests in the United States typically involved only proxy solicitations, which were regulated by Section 14 of the 1934 Securities

20 Legal scholars have relied heavily on this argument to advocate a prohibition on defensive tactics by management. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Moreover, in *Edgar v MITE Corp.*, 457 U.S. 624 (1982), Justice Byron White argued along similar lines to prevent Illinois from adopting anti-takeover legislation. Recently, the market for corporate control was described as a "peer review process." Ronald T. Gilson & Reinier Kraakman, *Takeovers in the Boardroom: Burke Versus Schumpeter* (Harvard Law & Econ. Discussion Paper No. 517, 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=732783.

21 Many more restraining market forces and internal mechanisms help reduce managerial agency costs. However, they also leave a huge gap for a takeover to occupy. See, e.g., Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 847 (1993).

22 Bernard S. Black, *The First International Merger Wave (and the Fifth and Last U.S. Wave)*, 54 U. MIAMI L. REV. 799, 800 (2000) (describing five merger waves since the Sherman Act was enacted in 1890). The tender offer mechanism was invented in the 1950s in Great Britain and has become the main tool for acquiring shares in control contests. In contrast to the simple aggregation of single purchases on the open market, each at a different price, the bidder in a tender offer sets a time period for the public shareholders to tender their shares, the price at which the bidder is interested in buying the shares, and the amount it is willing to pay. See DOUGLAS V. AUSTIN & JAY A. FISHMAN, CORPORATIONS IN CONFLICT—THE TENDER OFFER 7-23 (1970) (describing the tender offer tool and its evolution).

23 This informal definition is taken from the Supreme Court decision in *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 22 (1977).

Exchange Act.²⁴ Within a few years of the mechanism's adoption it became apparent that this new corporate tool posed a threat to the welfare of dispersed and uninformed shareholders: a bidder was now able to make a cash bid for a specified amount of the target's stock, with the bid open for an especially short period of time but without any information provided to shareholders regarding the identity or plans of the bidder.²⁵ Beyond the informational problems that arose in such a setting, the bidder was able to apply pressurizing tactics on the shareholders to sell, for example, through an undertaking to buy the specified amount of shares on a first-come, first-served basis. The panic that gripped some shareholders when faced with such a narrow horizon and information deficiency, coupled with management's natural hostility towards takeovers, eventually led to a regulation that abolished these "Saturday Night Specials," as these tender offers were notoriously dubbed.²⁶

In 1968, Congress added Sections 13(d)-(e) and 14(d)-(f) to the 1934 Act, collectively known as the Williams Act.²⁷ The Williams Act ensured that shareholders enjoy adequate disclosure concerning the bidder and the bid and outlawed common pressurizing tactics. As articulated by the Supreme Court, "[t]he purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information"²⁸ Thus, the Williams Act and the rules promulgated thereafter require full disclosure about the bidder and its plans,²⁹ demands that the tender offer be held open for at least twenty business days,³⁰ mandates proration (as opposed to purchase on a first-come, first-served basis) and withdrawal rights throughout the entire duration of the bid,³¹ and prohibits any unequal treatment of the target's shareholders.³² However, the Williams Act did not and could not completely level the playing field between informed and uninformed shareholders, a point on which we focus further on. For instance, an institutional investor will typically have better capabilities and

24 See AUSTIN & FISHMAN, *supra* note 22, at 7-23 (describing the tender offer mechanism and its evolution).

25 Note that, in contrast to cash tender offers, tender offers that involved an exchange of securities, or "exchange offers," were subject to the registration requirements of the 1933 Act and therefore regulated many decades before the Williams Act was legislated.

26 These offers are also sometimes referred to as "Blitzkrieg Tender Offers." See, for example, Investopedia's explanation of the abovementioned terminology, <http://www.investopedia.com/terms/b/blitzkriegtenderoffer.asp>.

27 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000).

28 *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975).

29 15 U.S.C. § 78n(d)(1), which is complemented by the specific antifraud provision of 15 U.S.C. § 78n(e), specifies that "such person has filed with the Commission a statement containing such of the information specified in section 78m(d) of this title, and such additional information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors."

30 17 C.F.R. § 240.14e-1(a) (2007).

31 15 U.S.C. § 78n(d)(6); 17 C.F.R. § 240.14d-7.

32 17 C.F.R. § 240.14d-10. This is also known as the "all holders/best price" rule. The rule prohibits bidders from making a tender offer that is not open to all shareholders or that is made to shareholders at varying prices.

resources than an ordinary public investor to analyze and understand overt and covert data about the bidder and the target and, consequently, will make a more informed decision as to whether to tender.³³

It is also important to note that the Williams Act did relatively little to alleviate two other problems, to be discussed and illustrated below, associated with tender offers: coercion and free-riding. These problems arise due to the problem of collective action amongst dispersed shareholders and, therefore, will not emerge in concentrated ownership structures. Both types of problems stem from the fact that shareholders' individual tendering decisions may diverge from what would be in the best interest of the collective group of shareholders.

2. Collective Action Problems (Free-Riding and the Pressure to Tender)

The first problem, termed the "free-rider problem" in takeovers, may impede efficient control transactions.³⁴ The following numerical example demonstrates the problem. Suppose that Target Corp.'s shares are traded at \$26. Bidder Inc. seeks to take control of Target and makes a tender offer at \$30 per share for any or all of Target's stock.³⁵ Bidder conditions its bid on gaining control of Target; namely, the bid will be revoked if less than 50% of the shares are tendered. Since Bidder has a reputation for superior managerial skills, Target's shareholders believe that, following the takeover, Target's shares will be traded at \$35 on the market. Clearly, all shareholders should support the deal. However, since the anticipated market price after the takeover is higher than the proposed tender offer price, each shareholder individually prefers to keep all her shares, in the hope that other shareholders will tender and allow Bidder to take control. Since all shareholders think alike, all will try to free-ride on their peers and will refrain from tendering, in which case Bidder will not gain control.³⁶ The individual tender decisions thus will diverge from what would be in the shareholders' collective best interest. Shareholders prefer individually to

33 For the assumption of institutional investors' superiority see *infra* note 108 and accompanying text. Note, however, that part of the literature criticized certain institutional investors and especially pension funds for having motivations that deviate from shareholders welfare. See, e.g., Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993) (criticizing the role played by pension funds as shareholders advocates); Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance* (New York University School of Law, Law & Econ. Research Paper Series, Paper No. 07-30, 2007), available at <http://ssrn.com/abstract=1010330> (reporting mixed findings in a recent empirical study of pension funds role in corporate governance).

34 The phenomenon is widely acknowledged and discussed in the financial literature but less so in the legal literature. See Sanford J. Grossman & Oliver Hart, *The Allocational Role of Takeover Bids in Situations of Asymmetric Information*, 36 J. FIN. 253 (1981); Grossman & Hart, *supra* note 10. For a more recent model, see Ilya Segal, *Contracting with Externalities*, 114 Q.J. ECON. 337 (1999).

35 Note that a partial bid, say for 50% of Target's stock, would lead to similar results.

36 We assume that the holdings of each shareholder are miniscule, and therefore that no one expects his or her decision about whether to tender or not to be pivotal in determining the bid's outcome.

hold out in order to capture the higher post-acquisition value of their corporation rather than tender but, as a result, an attractive bid will fail.

The above illustration offers an important lesson: theoretically, a tender offer can be successful only if the bid price exceeds the price at which Target's shares will be traded after Bidder takes control.³⁷ Only such bids will motivate shareholders to tender their shares and prevent them from trying to free-ride at the expense of their peers. However, as will be shown below, this may lead to the second collective action problem. The mirror image of the first problem, the pressure-to-tender (or coercion) problem arises when individual shareholders prefer to tender rather than hold a minority position in the post-acquisition corporation.³⁸ Tendering may occur even if each shareholder considers the offered acquisition price to be lower than the independent value of the target firm.³⁹

To demonstrate the way coercion leads to inefficient deals, it is best to discuss first the case of partial bids. Hence, we will modify two features in the above example. First, we will assume that Bidder makes a partial bid for no more and no less than 50% of the outstanding shares of Target. Second, in

37 This statement also implies that if the value of the controlling shares (eventually to be held by Bidder) and the value of the minority shares are equal, no takeovers would occur in this state of equilibrium. However, in reality, the expected value of a minority share is often less than the expected value of a controlling share, since a controller is able to divert part of the value of the corporation to herself and "dilute" the value of the minority shareholders' holdings. Dilution, coined by Grossman and Hart, is therefore necessary for efficient takeovers to take place. Grossman & Hart, *supra* note 10.

38 For an early discussion of the problem, see Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974). Discussions of the problem by practicing lawyers include R. Franklin Balotti & Jesse A. Finkelstein, "Coercive" Structures in Tender Offers, 15 REV. SEC. REG. 820 (1982); Jesse A. Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291 (1984); Edward F. Greene & James J. Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 676-93 (1984); and Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113-14 (1979). Discussions of the issue by legal academics begin with Brudney & Chirelstein, *supra*, and include Lucian A. Bebchuk, *The Case for Facilitating Competing Bids: A Reply and Extension*, 35 STAN. L. REV. 23, 45-46, 48-49 (1982); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1039-41 (1982) [hereinafter Bebchuk, *Tender Offers*]; William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341; John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1183-95 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 710-11 (1982); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 859-62 (1981); and Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307-09 (1983). Finally, the issue has also been discussed by economists. See, e.g., Michael Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 352-56 (1980); Harry DeAngelo & Edward M. Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983); Grossman & Hart, *supra* note 10, at 44-47; Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & ECON. 151, 154-58 (1985); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 31-32 (1983).

39 If the bid price is higher than the post-acquisition value but still exceeds the independent value of the target, the pressure to tender is beneficial, as it pushes shareholders to sanction an efficient transaction.

contrast to the previous scenario, we will assume that Target's shareholders anticipate that, after taking control of Target, Bidder will "milk" the firm, and the remaining minority shares will be traded at \$16 each. If shareholders were to act in concert, they would reject this deal as they would prefer to maintain the status quo prior to the bid, with a value of \$26 per share, than to sell half of Target for \$30 per share and remain with the other half at \$16 per share.

However, since the shareholders act independently of one another, their joint action problem will lead each of them individually to accept the deal. Any shareholder whose holdings are too small to influence the outcome of the bid will selfishly consider the following two possibilities. If the majority of her peers have decided to reject the bid, then it is worthwhile for her to tender and receive \$30 per share. Alternatively, if the majority of shareholders have decided to tender their shares, then tendering would minimize her individual losses since a minority interest in post-acquisition Target will not be worth much. Combined, these two lines of reasoning will theoretically induce all shareholders to tender their shares, and they will each suffer a consequent loss of \$3 per share in the transaction (that is, they will receive \$30 for half of their shares and \$16 for the other half as a minority, instead of \$26 for all their shares were they to reject the bid).⁴⁰

Surprisingly enough, coercion is possible not only in partial bids but also in any-or-all bids, in which the bidder offers to purchase all tendered shares.⁴¹ At first glance, it seems that such deals will always be beneficial to shareholders. Suppose, for example, that Bidder made an any-or-all bid of \$30 per share. In such a case, each individual shareholder would tender her shares. This decision would also be in the best interests of the collective body of shareholders since selling the entire firm for \$30 per share is not only better than the \$16 post-acquisition minority value but also better than the independent value of \$26 per share.

But consider the same example with a slight twist: Bidder's offer is not for \$30 per share but for \$22 per share, and he conditions the bid on acceptance by the holders of at least 50% of the shares. Clearly, since \$22 a share is lower than the prevailing market price (\$26), shareholders as a group would prefer to reject the bid. However, it is important to consider the dilemma faced by holders of only a small fraction of the firm: if all other shareholders refrain from tendering their shares, the bid will not meet the 50% threshold, and therefore, whether or not the individual shareholder chooses to tender her shares will have no impact on her benefit from the bid. However, if more than

40 This scenario is known in game theory as the paradigmatic "prisoner's dilemma." See, e.g., AVINASH K. DIXIT & SUSAN SKEATH, *GAMES OF STRATEGY* 256-57 (1999) (presenting the prisoner's dilemma game, which illustrates how an inferior outcome for all players may result from each player's individual attempt to maximize her own payoff).

41 Before Bebchuk presented his analyses, it was widely held that only partial bids and two-tier bids could create coercion. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985); Bebchuk, *supra* note 11, at 925-26; Greene & Junewicz, *supra* note 38, at 676-93.

50% of the shares are tendered, our individual small shareholder will be better off tendering her shares for \$22 than being left with minority shares worth \$16 each. The only scenario in which our individual shareholder will refuse to tender her shares is when she anticipates a high probability that her shares will be decisive in the bid outcome, namely, that her decision to tender or not will determine the fate of the bid (or she is positive that the bid will fail).⁴² If we assume that the shareholder holds a tiny fraction of the firm's shares, the probability of her move being determinative is so slim that she will probably ignore that possibility and tender her shares.

The problem with any-or-all bids is less acute than the problem involved in partial bids, however. As illustrated above, in a partial inimical bid, a shareholder has an incentive to tender her shares even if she is certain her peers are going to reject the bid, whereas no such incentive is generated in the framework of an inimical bid for all shares. The decision to tender in an any-or-all detrimental bid is the result of the individual shareholder's fear that even if she does not tender, the bidder will still gain control, and she lacks any additional incentive to take advantage of peer shareholders in the event that they decline to tender (as the case may be in a partial detrimental tender offer). Put differently, adverse partial bids can be designed so as to pressurize shareholders, regardless of whether they believe the bid will succeed, whereas a detrimental any-or-all bid can succeed only if a substantial group of shareholders believe that the bid could succeed. While this Article concentrates on partial bids (and emphasizes a problem that has yet to be addressed by the literature), solutions have been proposed by scholars that address the coercion problem in both types of bids.

B. *The Scholarly Literature's Proposed Solution for Coercive Bids*

In the 1980s, the heyday of hostile takeovers, the coercion problem received much attention from all quarters. Managers of firms targeted by an unsolicited takeover attempt often argued that takeover bids were coercive,⁴³ while scholars suggested a mechanism to overcome the coercion problem. The most comprehensive discussion and reform proposal was put forth by Bebchuk.⁴⁴ The objective of his proposed mechanism was to ensure shareholders' undistorted choice,⁴⁵ requiring that "a company should be acquired if and only if a majority of its shareholders view the offered

42 One of the authors has played this game with his Corporate Law students throughout the years, and in six out of seven cases, the majority of students decided to tender their "shares."

43 See *Unocal Corp.*, 493 A.2d at 953.

44 Bebchuk, *supra* note 11; see also Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1361-65 (1978); Brudney & Chirelstein, *supra* note 38, at 336-40; Carney, *supra* note 38, at 341.

45 Bebchuk believes that additional objectives should be pursued, but argues that any additional objectives should remain perfectly consistent with the undistorted choice objective. See Bebchuk, *supra* note 11, at 914 n.8; Bebchuk, *supra* note 3, at 1706-08, 1780-87, 1972-94.

acquisition price as higher than the independent target's value."⁴⁶ Ensuring undistorted choice protects not only the wealth of the target shareholders, but also social welfare in general. Efficiency requires that corporate assets be controlled by their most productive users, and undistorted choice prevents transfer of control in firms into the hands of inferior bidders that reduce the value of the post-acquisition target. Thus, only acquisitions that entail improvement in the management of the target or synergies between the bidder and the target could pass the test of undistorted choice.

The classic literature also supports the undistorted choice standard on the basis of an analogy to the sole-owner standard.⁴⁷ The law generally conditions the sale of a sole owner's assets upon her consent.⁴⁸ Therefore, a sale will materialize only if the owner regards the offered price to be higher than the value to her of retaining the asset. The sole owner might err in assessing the value of her assets, but there is general and common consensus that the sole-owner decision brings us as close as possible to the most efficient outcome.⁴⁹ This logic, the argument goes, applies also to acquisitions of dispersed ownership corporations and therefore justifies the undistorted choice objective. The target's shareholders might make mistakes in assessing how the offered acquisition price compares with the target's independent value. This problem corresponds to the problem in the sole-owner context, and therefore a mechanism that will ensure undistorted choice seems to be the best available solution.⁵⁰ While we do not disagree with this line of reasoning, we do believe that an important refinement is necessary. Unlike the sole owner, the group of individuals comprising the shareholder body of a dispersed ownership firm typically includes both informed shareholders (such as institutional investors) and uninformed shareholders (mostly public investors with fractional holdings).⁵¹ Below, after presenting the arrangement suggested in the literature and the arrangement eventually adopted by the market (guided by the SEC regulation), we outline a proposed reform that harnesses the knowledge of the informed group of shareholders to the benefit of the entire group of shareholders. The simple reform merely requires reversing the order of the two phases of the mechanism discussed below, as well as the mechanism adopted in the market in practice.

46 Bebchuk, *supra* note 11, at 914.

47 *Id.* at 915 (using the logic of the sole-owner standard to support the undistorted choice objective).

48 See, e.g., Lucian A. Bebchuk & Oren Bar-Gill, *Consent and Exchange* (Harvard Univ. Law & Econ. Research Paper Series No. 590, 2007), available at http://papers.ssrn.com/abstract_id=998486 ("Exchanges—transfers of value from a 'seller' to a 'buyer' for a consideration—commonly require the mutual consent of both sides to the exchange.").

49 *Id.*

50 Bebchuk, *supra* note 3, at 1770-74.

51 See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, U. PA. L. REV. 1021, 1042-43 (2007). For data on the high level of institutional investors, see *id.* at 1048-59.

The underlying rationale of the arrangement proposed in the literature is to allow the shareholders to express their views on the bid detached from their decision whether or not to tender.⁵² Simply put, it would require attaching a shareholder referendum to the tender offer or any other instance of an attempt to gain a controlling stake in a dispersed ownership firm.⁵³ Two versions of this proposed arrangement have emerged in the literature. The first version entails that tendering shareholders be able to indicate, at the time that they tender, whether or not they approve of the bid overall. A simple way to allow for such an indication would be to include two boxes on the tender offer form that accompanies all tendered shares and require tendering shareholders to mark if they “approve” or “disapprove” of the tender offer. The bid’s success would be determined by whether or not it attracts the approval of a majority of tendering shareholders and not simply by the number of tendered shares. If the bid attracts the requisite proportion of approving tenders, the bidder will have succeeded in the tender offer and will have to treat equally both approving and disapproving tenders. In a bid for all shares, the bidder will have to purchase all tendered shares; in a partial bid, the bidder will have to buy a prorated share from all tendering shareholders.⁵⁴

This scheme would enable shareholders to overcome the detrimental effects of the pressure-to-tender phenomenon. As long as a shareholder believes that the bid price is higher than the post-acquisition value, she will tender her shares no matter how high her estimate of the target’s independent value. However, a shareholder who believes that the independent value is higher than the bid price will tender disapprovingly.⁵⁵ Accordingly, such a shareholder would do her best to fend against the bid as well as to insure herself against the possibility of most of her peers approving the bid. Conversely, a shareholder would tender approvingly if and only if she estimates the expected acquisition price to be higher than the target’s independent value.⁵⁶ Thus, this proposal (which is expanded on in our own proposal) comes fairly close to ensuring undistorted outcomes.⁵⁷ At the heart of the mechanism is the decoupling of the tendering decision from the tendering shareholders’ indication of their view on the bid’s quality.

52 Bebchuk, *supra* note 11, at 931.

53 Bebchuk, *supra* note 3, at 1748.

54 Some additional safeguards are necessary, such as dealing with the bidder’s desire to purchase a non-controlling stake in the event that the bid fails. See Bebchuk, *supra* note 11, at 932.

55 In the event of a partial bid, the bid price in the text above should take into account the number of shares that would be purchased in the bid and the post-acquisition price for the unpurchased shares. This important issue will be addressed in Section D of this Part.

56 It should also be assumed that there is some positive probability, even if minute, that the shareholder’s decision will be pivotal. Otherwise, the shareholder has no reason to even consider whether she tenders approvingly or disapprovingly of the bid.

57 Another possible refinement of the mechanism is to add the requirement that the bidder secure not only a majority of approvingly tendered shares but also a majority of those held by neutral parties. See Bebchuk, *supra* note 11, at 933 n.40. Note also that the mechanism does not contend with the free-rider problem.

The second version of the literature's proposed arrangement seeks the same goal as the first version, allowing shareholders to express their preferences in a vote separate from their decision whether or not to tender. In the words of the author of this version (who also suggested the first version), "[u]nder this alternative version, a vote would be conducted among the target's shareholders (and the vote's outcome would become known) prior to the bid's closing. The bidder would be allowed to purchase a controlling interest only if its bid obtains a prior majority approval in this vote."⁵⁸

This mechanism alleviates the pressure-to-tender problem similarly to how the first version of the arrangement functions.⁵⁹ If a shareholder considers the bid price to be higher than the post-acquisition value, she will tender her shares no matter how high she estimates the independent value of the target. However, if that shareholder believes the target's independent value to be higher than the bid price, she will vote against the bid's approval.⁶⁰ This would indicate her desire to reject the bid, while tendering would insure her against receiving the even lower post-acquisition value in the event that the majority of her peers believe the bid to be beneficial. Conversely, a shareholder will tender and vote in favor of the bid if and only if she regards the expected acquisition price to be higher than the target's independent value (as well as higher than the post-acquisition minority value).

It is important to emphasize the sequence of events. In both versions of the arrangement developed in the literature, shareholders express their views regarding the bid before they know what fraction of their peers have decided to tender. In the first version, shareholders mark their approval or disapproval on the tendering document at the same time they decide to tender. In the second version, the vote is conducted and its results made public before the bid is closed. In this Article, we propose reversing the order of events, at least in the context of partial bids. The period for accepting tenders should be consummated and then, only after the proportion of tendering shareholders is made public, a separate vote should be held on the bid and the contingent bid executed only if approved in the vote. As we will show below, this structure would both preserve the arrangement's utility in fending off coercive bids as well as produce substantial additional benefits. We first, however, discuss market developments that, in some sense, represent the adoption of the literature's proposal.

58 *Id.* at 934-35.

59 Though both versions are quite similar, Bebchuk prefers the first, for the reason that the separate vote mechanism requires that shareholders act twice. This two-stage process entails additional transaction costs, and a shareholder who believes that her chances of being pivotal in the vote are minimal may not even read the separate voting material. *See id.* at 935.

60 Once again, in the case of a partial tender offer, the bid price should take into account that it is possible that only a fraction of the tendered shares will be purchased, and therefore, the post-acquisition minority value of the unpurchased shares should be considered part of the purchase price.

C. *Market Developments and Regulation*

Generally speaking, the scholarly proposal discussed above is the arrangement practiced in the United States and certain foreign markets,⁶¹ at least in regard to unsolicited control bids.⁶² This, as we shall see below, has been more a matter of chance than an articulated adoption of a beneficial solution. We must fully examine the market developments and regulation that led to such arrangement in order to understand the proposal of this Article.

Unsolicited tender offers, otherwise known as hostile takeover attempts, became common practice in the 1980s.⁶³ In a hostile takeover, a bidder seeking to gain control appeals to the shareholders of the target to overcome managerial disapproval of the transaction. In corporate codes, directors are usually elected or dismissed from office by the corporation's vote and proxy mechanisms at the culmination of certain periods.⁶⁴ However, when a bidder successfully purchases a majority of the target's shares, it is only a matter of time until it will use the vote mechanism and replace the incumbent directors with the bidder's supporters. In practice, whenever the bidder has purchased enough stock without the directors' approval, the incumbent board resigns without awaiting the formal voting process.⁶⁵ Thus, the ability to buy shareholders' stakes in a market transaction, usually by way of a tender offer, left the vote mechanism unexploited in the takeovers of the early 1980s.⁶⁶

Legal counsel for targets reacted rather quickly to this trend and devised innovative legal devices that reshuffled the cards of the takeover game. Shareholders' rights plans, more commonly known as poison pills, were designed by lawyers to impede hostile market transactions. Courts certified their use.⁶⁷ Under the terms of such plans, a purchase of a significant fraction of the target's stock without its directors' approval triggers special rights for the

61 For foreign markets see, for example, Companies Law, 5759-1999 § 331, SH 1711 (Isr.) (a similar Israeli arrangement) and THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS (8th ed. 2006), available at <http://www.thetakeoverpanel.org.uk/new/codesars/DATA/code.pdf> (a similar U.K. arrangement).

62 Note that, unless the management of the target conspires with the bidder, shareholders should not fear that solicited "friendly" bids are in fact harmful. Hence, at the outset, it seems sufficient that only unsolicited bids are covered by the proposed arrangement.

63 In the 1980s, 29% of the Fortune 500 companies were subject to takeover bids. See Gerald Davis & Suzanne Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980-90*, 37 ADMIN. SCI. Q. 605, 605 (1992).

64 In some cases, the periods may be shortened by written consent or by calling a special shareholder meeting, but corporations can and often do foreclose these possibilities in the corporate charter. See Hannes, *supra* note 4 at 64-68.

65 Cf. John C. Coates, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 850 (1999) (describing the tendency of directors to resign or be replaced once a bidder gains control).

66 See AUSTIN & FISHMAN, *supra* note 22, at 7-23.

67 For criticism of these developments by scholars who generally believe that state law competition leads to efficient results, see Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843 (1993).

incumbent shareholders.⁶⁸ As a result, the value of the hostile purchase is diluted to the point of self-defeat.⁶⁹ Most importantly, since shareholders' rights plans are distributed as dividends in kind subject to the discretion of the board of directors, directors do not need shareholder approval to adopt poison pills, thus easing use of the device by managers. Notwithstanding the potential clash of wills between shareholders and the firm's directors and managers, the seminal Delaware Supreme Court decision in *Moran* and many others that followed in its wake legitimized the adoption of poison pills.⁷⁰

At first, commentators debated as to whether a board's decision to reject a bid, reached in the guise of the activation of a poison pill, would be carefully scrutinized by the courts.⁷¹ However, it soon became clear that, in most cases, the courts gave boards great leeway to reject acquisition offers.⁷² Thereafter, it became clear that pure market transactions could no longer serve as a possible means of accomplishing a hostile takeover.⁷³

Nevertheless, with some effort and expense, bidders could still circumvent the poison pill apparatus and surmount the target management's resistance. The possibility of overcoming poison pills exists because they do not hamper the vote and proxy mechanisms of the firms.⁷⁴ Thus, even in the presence of a poison pill, bidders can solicit shareholder votes to replace the incumbent board

68 Poison pills typically allow the incumbent shareholders to buy the acquirer's stock (so-called "flip-over" poison pills) or the target's stock (so-called "flip-in" poison pills) at substantially discounted prices. A flip-over poison pill is generally a far less potent defense than a poison pill with a flip-in provision. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 747 (2d ed. 1995).

69 For the terms of a standard poison pill, see H. Wachtell, M. Lipton, L. Rosen & J. Katz, *The Share Purchase Rights Plan*, reprinted in GILSON & BLACK, *supra* note 68, at 741, 743-48.

70 See the seminal case of *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

71 Gilson and Kraakman have advocated substantive judicial review of any board decision regarding unsolicited offers to purchase the firm. Specifically, they have suggested an intermediate review standard that is not too harsh but nevertheless does not leave unconditional discretion in the hands of the board of directors. See Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defense Tactics: Is There Substance to Proportionality View?*, 44 *BUS. LAW.* 247, 247-48 (1989). Kahan explains that the Delaware court never intended to and will not conduct such substantive scrutiny. The only requirements that the board of directors is obliged to fulfill in a case of an offer to purchase the firm are procedural. See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 *J. CORP. L.* 583, 589-92 (1994).

72 See *Paramount Commc'ns, Inc. v. Time*, 571 A.2d 1140 (Del. 1989); Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 *CARDOZO L. REV.* 511, 522-30 (1997). Only one doctrine, which covers a minority of the cases, allows for straightforward court intervention. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount Commc'ns, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

73 According to Gilson's recent criticism, by approving the usage of poison pills, which prevent bidders from purchasing stock directly from the corporate shareholders, the Delaware Court prompted bidders to use target firms' voting mechanisms. See Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 *DEL. J. CORP. L.* 491 (2001). Indeed, the Delaware Court has always been sensitive to managerial interference in the voting process. See *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

74 Dispersed shareholders usually do not show up for a vote but, rather, mail in their proxies with their decisions. Hence, the vote and proxy process is usually referred to as simply the proxy process.

of directors with pro-bidder directors. The latter, in turn, will redeem the poison pill and allow the bidder to purchase the stock, since “poison pills can be removed by a board of directors as easily as they can be installed.”⁷⁵ Thus, the vote mechanism that at the outset was designed to enable shifts in control reassumed a major role in the takeover game following the emergence of the poison pill.⁷⁶

When shrewd lawyers tried to modify the poison pill to defend against the overriding proxy maneuver, by inventing the so called “dead-hand” poison pill, the courts did not play along. A dead-hand poison pill limits the ability to redeem the poison pill to those directors who were members of the board at the time of the pill’s adoption. Hence, the nomination of pro-bidder directors cannot guarantee the control transaction. However, these types of poison pills were prohibited by the Delaware Chancery Court in *Carmody*,⁷⁷ at least in the event that the articles of incorporation do not authorize their adoption,⁷⁸ with the Delaware Supreme Court adopting a similar approach in *Quickturn*.⁷⁹ The availability of the proxy mechanism as a vehicle for overcoming the poison pill was thus secured.

For the purposes of our discussion, it is crucial to understand that the availability of the proxy mechanism does not eliminate the need to initiate a tender offer as well. In reality, when the bidder solicits shareholder votes to circumvent a poison pill, it must also show a credible commitment to purchase the stock once it has captured the board.⁸⁰ This commitment is necessary for assuring the shareholders that the bidder will not pursue an agenda at the shareholders’ expense after it has prevailed in the vote. Moreover, the

75 Coates, *supra* note 65, at 852.

76 Given the possibility of circumventing the poison pill with a proxy contest, the real costs entailed by poison pills are those of delay. Market climates change rapidly, and therefore deals are more valued when they can be finalized quickly. Moreover, the takeover activity engages the bidder’s management, creating significant opportunity costs. Finally, the longer it takes for the deal to consummate, the more competition the bidder should expect. There are various measures that can be taken to foster delay and thus intensify the strength of the poison pill, such as the adoption of a staggered board charter provision. To implement such delays beyond the legal default arrangement normally requires that the firm accept shareholders’ approval, in contrast to poison pills, whose adoption is solely within the board’s discretion. However, as illustrated by Danielson and Karpoff, in the second half of the 1980s managers easily obtained shareholder consent for various delay mechanisms. Their empirical work shows that the fraction of anti-takeover shields in seasoned firms grew tenfold during the second half of the 1980s. Morris G. Danielson & Jonathan M. Karpoff, *On the Uses of Corporate Governance Provisions*, 4 J. CORP. FIN. 347, 354 tbl.2 (1998). Alternatively, anti-takeover defenses may be installed in the original charter of the firm or while ownership is concentrated before the initial public offering.

Given this importance of delay, Coates measures the potency of a takeover defense by the number of days in which the defense can delay a purchase of the company’s stock. This delay is computed for every firm and thus creates an innovative index, the “contestability index,” for every measured company. The contestability index allows for a fine-tuned and comparative analysis of different types of legal defenses, including combinations of defenses. See Coates, *supra* note 4, at 1389-410. Business combination statutes sometimes require a vote as well. See Hannes, *Takeover Defenses*, *supra* note 6, at 128 n.10.

77 *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

78 *Id.* at 1191-92.

79 *Quickturn Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

80 See Hannes, *Takeover Defenses*, *supra* note 6, at 135.

committed purchase price serves as a signal to uninformed shareholders that can help them evaluate the quality of the bid.⁸¹ Under our proposed arrangement, this signal is enhanced.⁸²

The market mechanism that enables such a commitment is a contingent tender offer that is held in conjunction with the proxy fight for the board, on the condition that the poison pill is redeemed before the shares are purchased.⁸³ First the shareholders are presented with a tender offer and decide whether or not to tender their shares. However, the tender offer is not consummated at this stage, so as not to trigger the poison pill. Thereafter, and in the midst of the tendering period,⁸⁴ the shareholders vote for the board. If the bidder prevails, the contingent tender offer consummates once the new board redeems the poison pill.⁸⁵

All these developments miraculously led to a state of affairs that closely resembles the literature's solution to the pressure-to-tender problem in the context of unsolicited bids.⁸⁶ Since almost all targets have a poison pill in place, or can adopt one instantaneously,⁸⁷ hostile bidders must hold tender offers in conjunction with proxy contests to avoid the harsh effects of poison pills. And since the success of tender offers is practically dependent on the outcome of the shareholder vote, the actual result is quite similar to that advocated in the literature. The invention of the poison pill, the market mechanism to overcome it, and courts' willingness to protect the proxy mechanism have together produced this desirable outcome.⁸⁸

81 The offered price compared to the pre-bid price of the firm's stock may help uninformed shareholders reach a decision. A more accurate explanation can be found in Lucian Bebchuk & Oliver Hart, *Takeover Bids, Proxy Fights and Corporate Voting* (Nat'l Bureau of Econ. Research, Working Paper No. W8633, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=293246. As we will discuss below, however, in a partial bid setting, this signal is insufficient, and the Bebchuk & Hart model does not cover such scenarios.

82 See *infra* Parts III.A and III.B.

83 See Harold Mulherin & Annette Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholders Wealth*, 47 J. FIN. ECON. 279, 286 (1998) (discussing the mechanism).

84 The fact that the vote must take place in the middle of the tendering period stems from the SEC's interpretation of the existing securities regulation, a point that we will discuss here.

85 Prior to the tender offer, the bidder may also purchase a small stake of the target's stock that does not trigger the poison pill (a "toe-hold"), but this strategy is limited by the disclosure requirements of the federal securities laws and state law restrictions on business combinations with interested parties. See DEL. CODE ANN. tit. 8, § 203 (2006), and 15 U.S.C. § 78m(d)(1) (2000), which require disclosure of holdings beyond 5%.

86 In the case of a solicited bid, where this mechanism is not in place, the target's board of directors is assumed to protect its shareholders.

87 See John C. Coates, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000) (arguing that any target that does not have a poison pill actually has a "shadow pill" since it can easily adopt one at any point in time).

88 This does not mean, however, that the mechanism does not have other, detrimental side-effects. For instance, the addition of staggered board charter provisions to the abovementioned legal structures may arguably harm shareholders since it deters many beneficial transactions. See Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 920 (2002) ("If the bidder makes a firm offer, however, the bidder will expose itself to risk—essentially the bidder will be providing the target shareholders with a year-long put option for their shares."); see also Lucian A. Bebchuk, John C. Coates

It is also noteworthy that in addition to the major nationwide developments discussed above, many states explicitly adopted the solution advocated by scholars in the context of hostile bids. Control share acquisition statutes were legislated as part of the corporate codes, requiring that bidders obtain shareholder approval in a separate vote prior to the acquisition of a significant stake in the target.⁸⁹ After some debate, these arrangements were upheld by the Supreme Court in *CTS Corp. v. Dynamics Corp. of America*.⁹⁰

Finally, the arrangement that has been implemented in practice is not unique to the United States. The British City Code, for instance, has specific requirements for share purchases by way of partial bids, including some shareholder votes.⁹¹ Similar to the literature's solution, albeit only in regard to partial bids, shareholders are required to indicate whether or not they approve the bid in a special box on the tender form.⁹²

D. *Securities Regulation and Its Official Interpretation*

In this Article, we propose altering the currently prevailing arrangement for partial bids to allow shareholders to know the tendering choices of their peers at the time they vote on bids. Under our scheme, at the first stage shareholders will commit to tender or not to tender; at the second stage, which will occur soon after the number of tendered shares and non-tendered shares are announced, shareholders will vote on the bid itself. Finally, the bid will be approved only if the number of shares tendered meets the bidder's conditions in the bid and the bid is approved by the required majority of shareholders.

To understand the need for reform, special attention must be paid to the sequence of events in a joint proxy contest and contingent tender offer, as well as to the proposals in the scholarly literature and foreign legislation. Recall that, in both versions of the literature's proposal, as well as in the control share acquisition statutes and the British arrangements, the shareholders vote *before* they know the tendering decisions of their peers. Interestingly, it is the federal regulator that determines the order of events in the market mechanism of the joint tender offer and proxy contest that emerged in reaction to the invention of the poison pill.

Securities law, as discussed above, regulates the tender offer mechanism and mandates certain procedures and restrictions, such as the requirement to

& Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002) (reinforcing the previous study that included a critical theoretical and empirical account of staggered boards).

89 See, e.g., OHIO REV. CODE ANN. § 1701.831 (LexisNexis 2006). It is naïve, however, to view these Control Share Acquisition Statutes as motivated by mere shareholder benefits considerations. In fact, they are the outcome of managerial influence, and the beneficial idea of adding a separate vote aside, they have many questionable aspects, such as fostering delay and procedural obstacles.

90 481 U.S. 69 (1987).

91 See THE PANEL ON TAKEOVERS AND MERGERS, *supra* note 61, at Rule 36.

92 For a detailed discussion of the British provisions, see Bebchuk, *supra* note 3, at 1796-801.

allow shareholders to tender their shares and withdraw tendered shares up until the last day of the tendering period.⁹³ However, nothing in the 1934 Securities Act explicitly forbids the bidder from structuring a contingent bid that adheres to our proposed arrangement. That is to say, there should be nothing to prevent structuring a tender offer so that the tendering period ends prior to the shareholder vote and the final tally of the contingent tender offer thereafter announced, before proceeding to the vote that will ultimately decide the fate of the bid. Nevertheless, the SEC's interpretation of a seemingly benign provision in the tender offer regulation, known as the "prompt-payment-or-return rule," prevents bidders from structuring their bids in this fashion. This interpretation, to which we strenuously object, was adopted without taking into account the informational advantage of an alternative arrangement.

The prompt-payment-or-return rule⁹⁴ requires that the bidder pay the consideration for the tendered and accepted securities promptly after termination of the offer. However, "prompt" acquires a liberal understanding when the bid is contingent upon regulatory approval, which mandates delay, provided that adequate disclosure of the anticipated delay is given.⁹⁵ For example, the consummation of a tender offer is often contingent upon federal antitrust clearance. In such a case, the SEC allows the offeror to complete the period for tendering and await regulatory approval, without requiring immediate payment and purchase of shares. Once regulatory approval is granted, the tender offer is accomplished and only then is the bidder required to pay the consideration and formally purchase the securities (and if approval is not granted, then the bidder must promptly return the securities).

This interpretation of promptness of payment does not stretch to delays imposed by a bid that is conditioned on the redemption of a poison pill.⁹⁶ The SEC does not interpret the prompt-payment-or-return requirement as permitting the bidder to let its offer expire (i.e. terminate the tendering period), but to retain the tendered shares while it waits to see whether the conditions that it has imposed can be met. Hence, when a bidder conditions its obligation to purchase the tendered shares on the target's redemption of the poison pill, the SEC position is that the bidder must either extend its offer pending satisfaction of

93 15 U.S.C. §§ 78m-n (2000); *see also supra* note 31 and accompanying text.

94 17 C.F.R. § 240.14e-1(c) (2007).

95 This interpretation follows in the footsteps of the guidelines to the rules that do not view "prompt" to be synonymous with "immediate." In promulgating the rule, the SEC stated:

Thus, any person making a tender offer is required to use all reasonable efforts to pay promptly for or to return securities. The [SEC] recognizes that the operation of this standard will be affected by the practices of the financial community and the following factors: current settlement, handling and delivery procedures relating to tenders made by guaranteed deliveries by appropriate institutions; procedures to cure technical defects in tenders; and the application of the Hart-Scott-Rodino [Act] . . . and the rules promulgated thereunder

Securities Law Techniques, *supra* note 9, at § 72.05(6)(c) (quoting a 1979 SEC Release) (citations omitted).

96 Recall that the bidder cannot pay for the tendered shares as this will conclude the purchase and trigger the poison pill, which is an outcome that the entire procedure was structured to avoid.

these conditions or terminate the offer and promptly return the tendered shares.⁹⁷ Any other option would be considered a violation of the prompt-payment-or-return rule. Furthermore, since extending the tendering period allows tendering shareholders an ongoing withdrawal right (as well as allowing new tenders), the SEC interpretation prevents a final tally of tendered shares prior to the shareholder vote on the tender offer. In short, the SEC position prevents bidders from communicating the final results of the tender offer before shareholders consider the benefits of the bid and vote. In Part III, we will stress the benefits of the opposite arrangement, that is, where the bidder is allowed, and in fact demands, communication of these data prior to the vote on a partial tender offer.

II. The Problem of Uninformed Votes and a Proposal for Reform

We have seen that tender offers may generate collective action problems among a firm's shareholders, some of which may be addressed by a shareholder referendum. We also have seen that, at least in regard to hostile bids, such a shareholder referendum does, indeed, take place.⁹⁸ However, a partial bid entails another problem, which the literature does not raise. In contrast to a bid for any-or-all shares, in which all tendered shares are purchased, a partial offer may end up in a partial purchase of each block of tendered shares. If the number of tendered shares exceeds the number of shares requested, then only a pro rata share of each tendered parcel of stock will be purchased from each shareholder.⁹⁹ Beyond the threshold of the number of requested shares, the more shares tendered, the lower the fraction of shares sold by each tendering shareholder. This means that target shareholders in a partial bid have to consider the choices of their peers and not just the stand-alone value of the target versus the bid price.¹⁰⁰ In other words, whereas in any-or-all bids shareholders may lack information about the value of the firm, in partial bids shareholders may also lack information about the preferences of their peers. One crucial reason for this information gap that was recently highlighted in the

97 Securities Law Techniques, *supra* note 9, at § 72.05(6)(c).

98 If the bid is solicited by the target's management and is therefore a friendly one, the entire issue of harmful bids is irrelevant. First, unlike in the case of a hostile bid, the management of the target approves the transaction, which may guarantee its benefits, especially since managers usually hold large equity stakes. Second, friendly deals are almost always structured as mergers (again, requiring managers' approval) and not as tender offers, and thus are immaterial to the discussion in this Article.

99 The fraction of purchased shares from each tendering share is calculated by dividing the proportion of shares the bidder requested by the total number of shares tendered. As an example, if the bidder asks for 50% of the stock and 75% of the shares are tendered, then each tendering shareholder will be able to sell 2/3 of the shares she tendered ($50\% \div 75\% = 2/3$). See generally 15 U.S.C. § 78n(d)(6) (2000).

100 The fact that different shareholders may have different opinions on the bid is discussed extensively in Bebchuk, *supra* note 11, at 916: "[A] target's shareholders might well differ in their judgment of how the offered acquisition price compares with the independent target's value." We argue that the same applies for the post-acquisition price, which involves even further uncertainties stemming from the unknown characteristics and plans of the bidder.

literature stems from the uncertain character of the bidder seeking to gain control.¹⁰¹

To understand the problem and the difference between a partial bid and an any-or-all bid, consider the following example. Assume that the stand-alone value of each target share is \$9,¹⁰² the offered price per share is \$10, and, if the bidder gains control, a minority share in the target will be worth \$6. In a bid for any-or-all shares, a shareholder will certainly want to tender her shares and vote for the takeover in the referendum, assuming she is well-informed of the above figures. Whatever choices her peer shareholders make, she will be able to sell all her shares for \$10 each. However, if the bidder makes a partial bid for 50% of the target stock, the calculation becomes more complicated. The literature assumes homogenous and informed shareholders.¹⁰³ In such cases, we have seen that all shareholders will tender their shares due to the pressure-to-tender phenomenon but then will vote against the bid so as to avoid its harsh results.¹⁰⁴ However, the anticipated vote against the bid assumes that all shareholders tender their shares. If, for example, only 50% of the shares are tendered, the tendering shareholders will be able to sell all their shares for \$10 per share, and therefore the low value of the post-acquisition minority stake will not impact the tendering shareholders. Thus, if the tendering shareholder believes that the fraction of shareholders deciding to tender their shares is sufficiently small, she will vote in favor of the bid.

Possible reasons for such a belief, to which we will return later, may stem from the fact (or from a shareholder's belief) that some shareholders are more informed of the relevant parameters than others¹⁰⁵ or because certain shareholders enjoy relatively favorable benefits when they are minority

101 See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance. Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006) (distinguishing between efficient and inefficient controlling shareholders and between pecuniary and non-pecuniary private benefits of control); see also Sharon Hannes, *Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention*, 2 BERKELEY BUS. L.J. 263 (2005) (explaining the complexities of controlling shareholders' behavior).

102 Note that the stand-alone value of the target is not identical to the market price before the bid's announcement. There are several reasons for this. For one, there is typically a long period between the bid announcement and the shareholder vote, during which shareholders can gather new information. Second, the bidder, investment community, and management release much information in reaction to the bid, which may change shareholders' calculations. For an extensive discussion of these reasons and others for the stand-alone value and pre-bid market price not being identical, see Bebchuk, *supra* note 11, at 928-31. See also Reimer Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988) (discussing market undervaluation of firms' intrinsic value).

103 See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 63-89 (1991); Bebchuk, *supra* note 3 at 1720-22.

104 See *supra* Subsection I.A.2.

105 As we shall see, in Section II.A, when some shareholders are more informed than others, the uninformed shareholders may approve the inimical bids even if they do not assume that only a small fraction of the shares were tendered. The reason is that uninformed shareholders may not understand that the bid is inimical and will prefer to approve all bids when the benefits of favorable bids outweigh the harm of inimical bids.

shareholders.¹⁰⁶ One way or another, once such a belief arises in the minds of shareholders, even if unfounded, the bid may be approved in the shareholder vote and the shareholders who do approve it will eventually regret their choice. This outcome is, of course, impossible under our proposed arrangement, in which shareholders know the final tendering tally at the time they vote.

Note also that, under the values in the numerical example above, the partial tender offer is socially undesirable. The 50% post-acquisition minority stake that is worth only \$6 per share together with the 50% stake sold for \$10 falls short of the \$9 per share stand-alone value of the firm.¹⁰⁷ However, the tender offer may seem privately optimal for all those shareholders who believe that most of their peers will not tender, and those shareholders may approve the socially harmful tender offer with their vote (and if there is a basis to their belief regarding their peers' decisions, then voting for the bid is, indeed, privately optimal for them). We argue that a seemingly minor modification to the SEC regulation would improve the former result under the current arrangement and, in some cases, cure the problem. All that would be necessary is to announce the final proportion of tendered shares prior to the shareholder vote on the bid. We illustrate the benefits of this reform below in two more complicated settings: one stressing the tension between informed and uninformed shareholders and the other where shareholders possibly differ in how they are able to cope with a controlling shareholder.

A. *The Operation of the Proposed Arrangement when Shareholders Suffer from Asymmetrical Information*

This Section discusses the operation of our proposed scheme in a realistic setting. Our analysis of partial bids differs from the common one found in the literature in that we acknowledge that shareholders are heterogeneous. In this Section, we consider the well-accepted distinction between informed (or knowledgeable) shareholders and uninformed shareholders.¹⁰⁸ The aim of this discussion is to show that uninformed shareholders may learn about the type of

¹⁰⁶ Simpler reasons could be that some shareholders are simply not responsive, are unaware of the bid, do not understand it, or are too busy to respond.

¹⁰⁷ To conclude that the sale is socially undesirable, we must also assume that the controller does not capture the entire value that the public shareholders lose in this transaction. This is a common assumption in the literature, as consumption of private benefits of control is usually wasteful. See Lucian A. Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000) (discussing the huge waste potential involved in the consumption of private benefits of control).

¹⁰⁸ On the distinction between informed and uninformed shareholders, see Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 (1990). On the large fraction held by institutional investors, see Richard M. Buxbaum, *New Owners and Old Managers: Lessons from the Socialist Camp*, 18 DEL. J. CORP. L. 867, 882 (1993). See also Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); and Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991). See also Hannes, *supra* note 4, at 74-77.

bidder they are facing from the revelation of the tendering decisions of the informed shareholders. The intuition is that when many informed shareholders tender their shares, the uninformed shareholders should deduce that minority shareholders will not fare well if the bidder gains control. Conversely, if informed shareholders hesitate to tender their shares, uninformed shareholders should deduce that the bidder is more likely to be of the type that accommodates and enhances the firm value for minority shareholders. The following numerical example illustrates the information difficulties facing uninformed shareholders, clarifying also the contribution of our proposed reform, in some scenarios.¹⁰⁹

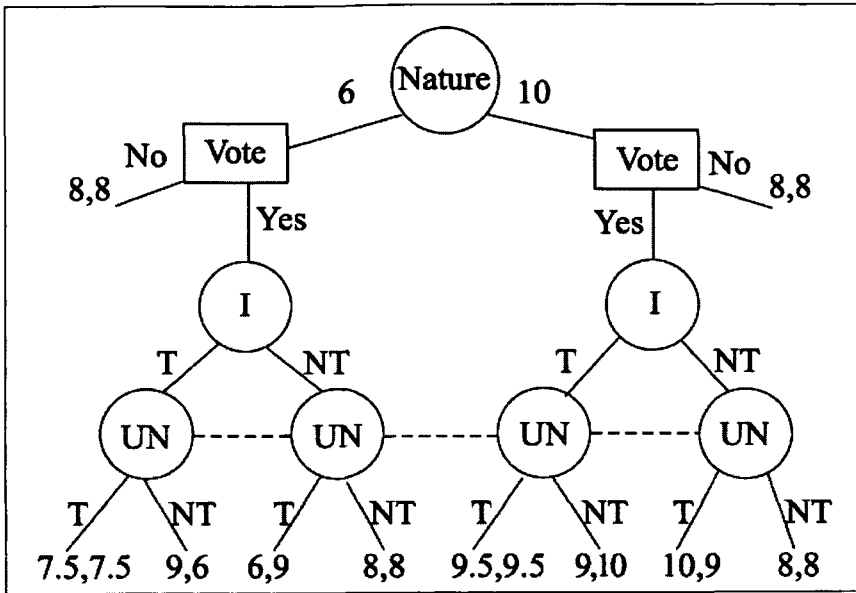
1. The Shareholder Body

Assume that a target corporation has two types of shareholders: institutional shareholders, each of which is a professional shareholder that also has a sizable holding in the firm which motivates it to invest and become highly informed about the firm and its business environment, and public investors with miniscule holdings and no special expertise who are thus uninformed holders. Each group of the two types of shareholder holds approximately 50% of the firm's stock (perhaps a score of informed ones and thousands of uninformed ones), with a slightly higher percentage in the hands of the informed shareholders.

2. The Bid and Shareholders' Estimations of the Bid's Value

Further assume that a bidder approaches the target and launches an unsolicited partial bid for 50% of its stock. The managers of the target oppose the bid and argue that the price is inadequate, but the uninformed shareholders cannot ascertain if the managers' statement is trustworthy or if they are simply trying to thwart the bid to preserve their positions with the firm. Specifically, while all shareholders believe that the stand-alone value of the target is \$8 per share (as this is the market value), uninformed shareholders do not know if the post-acquisition value of each minority share (assuming that the bid succeeds and the bidder gains control) would be \$6 or \$10 and therefore attach a 50% probability to each possibility. The following decisionmaking tree delineates the possible decisionmaking processes of both types of shareholders in the event that the bidder offers \$9 per share, but for no more than 50% of its outstanding stock:

¹⁰⁹ In the analysis, we informally rely on a type of solution for games with incomplete information, called a Perfect Bayesian Equilibrium, which is often used in game theory. See ROBERT GIBBONS, *GAME THEORY FOR APPLIED ECONOMISTS* 175-83 (1992).



3. Explanations for the Shareholders' Decision Tree

The first node in the tree requires that “nature” decide whether the bidder in our case is a productive bidder that will drive the post-acquisition value up to \$10 per share (which is represented by the right side of the tree) or an inimical bidder that will harm the shareholders and drive the post-acquisition value down to \$6 per share (which is the case of the left side of the tree). As shown in the decision tree, and as required by the SEC’s current interpretation of the prompt-payment-or-return rule,¹¹⁰ the shareholder vote on the outcome of the bid occurs before the final tally of the tender offer is revealed. Following the vote, the tendering decisions of both informed and uninformed shareholders are made and then revealed. Although the two types of shareholders make their tendering decisions simultaneously, for purposes of simplicity the decisionmaking tree reaches first the decision of the informed shareholders, who know the type of bidder they are facing. In each of the two cases, with the two nodes marked with the notation “I”, the informed shareholders decide whether to tender or not, with “T” being the notation for the decision to tender and “NT” for the opposite decision. Next, the uninformed shareholders make their tendering decisions, without knowing how their informed peers have acted and without knowing the type of bidder they are facing. This decision is made in each of the nodes with the notation “UN”, and the dotted line connecting the four nodes alludes to the uninformed and uncertain nature of the decision.¹¹¹

110 See *supra* note 97 and accompanying text.

111 The dotted curve defines a data set for the four nodes, where the uninformed shareholders decide whether to tender without knowing in which of the four nodes they are standing.

Simply put, the uninformed shareholders must make their tendering decisions without knowing in which of the four relevant nodes they stand. Here, too, the letter “T” denotes the decision to tender and “NT” a decision not to tender.

4. Shareholders’ Payoffs for Any Combination of Tendering Decisions

Finally, at the bottom of the tree lie the payoffs for both parties for each combination of decisions, with the left-side number in each case referring to the payoff to an informed shareholder, and the number on the right referring to the payoff to an uninformed shareholder. From right to left, consider first the branch that represents a beneficent bidder. If both informed and uninformed shareholders decide against tendering, then the payoff per share for each shareholder (whether informed or uninformed) will be \$8 per share, since such a decision would result in rejection of the bid and retain the stand-alone value of the firm. However, when we move to the second scenario, where the uninformed shareholders (but not informed shareholders) choose to tender their shares, the payoffs for both types of shareholders improve. The bidder buys its desired 50% of the firm’s shares from the tendering uninformed shareholders, paying each of them the offered \$9 per share, while the informed shareholders remain under the control of the new bidder in the improved corporation with a higher price per share of \$10. In the next, opposite scenario, informed shareholders (but not uninformed shareholders) tender their shares. The payoffs of \$9 per share to the informed and \$10 per share to the uninformed are the result of the fact that this is the mirror image of the previous scenario.¹¹² Finally, if all shareholders decide to tender their shares, each will receive a payoff of \$9.50 per share. The reason for this uniform payoff is that the bidder will buy a prorated 50% from each of the tendering shareholders, paying them \$9 for the fraction of shares bought and leaving them with a value of \$10 for the 50% of the shares that remain unpurchased as a minority stake in the improved target.

Note that, if all shareholders were informed, these four scenarios would together generate the free-riding problem discussed earlier.¹¹³ Since it is better to be a shareholder in the improved post-acquisition target (with a value of \$10 per share) than to tender one’s shares for \$9 per share, each shareholder would selfishly hold on to her shares, waiting for the other shareholders to tender their shares and then free-riding on that decision. This strategic and selfish behavior could lead to the rejection of beneficial bids, but it will not occur in our example, since, as we shall see momentarily, the uninformed shareholders do not know for certain that they are faced with such a beneficial bid. This leads us

¹¹² Although we have assumed above that an informed shareholder holds slightly less than 50% of the shares, this fraction is enough to ensure effective control once purchased by the bidder. There is no requirement to exceed 50% of the shares to achieve full control (although, as we saw, a vote in favor of the bid by more than 50% of the shareholders may be required under state law or in order to remove the poison pill).

¹¹³ See Grossman & Hart, *supra* note 10, at 42-45

to the other branch of the decisionmaking tree, the side that deals with the case of an inimical bidder.

Once again, from right to left, the payoffs in the first scenario are \$8 per share for each shareholder, the reason being that the bid is rejected when both types do not tender. In the second scenario, where the uninformed shareholders (but not the informed ones) tender their shares, the uninformed shareholders end up better off than their informed peers. The bidder buys 50% of the target's stock, all of her desired stake, from the tendering shareholders, leaving the rest of the shareholders in the inferior position of minority shareholder in a firm with an inimical controlling shareholder; thus, in this scenario the uninformed shareholders receive \$9 per share and the value of the informed holdings declines to \$6 per share. The third scenario, where the informed (but not uninformed) shareholders tender, is the mirror image of the second scenario. Here, the tendering, informed shareholders receive \$9 per share and the non-tendering, uninformed shareholders are left with \$6 in value per share. Finally, in the fourth scenario, both informed and uninformed shareholders tender their shares, and they each receive a payoff of \$7.50, as the bidder buys a prorated 50% from each for \$9 per share, and the remaining unpurchased 50% of their stock declines in value to \$6 per share.

Note that this left branch of the tree presents the familiar pressure-to-tender problem.¹¹⁴ If all shareholders were informed and aware of the post-acquisition value of the target, they would all tender their shares. Whether or not all the other shareholders tender, it is always better for the individual shareholder to tender her shares, as it leads to a payoff of \$7.50 when all shareholders tender their shares and \$9 if all other shareholders do not tender their shares. This pressure to tender may result in the acceptance of an inimical bid, but recall that this problem is solved in practice by the necessity to receive an approving vote of a majority of the shareholders (either due to state business combination statutes or the need to overcome the poison pill).¹¹⁵ Hence, if shareholders are aware of the detrimental nature of the bid, they will fend it off in the shareholder referendum. However, in our example, the complication of the presence of uninformed shareholders does result in the acceptance of inimical bids, as we explain below. To simplify the presentation, we first analyze the example assuming all uninformed shareholders, as well as informed shareholders, act in concert. Only at the end of the analysis will we tackle the more realistic situation in which each shareholder, within each group, acts separately and independently. That is to say, first we will analyze the numerical example as though there is one informed shareholder and one uninformed shareholder and will then proceed to discuss group behavior.

114 See Bebchuk, *supra* note 3, at 1719-32; Bebchuk, *Tender Offers*, *supra* note 38, at 1039-41; *supra* Subsection I.A.2.

115 On business combination statutes, see Hannes, *Takeover Defenses*, *supra* note 6, at 128 n.10.

5. The Solution of the Game (and Shareholders' Decision Problem)

Since uninformed shareholders assign a 50% probability to the possibility of the bidder being beneficent and 50% to the opposite possibility, in our example, they will not vote against any bid. A strategy by which uninformed shareholders always tender their shares and always vote for any bid will maximize their payoff in this example. The reason is that the informed shareholders will react to such a strategy by tendering in the case of an inimical bidder and not tendering in the case of a beneficent bidder.¹¹⁶ This would leave \$7.50 per share to the uninformed shareholders when the bidder is inimical¹¹⁷ and \$9 per share when the bidder is favorable.¹¹⁸ Altogether, this leads to an average value of \$8.25 per share ($50\% \times 7.5 + 50\% \times 9$), which is a better result than that obtained from voting against the bid (a payoff of \$8 per share because the bid is thwarted) or from voting for the bid but not tendering (also a payoff of \$8 per share).¹¹⁹ These optimal strategies for both parties render both good and bad outcomes. The positive side is that the uninformed shareholders' lack of knowledge of the nature of the bidder overcomes the free-riding problem on the right-hand side of the tree. While the prediction of the literature is that such a bid would fail, the fact that the uninformed shareholders do not know for certain that this is the scenario they are facing is what enables the bid to succeed. The very same decision has, however, negative implications, as evidenced on the left-hand side of the tree. Simply put, the uninformed shareholders approve inimical bids that the literature identifies as cases of pressure to tender (and assumes that the shareholder vote will thwart).

116 The votes of the informed shareholders do not make a difference since the uninformed shareholders in our example account for slightly more than 50% of the votes, making them pivotal. Note also that our scenario requires that the uninformed shareholders vote. Theoretically, the uninformed may refrain from voting, in the hope that the informed voters will screen inferior bidders. However, if informed shareholders were to know that the uninformed count on their votes, they might lure the latter into believing that an inferior bid is beneficial by voting in its favor. In turn, the uninformed might refrain from tendering, hoping to become minority shareholders under the bidder's control, and the informed could take advantage of them and tender their shares to the inferior bidder. This outcome undermines the benefits of counting on the votes of the informed before the uninformed have revealed their preferences in the tender offer. In any case, we do not wish to analyze this possibility at length, as the example in the text is structured to support a straightforward intuition inherent to our proposed scheme: when informed shareholders reveal their preferences by tendering many shares, the uninformed must deduce that the potential bidder would not be favorable to minority shareholders and therefore modify any previous assumptions regarding the bidder's character. In the absence of transparency of tendering decisions, uninformed shareholders might mistakenly perceive an inimical bid as beneficial or vice versa.

117 This would also be the payoff for the informed shareholders in this case.

118 In this case, the informed shareholders who do not tender are better off and receive a payoff of \$10 per share.

119 The reason for the payoff of \$8 in this case is that the informed shareholders would react to this strategy by tendering in an inimical bid, leaving the uninformed shareholders with a value of \$6 per share, and also tendering in the event of a beneficial bid, leaving the uninformed shareholders with \$10. Altogether, in equilibrium, this strategy yields an average value of \$8 for the uninformed shareholder and \$9 for the informed shareholder, making it less likely to occur than that described in the text above.

6. The Reform Proposal

Our suggestion—to reveal to shareholders the final tally in the tendering decisions before voting on the bid itself—could preserve the benefit of solving the free-riding problem while blocking some inimical bids that the current regulatory structure facilitates. Recall that the current SEC interpretation of the prompt-payment-or-return rule prevents such a proposal from materializing.¹²⁰ Let us assume, however, that the final tendering tally is made available to shareholders before the vote. In the event of an inimical bidder, the uninformed shareholders would observe that the informed shareholders have tendered their shares. The fact that informed shareholders do not wish to retain shares in the post-acquisition target would signal the unfavorable nature of the bidder. Hence, the uninformed shareholders would vote the bid down and prevent it from materializing.

Conversely, if the uninformed shareholders were to discover that the informed shareholders have not tendered their shares, they would deduce the bidder to be beneficent and the post-acquisition value of shares to be high. Had the uninformed shareholders known this fact in advance of the tendering decision, each would individually have tried to free-ride on her peers and hold on to her shares, similar to the decision of the informed shareholders. However, the tendering period has closed, and the uninformed shareholders are committed to their tendering decisions. They will therefore vote for the bid, knowing that they will end up with \$9 per each sold share (whereas voting the bid down would result in a payoff of \$8 per share).

7. Discussing Group Behavior

Before we conclude the discussion in this Section, we will analyze the more realistic scenario, where uninformed shareholders do not act in concert. Since the uninformed group consists of many shareholders with small holdings, it is unlikely that the tendering decision of a single uninformed shareholder would be pivotal in rendering control to the bidder. This cannot be said with regard to members of the informed group of shareholders, who often individually hold a sizable package of shares.¹²¹ Since uninformed shareholders do not act in collaboration and cannot coordinate their actions, any one of them can try to masquerade as an informed shareholder and refrain from tendering her shares. This tactic will lead her to a payoff of \$10 per share when the bidder is beneficent (the right branch of the decisionmaking tree) and, relying on the other shareholders to thwart the bid when necessary, as discussed above, will

120 See *supra* note 97 and accompanying text.

121 The institutional shareholders of a single target are a much smaller group than the uninformed shareholders group, enabling them to coordinate their acts implicitly or explicitly. Institutional shareholders also often follow the advice of a third party, such as the Council of Institutional Investors or the RiskMetrics Group. See also Kahan & Rock, *supra* note 51. Finally, increased power for institutional shareholders assists them in structuring their actions. See Hannes, *supra* note 4, at 74-77.

not yield any negative outcomes when the bidder is inimical (the left branch of the tree). However, such a tactic is quite risky. At some point, when enough uninformed shareholders have not tendered, it will be worthwhile for the rest of the tendering shareholders (both informed and uninformed) to vote in favor of the bid in the inimical bidder scenario (the left branch). The reason is that the non-tendering shareholders increase the fraction of shares sold by each tendering shareholder to the bidder.

In the above numerical example, if more than 25% of the shareholders choose not to tender, it will be worthwhile for the remaining tendering shareholders to approve the inimical bid. To illustrate, let us assume that 25% of the shareholders do not tender and the remaining 75% do tender their shares. Since the bid was for 50% of the shares, and since shares are purchased pro rata, each tendering shareholder will actually sell two-thirds of her shares (50% divided by 75%).¹²² If the bidder is inimical but the bid nevertheless is approved, then each tendering shareholder will sell two-thirds of his holdings for \$9 a share and become a minority shareholder in the post-acquisition firm remaining with one-third of her holdings at a value of \$6 per share. Altogether, this leads to a payoff of \$8 per share ($2/3 \times 9 + 1/3 \times 6 = 8$) for tendering shareholders, leaving them indifferent between voting for or against the bid. Moreover, if any more than 25% of the shares are not tendered, then the fraction sold by each tendering shareholder will surpass two-thirds, making a pro-bid vote privately beneficial for all tendering shareholders, even though the bid is inimical to the group as a whole. Surely, however, if the inimical bid is approved, it is not worthwhile to be on the non-tendering side, as the non-tendering shareholder will be left with the inferior value of \$6 for each of her shares and a minority stake with an unfavorable controlling shareholder.

The ramifications of this analysis are that, in the above example, uninformed shareholders who cannot distinguish between good and bad bidders cannot freely refrain from tendering, in reliance on the decisions of their peers to thwart inimical bids. Beyond a threshold of 25% of the uninformed shareholders refraining from tendering, this tactic will be self-defeating. If the entire population of uninformed shareholders is risk averse, we should see even less than 25% of this group taking the risk and refraining from tendering; those who do take the chance are simply less risk averse. Note, also, that since some uninformed shareholders do not choose to tender (up to 25% in our example), there is a possibility that beneficent bidders will not be able to consummate their bids, as they will not be able to buy enough shares to gain control. However, anticipating this problem in advance, the informed shareholders would tend to tender some of their shares when they identify a beneficial bid scenario in order to make sure that the bid attracts enough shares to push it through.¹²³ In any event, the central results of the simple example and its

¹²² See generally 15 U.S.C. § 78n(d)(6) (2000).

¹²³ In the above example, the equilibrium state is when almost 75% of the shareholders in the left branch tree (all informed shareholders and up to 25% of the uninformed shareholders) tender their

intuition hold even when the fact that uninformed shareholders do not act in concert and may try to masquerade and imitate the behavior of the informed types is factored in. The intuition is that when uninformed shareholders see that many (in our example, more than 75%) of their peers have tendered their shares, they will understand that the informed shareholders do not wish to become a minority in the post-acquisition firm and will, therefore, vote against the bid. If, however, the uninformed shareholders discover that a lower fraction of shareholders have tendered their shares (in our example, about 50%) they will understand that the informed shareholders wish to be a minority in the bidder-controlled firm and therefore will approve the bid in the vote. In this way, the behavior of the informed shareholders reveals the bid to be a beneficial one.

To conclude, in the above example, reversing the structure of the tender-vote procedure alleviates the harsh effects of information problems without tampering with the benefits ensuing from the current arrangement. Uninformed shareholders are able to infer from the tendering decisions of their informed peers. These inferences then allow them to block inimical bids, while beneficial bids that could be threatened by free-riding are not undermined by our proposed restructuring. We do not argue that any information difficulty could be solved by our modified tender-vote process, but in some cases, such as those that resemble the scenario in the above example, our proposed mechanism could be beneficial. In other cases, it would simply cause no harm.

B. *The Operation of the Proposed Arrangement if Shareholders Diverge in Ability to Cope with a Controlling Shareholder*

In the preceding Section, we discussed the benefits of our proposed arrangement in the setting of asymmetric information with the familiar division between informed and uninformed shareholders. We will now show that our modest proposal (to announce the final tendering tally prior to the shareholder vote) can at times solve additional uncertainty-related problems. In addition to its distinction between informed and uninformed shareholders, the literature also sometimes differentiates between shareholders according to ability to cope as minority shareholders with a controlling shareholder. The literature shows that certain types of investors, such as those holding large blocks of stock, are well-connected to the financial community or otherwise more sophisticated or organized, and will more freely invest in firms with low-quality corporate

shares and, in the case of the right branch, when 50% of the shareholders tender their shares (25% of the uninformed shareholders and 25% of the informed shareholders). Inferences can be made once the tendering decisions are reported, and all shareholders will vote against an inimical bid of the type depicted in the left branch of the tree, and in favor of a beneficial bid of the type depicted in the right branch. Note that, in this case, the informed and uninformed shareholders equally share the benefits of the favorable bid, as each group sells half of its holding for \$9 per share and is left in the post-acquisition minority with half of its initial holdings at a value of \$10 per share.

governance or firms with controlling shareholders that are prone to extract high levels of private benefits.¹²⁴

This possible distinction between shareholders can be of crucial relevance in partial bids. Since a successful partial bid always has the outcome of a firm comprised of a controlling block on the one hand and a group of minority shareholders on the other, it is important to understand that different shareholders can cope differently with the new controlling shareholders. Organized, sophisticated, informed, or connected investors are harder to abuse and may compel the controlling shareholder to either refrain from abusive behavior or otherwise share with them the private benefits it extracts from the firm. This may be achieved in a variety of ways, including threatening litigation, exposing the actions of the controlling shareholder, and using ties with the financial or political community to bring pressure to bear on the controlling shareholder. This possibility complicates our discussion, since throughout we have emphasized the importance of shareholders to know how many of their peers have decided to tender. The more shares tendered, the fewer shares will be purchased from each tendering shareholder in the tender offer. The possibility that different shareholders can derive different benefits following the transaction complicates decisionmaking for shareholders in the tender offer. In the example presented below, we will show how revealing the results of the tender offer prior to the shareholder vote on the bid can sometimes resolve this complication as well. We will then discuss the intuition that underlies this beneficial outcome.

In illustrating our claim, we will use an example that resembles the one presented in the previous Section and follow the same methodology to analyze it. However, there is one major difference between the two scenarios in the examples. In the preceding Section, the group of shareholders was divided into informed shareholders and uninformed shareholders, with only the former possessing precise information regarding the value of the minority stake should the bid materialize. That post-bid value, however, was identical for both groups. In the present example, the shareholder body is divided into two groups, but with the post-bid value for minority shares possibly diverging between the two groups.

1. The Shareholder Body

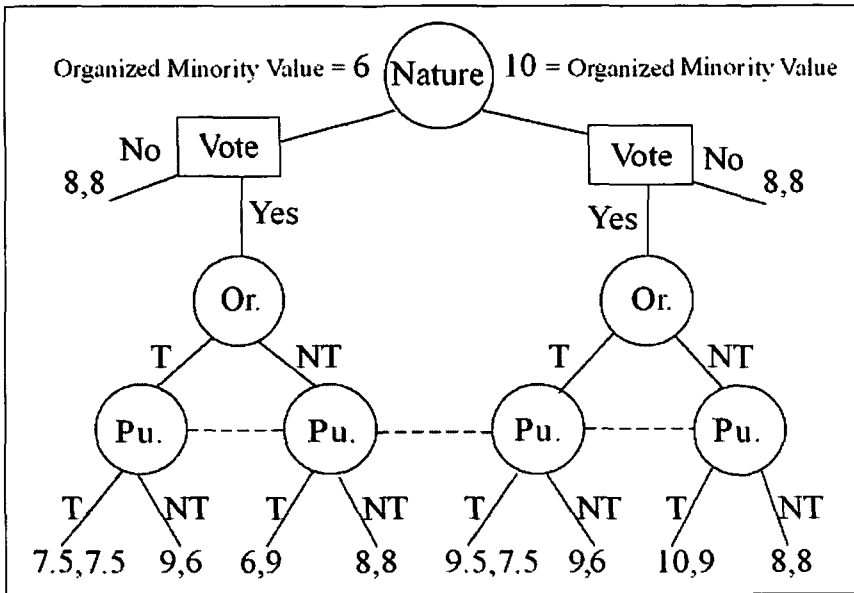
Let us assume, therefore, two types of shareholders in a corporation that is the target of a partial hostile bid: organized or informed shareholders, perhaps shareholders who have held or hold management positions in the firm and

124 See Mariassunta Giannetti & Andrei Simonov, *Which Investors Fear Expropriation? Evidence from Investors' Portfolio Choices*, 61 J. FIN. 1507 (2006) (analyzing investors' behavior and portfolio choices and suggesting that it is important to distinguish between investors who can cope with low quality corporate governance and powerful controlling shareholders and other investors who enjoy only security benefits).

could therefore possibly cope better than the rest of the shareholders with the bidder following the takeover, and public investors with miniscule holdings and no special leverage vis-à-vis the bidder. There are perhaps a score of organized shareholders and thousands of public shareholders, and each type of shareholder holds about 50% of the target's stock, but with a slightly higher proportion in the hands of the public shareholders.

2. The Bid and Shareholders' Estimation of the Bid's Value

Further assume that the bidder launches an unsolicited partial bid for 50% of the stock. The target's managers oppose the bid and argue that the price is inadequate. All shareholders believe the target's stand-alone value to be \$8 per share (as this is the market value), and the public shareholders believe that the post-acquisition value of each public minority share (assuming that the bid succeeds and the bidder gains control) would be \$6 as they believe that the controlling shareholder would extract high private control benefits from the firm. The public shareholders, however, are unsure of the reaction of the organized shareholders. It is possible that the organized shareholders would cope well with the new controlling shareholder and that *their* shares as a minority would be worth \$10 each; alternatively, it is possible that the organized shareholders would not be able to extract any higher value than the public shareholders, and therefore all minority shares would be worth \$6 each. Since the organized shareholders do not reveal their own beliefs, the public shareholders attach a 50% probability to each possibility. Using the same methodology as in the previous Section, the following decisionmaking tree delineates the possible decisionmaking processes of both types of shareholders. Recall that the bidder in our example offers \$9 per share, but for no more than 50% of its outstanding stock:



3. Explanations for the Shareholders' Decision Tree

The first node in the tree requires that “nature” determine whether the organized shareholders can cope well with the bidder after acquisition and therefore extract a post-acquisition value of \$10 per share (which is the case reflected by the right-hand side of the tree) or, alternatively, cannot counter the bidder, who will drive the post-acquisition value of the target down to \$6 per share for all shareholders (which is the case reflected by the left-hand side of the tree). Again, in this example, the public shareholder, as a minority in the post-acquisition target, will always be left with a share value of \$6, as the inimical bidder will try to extract high control benefits. As shown in the decision tree and as required under the SEC’s current interpretation of the prompt-payment-or-return rule,¹²⁵ the shareholder vote precedes the revealing of the final tally in the tender offer. Only after the vote are the tendering decisions of both organized and public shareholders known. Although the two groups of shareholders decide simultaneously whether to tender, for simplicity’s sake the decisionmaking tree reaches first the decision of the organized shareholders, who know how well they can cope with the bidder they are facing. In each of the two cases, with the two nodes marked with the notation “Or.,” the organized shareholders decide whether to tender or not, with “T” being the notation for the decision to tender and “NT” for the opposite decision. Next, the public shareholders reach their tendering decisions, without knowing how their organized peers acted and without knowing the type of

125 See *supra* note 9 and accompanying text.

bidder they are facing. This decision is made in each of the nodes bearing the notation "Pu." ("public"), with the dotted line connecting the four nodes alluding to the uncertain nature of the public shareholder decision.¹²⁶ Simply put, the uninformed shareholders must make their tendering decision without knowing in which of the four relevant nodes they stand. Here, too, the letter "T" denotes the decision to tender and "NT" a decision not to tender. The essence of our proposed reform will be to overcome this uncertainty and its harmful outcomes, as illustrated below.

4. Shareholders' Payoffs for any Combination of Tendering Decisions

At the bottom of the tree lie the payoffs for both types of shareholders for each combination of decisions, with the left-hand number in each case referring to the payoff per share for an organized shareholder and the number on the right-hand side referring to the payoff to a public shareholder. From right to left, consider first the branch in which an organized shareholder can extract a value of \$10 per share if the acquisition succeeds and the shareholder is left in the minority following the acquisition. If both types of shareholders fail to tender, then the payoff per share for each type will be \$8, since these decisions would entail rejection of the bid and retain the stand-alone value of the firm. However, when we move to the second scenario, where public shareholders (but not organized shareholders) tender their shares, the payoffs for both types of shareholders improve. The bidder buys its desired 50% of target shares from the tendering public shareholders, paying each the offered \$9 per share, while the organized shareholders remain under the control of the new bidder with which they cope well and enjoy a higher value per share of \$10. In the third scenario organized shareholders, but not public shareholders, tender their shares. Here, the bidder buys its desired 50% of the firm's shares from the tendering organized shareholders, paying each the offered \$9 per share, while the public shareholders remain under the control of the new bidder. The public shareholders are unable to restrain the power and actions of the bidder as a controlling shareholder and thus remain with a diminished value of \$6 per share.¹²⁷ Finally, if all shareholders tender their shares, the bidder buys a prorated 50% from each of them, paying \$9 per share for the fraction of shares bought and leaving each type of shareholder a 25% stake in the firm. The unsold fraction of shares held by the organized shareholders, who can extract additional benefits from the controller, will be worth \$10 per share; the shares

126 Once again, the dotted curve defines a data set for the four nodes, where the public shareholders decide whether to tender without knowing in which of the four nodes they are standing. See *supra* note 111.

127 Although we have assumed above that an organized shareholder holds slightly less than 50% of the shares, this fraction is enough to ensure effective control once purchased by the bidder. There is no requirement to exceed 50% of the shares to achieve full control (although, as we saw, a vote in favor of the bid by more than 50% of the shareholders may be required under state law or in order to remove the poison pill).

of the public shareholders, who derive no additional benefits, will be worth \$6 each. Thus, the net outcome for the organized shareholder per share will be \$9.50 (50% x \$9 for the sold shares and 50% x \$10 for the unpurchased minority shares) and \$7.50 for the public shareholders (50% x \$9 for the sold shares and 50% x \$6 for the unpurchased minority shares).

We will now proceed to the left branch of the decisionmaking tree, which illustrates the case in which the organized shareholders cannot cope with an inimical bidder any better than the public shareholders can. Once again, from right to left, the payoffs in the first scenario are \$8 per share for each shareholder, the reason being that the bid is rejected when both types do not tender. In the second scenario, where the public shareholders (but not the organized ones) tender their shares, the former are better off than the latter. The bidder buys the entire 50% of its desired stake in the firm from the tendering public shareholders, leaving the rest of the shareholders in the inferior position of minority shareholder in a firm with an inimical and untamed controlling shareholder; accordingly, public shareholders receive \$9 per share and the value of the organized shareholders' holdings declines to \$6 per share. The third scenario, where the organized (but not public) shareholders tender, is the mirror image of the second scenario. Here, the tendering organized shareholders receive \$9 per share and the non-tendering public shareholders are left with a value of \$6 per share. Finally, in the fourth scenario, both organized and public shareholders tender their shares, and both groups receive a payoff of \$7.50 per share. The reason for this is that the bidder buys a prorated 50% from each shareholder at \$9 per share, and the 50% that are not purchased decline in value to \$6 a share.

Note that this left branch of the tree illustrates the familiar pressure-to-tender problem.¹²⁸ If all shareholders were aware of the fact that this is the scenario they are facing, they would all tender their shares. Regardless of whether the other shareholders all tender or not, it will always be better to tender in such circumstances, which leads to a payoff of \$7.50 in the case that all shareholders tender and \$9 in the case that the other shareholders do not tender. As recognized by the literature and explained earlier in this Article, this pressure to tender may result in the consummation of an inimical bid. However, recall that this problem is solved in practice by the need for the approval of the majority of shareholders (either due to state business combination statutes or the requirement to redeem the poison pill).¹²⁹ Hence, if shareholders are aware of the detrimental nature of the bid, they will fend it off in the shareholder referendum. However, in our example, the added complication of organized shareholders enables the materialization of an inimical bid. In short, the public shareholders may mistakenly believe that they are facing a scenario from the right-hand side of the decisionmaking tree, namely, where the organized

128 See *supra* note 114 and accompanying text.

129 On business combination statutes, see *supra* note 76.

shareholders have superior abilities to cope with the bidder as a controlling shareholder and therefore will not tender their shares. We will now analyze the behavior of the two types of shareholders.

5. The Solution of the Game (and Shareholders' Decision Problem)

Since the public shareholders assign a 50% probability to facing a scenario belonging to the right branch of the tree (where organized shareholders cope well with the bidder) and a 50% probability to the left branch of the tree (where organized shareholders cannot cope well with the bidder), in our example they will not vote against any bid regardless of whether it is beneficial or not. A strategy in which the public shareholders always tender their shares and always vote for any bid maximizes their payoff in this example. The reason is that the organized shareholders would react to such a strategy with a decision to tender in the event of an untamable bidder (left branch) and a decision not to tender in the event of a tamable bidder (right branch).¹³⁰ This combination of decisions on the part of both types of shareholders would result in \$7.50 per share for the public shareholders in the event of an untamable inimical bidder (the left-side of the tree)¹³¹ and \$9 per share in the event of a bidder with whom the organized shareholders can cope (the right side of the decisionmaking tree).¹³² Altogether, this leads to an average value of \$8.25 per share ($50\% \times \$7.50 + 50\% \times \9) for the public shareholders, which is a better result than that obtained from voting against the bid (a payoff of \$8 per share because the bid is thwarted) or from voting in favor of the bid but not tendering (a payoff of \$6 per share).¹³³

These optimal strategies from the perspective of the public shareholders have, however, negative implications for the scenario drawn on the left-hand side of the tree (the untamable bidder). Simply put, the public shareholders vote

130 The vote of the organized shareholders does not make a difference since the public shareholders in our example have slightly more than 50% of the votes, making them pivotal in the vote. Note, also, that our example requires that the public shareholders vote. Theoretically, the public shareholders may abstain from voting, in the hope that the organized shareholders will screen out untamable bidders (from the left branch of the tree). However, if the organized shareholders know that the public shareholders are relying on their votes, they might even vote against tamable bidders, depicted on the right branch, which the public shareholders would want to attract. This might be the case if, for instance, the organized shareholders have ties with the incumbent management and extract significant value from the present state of the firm that the public shareholders do not enjoy.

131 This would also be the payoff for the organized shareholders in this case, as they do not cope better than the public shareholders do with the bidder as the controlling shareholder.

132 In this case, the organized shareholders who do not tender are better off and receive a payoff of \$10 per share as they cope well with the bidder as the controlling shareholder.

133 The reason for a payoff of \$6 in this case is that the organized shareholder would react to this strategy by tendering in the scenario depicted in the left branch of the tree (untamable inimical bidder), leaving the public shareholders with a value of \$6 per share, and also tendering in the scenario depicted by the right branch of the tree (potentially tamable bidder but only by the organized shareholders), leaving the public shareholders with \$6 per share here as well (the organized shareholders must tender, otherwise the bid will not pass, thereby leaving them with \$8 per share in the unacquired firm).

in favor of an inimical bid that the literature identifies as an instance of pressure to tender and assumes that the shareholder vote would thwart.

6. Our Reform Proposal

Our suggestion to allow shareholders to observe the final tally in the tender offer before voting on the bid may block some of these inimical bids that the current regulatory structure allows through. Recall that the current SEC interpretation of the prompt-payment-or-return rule prevents such a proposal from materializing.¹³⁴ Assume, however, that the final tally becomes available to shareholders before the shareholder vote. In the event of an inimical bidder who cannot be tamed even by the organized shareholders, the public shareholders will observe that the organized shareholders have tendered their shares. The fact that the organized shareholders do not wish to retain their shares in the post-acquisition target would signal that the organized shareholders do not believe they can cope with this bidder. Hence, the public shareholders would vote the bid down and prevent it from materializing.

Conversely, if the public shareholders were to discover that the organized shareholders had not tendered their shares, they would understand the bidder to be one with whom the organized shareholders can cope well and derive high post-acquisition benefits. Hence, the public shareholders will vote for the bid. They will know that they will end up with \$9 per each sold share and that, since the organized shareholders have not tendered, they will be able to sell all their holdings at this price (whereas voting the bid down would result in a payoff of \$8 per share).

The intuition underlying this result is that public investors cannot be fooled by the wrong assumption that shareholders who can cope better with the controlling shareholder will decide not to tender and choose to be in the post-acquisition minority. The example analyzed above supports the straightforward intuition underlying our proposed arrangement: when organized shareholders reveal their preference by tendering many of their shares, public shareholders must modify any previous assumptions regarding the fraction of shares they will actually sell in the tender offer. In the absence of transparent tendering decisions, uninformed shareholders might mistakenly approve a bid that they will later regret, by overestimating the fraction of shares they will be able to sell to the bidder.

III. Concluding Remarks

Partial bids were once a dominant part of the American takeover landscape (as they still are in other jurisdictions) but since the 1990s they have

134 See *supra* note 97 and accompanying text.

become a rare phenomenon.¹³⁵ One of the main reasons for this development has been the courts' hostility towards this type of bid structure, thus allowing target managers to fiercely resist partial bids and, in turn, causing bidders to refrain from using them. This Article has shown that the courts' intuition was well grounded. In addition to the regular challenges posed by a tender offer, the partial bid structure adds another hurdle. Simply put, in a partial bid a shareholder lacks the crucial information of what fraction of her shares is about to be purchased, which makes the decision to sell much more complicated than in a straightforward purchase offer. As we demonstrated, the shareholder vote on bids, which was added in the poison pill era, solves most of the problems of a tender offer, though not the difficulty focused on in this Article.

This outcome, however, could be improved by way of a slight change in the rules of the game. We suggest a simple reordering of the tender offer procedure in partial bids that would solve the problem to a significant extent. The decisionmaking problem faced by shareholders in partial bids could be substantially alleviated by first having the tendering period close prior to the shareholder vote on the bid, then making public the final tally of the tender, and finally having shareholders vote on the bid. Shareholders would be free from the burden of guessing the tendering choices of their peers. When they come to vote for or against the bid, shareholders will know exactly what fraction of shares were tendered, allowing them to have a better sense of the value they will receive for their shares if the bid is approved. This simple procedure overcomes an important challenge at virtually no cost, making shareholders less likely to approve a bid they will later regret. If this proposal were to be adopted, partial bids would no longer be so thorny and perhaps judicial hostility to this vehicle would abate. After all, partial bids sometimes make much sense from an economic point of view, as they allow mergers and acquisitions activity without any necessity for raising funds to acquire the firm in its entirety.

Interestingly, adopting our proposed procedure would not be blocked by legislation, nor by implicit regulation, but rather by the SEC's interpretation of the existing prompt-payment-or-return rule.¹³⁶ Since this interpretation does not take into consideration the benefits of the alternative that we have raised in this Article, we urge the SEC to reconsider its position.¹³⁷ Our proposal has additional benefits beyond the obvious advantage of allowing shareholders to know the fraction of shares they will sell if the takeover is approved in the shareholder vote. Using game theory methodology, we have illustrated such benefits in complicated scenarios. First, we have shown how uninformed

135 For data on partial bids occurrences, see Nick H. Nguyen, *Investor Protection and Transfer of Corporate Control: A Cross-Country Analysis* (Sept. 5, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=931789> (indicating that partial acquisitions are still the norm outside the U.S.).

136 See *supra* note 97 and accompanying text.

137 See generally Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty* (Georgetown Univ. Law Ctr., Law & Econ. Research Paper No. 947510, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=947510.

shareholders could take advantage of our proposed procedure to infer the character of a bidder from the behavior of informed shareholders. Hence, our procedure would, in certain instances, assist uninformed shareholders in identifying and defending against a bid whose harmfulness is difficult to discern. Second, when the shareholder body divides into public shareholders and other shareholders (such as the incumbent management team) who could possibly cope better with the bidder as the new controlling shareholder, our procedure informs the former of the plans of the latter. This is extremely helpful in cases where the incumbent managers (who also hold a large stake in the corporation) urge the public shareholders to vote against the bid and argue that the target is worth much more, but actually intend to sell their own stock if the bid is approved. The revelation of the incumbent managers' intention to sell their shares would prevent public shareholders from approving the bid under the erroneous assumption that the managers are not going to tender their shares as they expect a high post-bid value due to their position in the firm. In this scenario as well, our proposed procedure could, at times, help public shareholders counter inimical bids.

Finally, our proposal may sometimes be beneficial not only in partial bids, but also in any-or-all bids that do not culminate in merger freezeouts, for in both contexts, shareholders' preferences are important to their peers,¹³⁸ as the value of the post-acquisition minority stake may fluctuate depending on the size of that stake. There are a few conflicting effects stemming from the size of the post-acquisition minority stake. On one hand, the smaller the minority stake, the more incentive the controlling shareholder has to stop wasteful activities and self-dealing, since her relatively large stake in the corporation means she internalizes a relatively large proportion of the harm generated to the corporation.¹³⁹ Thus, the smaller the minority post-acquisition stake, the higher its per-share value. On the other hand, however, the smaller the minority stake, the smaller the public float and liquidity, and, perhaps, the harder it is for the minority to counter abuse. Hence, the smaller the minority post-acquisition stake, the lower its per-share value. Regardless of the outcome in the clash between these two effects, it is important for shareholders to know the fraction of shares tendered before voting on the bid. This is the only way to guarantee a fully informed decision. Our proposal, in facilitating knowledge of the number of tendered shares and, therefore, the post-acquisition size of the minority stake, would enable just such an informed decision.

138 Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 7 (2005) (explaining how state law, especially in Delaware, allows the controlling shareholder to cash out minority shareholders in a procedure known as "merger freezeouts")

139 See Bebchuk, Kraakman & Triantis, *supra* note 107, at 301.

