Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers

C. Stephen Bradford
University of Nebraska-Lincoln

Follow this and additional works at: http://digitalcommons.unl.edu/lawfacpub
Part of the Legal Studies Commons

http://digitalcommons.unl.edu/lawfacpub/80

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in College of Law, Faculty Publications by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.
Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers

C. Steven Bradford*

I. INTRODUCTION ................................................................... 417
II. THE PURE COERCION ARGUMENT .......................................... 421
III. THE MISVALUATION ARGUMENT ............................................ 427
IV. THE HETEROGENEOUS VALUATION ARGUMENT .................. 436
V. THE BARGAINING ARGUMENT ................................................ 449
VI. COMPETITION AND BARGAINING POWER .................................. 451
VII. POLICY IMPLICATIONS .......................................................... 457
   A. Target Management Resistance ..................................... 458
   B. Antitakeover Regulation .............................................. 461
VIII. CONCLUSION ...................................................................... 464

"The great enemy of the truth is very often not the lie—deliberate, contrived and dishonest—but the myth—persistent, persuasive and unrealistic."
—John F. Kennedy, commencement address, Yale University, New Haven, Conn., June 11, 1962.

I. INTRODUCTION

Hostile tender offers have captured broad public attention. Almost every businessman, business lawyer, and student of corporate law knows the basic script. A bidder, often described pejoratively as a raider, makes a public tender offer to purchase a controlling block of the stock of another corporation, known as the target. Target management opposes the offer, but because board approval is not necessary to complete a tender offer, the decision rests in the hands of the target shareholders. If enough of the target shareholders tender, the bidder gains control, and any remaining shareholders are cashed out in a merger between the target and some other entity controlled by the bidder.

Hostile tender offers have generated a great deal of controversy. Critics claim they are bad for employees, bad for the communities in which the target...
corporation is located, bad for the target’s debtholders, bad for the long-term development of the economy, and even bad for the bidding firm. This Article focuses on the argument that hostile tender offers are bad for the constituency affected most directly—the target shareholders.

Arguments that target shareholders are treated unfairly in takeovers are popular and commonplace. Martin Lipton, a well-known takeover lawyer, claims that the two-tier tender offer is “designed to stampede shareholders into tendering,” penalizing unsophisticated shareholders. “[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion—they will tender; therefore, it is misleading to speak of a free shareholder choice at all.” The Delaware Supreme Court agrees that two-tier tender offers “are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.” A committee of the National Association of Manufacturers terms such offers “inherently exploitative.” A.A. Sommer, a former commissioner of the Securities and Exchange Commission (SEC), warns that all tender offers are coercive and unfair to target shareholders, not just two-tier offers. The United States Supreme Court posits that some tender offers may unfairly coerce shareholders into tendering their shares “even if they doubt the tender offer is in the corporation’s best interest.”

The arguments that target shareholders are mistreated or exploited in hostile tender offers fall into four general categories. The first argument, the pure coercion argument, focuses on the blended price received by target shareholders.


6. Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, supra note 3, at 911, 914 (Committee on Corporate Finance, Management and Competition, National Association of Manufacturers, Recommendations Regarding hostile Takeovers for Control of Corporations).


9. See infra text accompanying notes 29-65.
This blended price is the average of the tender offer price and the second tier price, weighted by the proportion of stock purchased in each tier. If non-tendering shareholders are cashed out in a merger, the second tier price is the consideration paid in the merger. If non-tendering shareholders are not cashed out, the second-tier value is the market price of the minority stock after the takeover. The pure coercion argument contends that target shareholders lose when the blended price is less than the pre-offer market price of the target shares.

The second argument, the misvaluation argument, contends that shareholders may be treated unfairly even when the blended price exceeds the pre-offer market price because the pre-offer market price does not reflect the "fundamental value" of the target company. A tender offer that appears to offer a substantial premium may actually offer less than the fundamental value of the target shareholders' investments.

The third argument, the heterogeneous valuation argument, assumes an upward-sloping supply curve for target shares. This argument contends that, even if the offeror offers a premium price that is both attractive and fair to a majority of the target shareholders, there is no guarantee that the gains to tendering shareholders exceed the losses to nontendering shareholders who place a higher value on the target corporation. Even in the absence of coercion or undervaluation at the margin, target shareholders as a group may suffer a net loss.

The fourth and final argument, the bargaining argument, claims that, even if shareholders as a group receive a premium above the "fundamental" value of their stock, they are not necessarily treated fairly because they could receive an even higher premium with more effective bargaining. Structural problems in the tender offer process prevent target shareholders from realizing all the potential gains that they might receive.

The desire to protect target shareholders from alleged mistreatment in hostile takeovers has spawned a number of proposed remedies. Martin Lipton argues that the target's management should have unlimited discretion to block a hostile offer because the target shareholders are unable to protect themselves. Professor Lucian Bebchuk advocates restructuring the tender offer voting process. He argues that separating the tender decision from the decision to approve the tender offer will free target shareholders from the coercion which they currently face. Professor Louis Lowenstein advocates lengthening the time the tender offer must remain open, which would afford target shareholders more time to decide whether to reject or accept the offer and increase the possibility of competitive bids. These arguments for the protection of target shareholders

10. See infra text accompanying notes 66-127.
11. See infra text accompanying notes 128-86.
12. See infra text accompanying notes 187-205.
13. Lipton, supra note 4, at 114.
15. Id. at 1748, 1752-55.
have been reflected in the recent rush by the states to enact takeover statutes. Many states have adopted statutes limiting the voting rights of shares acquired in the tender offer\textsuperscript{17} or limiting a successful bidder's options after the tender offer.\textsuperscript{18} Such statutes are sometimes labelled "shareholder protection acts,"\textsuperscript{19} a term previously characterized as a mischievous misnomer.\textsuperscript{20}

The myth of target shareholder mistreatment is intuitively plausible, as most popular myths are. It is tempting to accept the four mistreatment arguments without further examination; however, each argument either leaves out crucial pieces of the puzzle, or is not supported by the empirical research on takeovers. The structure of tender offers is somewhat coercive, but shareholders do not suffer significantly from that structure. Legitimate instances of successful below-market offers are non-existent.\textsuperscript{21} The misvaluation argument is both theoretically and empirically flawed, and situations when the bid is arguably below the fundamental value of the shares are rare.\textsuperscript{22} Target shareholders appear to gain overall, even assuming an upward-sloping supply curve.\textsuperscript{23} It is impossible to prove that there are no offers when heterogeneous valuation creates losses, but the empirical evidence suggests that these offers are a rarity if they exist.\textsuperscript{24} The bargaining argument also appears unsupported by the evidence. Target shareholders capture almost all of the gains in takeovers, closely approximating the negotiated solution.\textsuperscript{25}

A competitive market for corporate control and the bargaining leverage of arbitrageurs and institutional shareholders adequately protect target shareholders. A hostile bidder is constrained by the existence of other actual or potential bidders for the target whose competitive bidding prevents any abnormally low bids and, although driven by self-interested pursuit of a bargain, ensures that target shareholders are fairly compensated. Even in the absence of a competitive market, large target shareholders, such as arbitrageurs and institutions, inject the elements of bargaining power and target shareholder control into the takeover game, elements which the mistreatment arguments do not consider. These large shareholders have the power to reject offers that do not fairly compensate target shareholders.

In short, the perception that target shareholders are mistreated in hostile takeovers is a fable, a fiction.\textsuperscript{26} The suggested solutions to the target shareholder problem are unnecessary or wasteful at best and counterproductive at worst.\textsuperscript{27} Target management resistance to takeovers and strong state antitakeover statutes

\begin{itemize}
\item \textsuperscript{17} See, e.g., \textsc{Ind. Code Ann.} §§ 23-1-42-1 to 23-1-42-11 (West 1988); see Booth, \textit{The Promise of State Takeover Statutes}, 86 \textsc{Mich. L. Rev.} 1635, 1681-99 (1988).
\item \textsuperscript{18} See, e.g., \textsc{Del. Code Ann.} tit. 8, § 203 (1988); \textsc{N.Y. Bus. Corp. Law} § 912 (McKinney 1986).
\item \textsuperscript{20} Bradford, \textit{supra} note 1, at 462.
\item \textsuperscript{21} See \textit{infra} text accompanying notes 54-62.
\item \textsuperscript{22} See \textit{infra} text accompanying notes 67-73.
\item \textsuperscript{23} See \textit{infra} text accompanying notes 95-103.
\item \textsuperscript{24} \textit{Id.}
\item \textsuperscript{25} See \textit{infra} text accompanying notes 192-205.
\item \textsuperscript{26} Coffee, \textit{The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups}, 1988 \textsc{Wis. L. Rev.} 435, 439 (stating that "demonstrated examples of coercion remain as rare as confirmed sightings of the Loch Ness Monster").
\item \textsuperscript{27} See \textit{infra} text accompanying notes 302-19.
\end{itemize}
provide no benefits to target shareholders and, in many cases, actually disad-

vantage them.28

II. THE PURE COERCION ARGUMENT

The pure coercion argument contends that target shareholders suffer harm when the price they receive in a successful hostile tender offer is less than the pre-offer market price of their shares; nevertheless, target shareholders are unable to reject these offers because of their coercive nature. The theoretical under-
pinnings of the pure coercion argument are consistent with efficient capital market theory, which argues that the market price of the target’s shares is the best estimate of the value of those shares.29 If target shareholders receive less than market value, they are not compensated for the market-determined worth of their shares. They lose value. Although the theoretical basis of the pure coercion argument is sound, the argument is unsupported by fact. Some tender offers are coercive, but identifying successful tender offers when the blended price is less than the pre-offer market price is almost impossible.

The pure coercion argument usually focuses on two-tier offers, when the bidder offers a premium price for a controlling interest (usually fifty-one percent) and then eliminates the remaining shareholders in a cashout merger at a lower price. For example, assume that the pre-offer market price of the target stock was $100 per share. The bidder offers to buy fifty-one percent of the target’s stock at a premium price of $110 per share and announces that, upon obtaining control, he will cash out the remaining forty-nine percent of the shareholders at $88 per share. No stock will be purchased by the bidder unless at least fifty-one percent of the stock is tendered. The target shareholder’s position in this situation has been described as a prisoner’s dilemma30 or a veto game.31 The individual decisions of most target shareholders to tender their shares will have only a negligible effect on the success or failure of the tender offer.32 The large number of target shareholders and the costs of organizing and enforcing a group response makes a cooperative response unlikely.33 The dominant strategy for each individual shareholder, therefore, is to tender whenever the first-tier price exceeds the second-tier price no matter how low the average, blended price of the offer.

28. Id.


30. Prentice, Front-End Loaded, Two-Tiered Tender Offers: An Examination of the Count-


32. See, e.g., Leebron, supra note 31, at 184-91.

The individual shareholder's decision is analyzed in Figure A. If the

34. For those who are more familiar with the classic prisoner's dilemma matrix, an individual shareholder's decision matrix is as follows:
Stampeding Shareholders

shareholder decides to tender and the offer fails, the shareholder keeps the stock. Assume for present purposes that the market price falls back to the pre-offer price of $100 per share. If the shareholder decides not to tender and the offer fails, the result is the same; thus, whether or not the target shareholder tenders is irrelevant if the offer ultimately fails. If the shareholder tenders the stock and the offer succeeds, the shareholder receives either $110 per share or some pro rata blend of $110 per share and $88 per share depending on how many shareholders tender. This blended price will always be higher than the $88 per share received in the second-tier cashout if the shareholder does not tender. Thus, rational shareholders would tender, regardless of the probability of success, as long as the tender offer price exceeds the second-tier price. The offer will succeed even though the blended price in the example

35. It does not matter in evaluating the pure coercion argument whether, after an unsuccessful tender offer, the price of the stock actually falls to its pre-offer level or remains at some higher level. The implications of a higher post-offer price are discussed in evaluating the misvaluation argument. See infra text accompanying notes 66-127.

36. This conclusion depends on the assumption that the bidder does not purchase any shares unless she gets the desired 51% of the shares. If the bidder is willing to purchase all tendered shares without any minimum tender condition, the balance is tipped even more in favor of tendering. The shareholder would then receive $110 per share if she tendered and the offer failed.

37. SEC rule 14d-8 requires that, if a tender offer is oversubscribed, the offeror must purchase from all tendering shareholders on a pro rata basis according to the number of shares tendered. 17 C.F.R. § 240.14d-8 (1989). Thus, if the target shareholders tendered a combined total of more than 51% of the stock, they would receive $110 for some of their shares in the tender offer and $88 for the rest in the second-tier cashout. The exact proportion of tendering shareholders' stock purchased in each tier and the average, blended price would depend on the total proportion tendered.

38. This proposition can be proven mathematically. Assume the following variables:

- T = Tender offer price
- S = Second-tier price in cashout merger of minority shareholders
- M = Pre-offer market price
- (1-p) = Probability that the tender offer will fail
- p = Probability that the tender offer will succeed

Make the same assumptions that are made in the text:

1. T > S (The tender offer price is greater than the price that will be paid in the second-tier cashout merger).
2. p is independent of the individual shareholder's decision to tender.

To simplify the mathematics, assume further that, if the offer succeeds, 100% of the shareholders will tender so that each shareholder receives the lowest possible blended price. This assumption is the least favorable to the coercion argument. The expected value of not tendering is pS + (1-p)M. The expected value of tendering is p(0.51T + 0.49S) + (1-p)M. The proposition to be proved is that

\[ p(0.51T + 0.49S) + (1-p)M > pS + (1-p)M \]

Subtracting the common term from both sides of the equation yields:

\[ p(0.51T + 0.49S) > pS \]

Simplifying:

\[ 0.51pT + 0.49pS > pS \]

Subtracting 0.49pS from each side yields:

\[ 0.51pT > 0.51pS \]

Dividing each side of the equation by the common factors (0.51p) yields:

\[ T > S \]

Since this is true by assumption, the equation is proven. The expected value of tendering is greater than the expected value of not tendering.
is only $99.22 per share, less than the value of the shares if the shareholders refused the offer. The problem is that shareholders cannot coordinate their response in deciding whether to tender and therefore are unable to affect the probability of success. Because of this coordination problem, the offeror may coerce the target shareholders into accepting less than market value for their shares.

Front-end loaded, two-tier tender offers have never been the predominant means of buying out a company and are even less prevalent today than in the past. From 1982 to 1986, the number of two-tier offers declined from eighteen percent of all bids to only three percent; only six two-tier offers were made in 1987. Most of those bids were not hostile. In 1985 and 1986, only one successful two-tier offer was opposed throughout the contest, and it was for a relatively small company. One scholar concludes that "the front-end loaded, two-tiered tender offer ha[s] almost disappeared as an offensive weapon in takeover battles."

Professor Bebchuk and others point out, however, that tender offers might coerce unfairly even where there is no second-tier cashout. Once in control, a successful bidder can divert a disproportionate amount of the target's profits to itself, reducing the value of minority shares. Anticipation of a future cashout might also decrease the market value of the minority's shares even if such a cashout is not announced as part of the tender offer. The minority's share

39. See supra notes 32-33 and accompanying text.
40. Two-tier offers have waned as the availability of junk bond financing has increased; this suggests that their primary function was not to coerce target shareholders but to help finance larger takeovers when the offeror could not afford initially to buy 100% of the stock. Some scholars have suggested that a two-tier structure of some sort is necessary to prevent target shareholders from free-riding on the post-takeover efforts of the bidder. It is argued that, with such free-riding, takeovers would never succeed. Easterbrook & Fischel, Corporate Control Transactions, 91 YALE L.J. 698, 710-11 (1982). See generally Grossman & Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 BELL J. ECONOMICS 42 (1980).
44. Prentice, supra note 30, at 405. Professor Prentice attributes the decline of two-tier offers to changes in SEC rules, the enactment of state takeover statutes, and recent cases which allow target managements greater discretion in defending against two-tier offers. Id. at 405-25. As mentioned above, the contemporaneous reduction in the number of two-tier offers and the increase in the use of junk bond financing suggests that two-tier offers disappeared because a better method of financing large takeovers was found. This suggests that, for the reasons presented later (competition and the existence of large shareholders), their coercive effect never was great and that they vanished as a superior method of financing appeared. See infra text accompanying notes 206-57.
price could fall below the pre-offer market price. Thus, the acquirer's operation of the firm with continued minority ownership could produce a lower second-tier value as in a cashout merger.

In either case, whether it be a cashout merger or continued operation, target shareholders clearly lose if the blended price is less than the pre-offer market value of the company, which represents the value of the target under the direction of existing management.\(^{46}\) In the example above, shareholders would receive an average price of $99 per share compared to the $100 per share they could have had selling their shares in the market prior to the tender offer. Hostile offers fitting the pure coercion argument, however, are rare or even non-existent. Professor Davis concludes that "the one issue in the takeover debate that seems beyond dispute is that target shareholders benefit handsomely from takeovers, at least in relation to the pre-offer value of their holdings."\(^{47}\) On average, target shareholders receive substantial premiums over the pre-offer market price even in the second tier of two-tier tender offers.\(^{48}\) In many two-tier offers, the second-tier price is substantially the same as the tender offer price.\(^{49}\) When there is no second-tier transaction, the price of minority shares also exceeds the pre-offer market price.\(^{50}\) It seems unlikely that a successful bidder could divert enough value from the minority to justify the huge first-tier premiums paid. Taking a tender offer price which is, on average, fifty to sixty percent above the pre-offer market price\(^{51}\) and assuming a first-tier offer for only fifty-one percent of the target's stock, the bidder would have to divert over sixty percent of the value of the remaining shares before the blended

---

\(^{46}\) If one accepts the misvaluation argument, the value of the target under the direction of existing management could be higher or lower than the pre-offer market price depending on whether the stock is undervalued or overvalued. Even under the efficient market hypothesis, the pre-offer market price may not reflect the value of the target under the direction of existing management; it is only a ceiling for that value. In an efficient market, the pre-offer market price should incorporate the probability that the target will be taken over by better management. For example, assume that the target's value with existing management locked in is $90 per share but investors feel that there is a 25% chance that better management will successfully offer $130 per share. The expected value of this premium, $10, would be incorporated into the market price, and the stock would trade at $100 per share.


\(^{48}\) See, e.g., Office of the Chief Economist, SEC, The Economics of Any-or-All, Partial, and Two-Tier Tender Offers, at 17-19 (1985) [hereinafter Office of the Chief Economist, SEC, Tender Offers] (finding blended premiums in two-tier tender offers in 1981-1984 averaging over 50%). The study by the Office of the Chief Economist also provides data on pure partial offers when there is no clean-up transaction closely following the execution of the tender offer. Both bid and blended premiums are lower for such partial offers. Id. Only 31 such offers were made from 1981 to 1984, of which 13 were in 1981. Twelve of those 31 offers were eventually negotiated with target management, so the number of hostile partial offers was even smaller. Finally, non-negotiated partial offers on average did not result in the bidder receiving majority control of the target. Id.

\(^{49}\) The SEC's Office of the Chief Economist found less than a 20% difference between the two tiers in 71% of all two-tier offers and an equal or higher second-tier price in 18% of all two-tier offers. Id. at Table 8.

\(^{50}\) Professor Bradley found that, after a successful offer, the price of outstanding target shares remained 36% above the pre-offer market price. Bradley, Interfirm Tender Offers and the Market for Corporate Control, 53 J. Business 345, 360-65 (1980).

\(^{51}\) Office of the Chief Economist, SEC, Tender Offers, supra note 48, at 17-19.
price would be less than the pre-offer market price. Although fiduciary duty law tolerates some diversion of profits by a controlling shareholder, it is unlikely to tolerate a diversion of this magnitude. 52

A below-market blended premium is especially unlikely when minority shareholders are cashed out after an offer. Any attempt to cash out the minority at a price below the pre-offer market price would almost certainly run afoul of the minority's appraisal rights. 53 Thus, the pre-offer market price is likely to set a floor for blended premiums when the second part of the transaction is a cashout.

Offers that fit the pure coercion argument are almost impossible to find. The Office of the Chief Economist of the SEC surveyed successful cash tender offers executed in 1981-1984 and found that only 3 of 159 any-or-all offers and 1 of 38 two-tier offers had negative-blended premiums. 54 Comment and Jarrell, working with the same data, found only one offer of any type with a blended price which was less than the pre-offer market price. 55 They indicated that this single case, rather than being an actual below-market blended offer, may have resulted from a methodological problem:

After negotiating for five months, National Semiconductor agreed to acquire Data Terminal Systems in a tender offer for up to 58% of the shares at $8.00 per share, followed by a cash merger at $7.25 per share. The offer was oversubscribed, with 73% tendering. One month before the offer announcement, Data Terminal traded at $7.875 per share, giving a blended premium of -2.9%. The market price one month prior may have increased because of an earlier announcement of ongoing merger talks. This earlier announcement was not treated as the "first" offer for purposes of calculating . . . [the pre-offer price] . . . because no merger proposal was made. 56

Pound, using a different measurement technique, reports premiums as low as -10.5%. 57 Although Pound does not report the number of offers with negative

53. Bebchuk, supra note 14, at 1709-10; Leebron, supra note 31, at 163 n.41.
54. OFFICE OF THE CHIEF ECONOMIST, SEC, TENDER OFFERS, supra note 48, at Table 5.
55. Comment & Jarrell, Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free-Riding Shareholder, 19 J. Fin. Econ. 283, 298 Table 4 (1987). Robert Comment and Gregg Jarrell conducted the SEC study; therefore, the data and methodology are similar. The only visible difference between the data used in the two studies is that Comment and Jarrell look at cash offers initiated in the January, 1981 to December, 1984 period whereas the SEC study looks at offers actually executed during that same period. Compare id. at 291 with OFFICE OF THE CHIEF ECONOMIST, SEC, TENDER OFFERS, supra note 48, at 5. Comment and Jarrell do not discuss whether this is the sole reason for the differences in the results.
56. Comment & Jarrell, supra note 55, at 299 n.7.
57. J. Pound, The Effects of Institutional Investors on Takeover Activity: A Quantitative Analysis 10 (1985). Pound measures the percentage change in the market price of target stock from 30 days before the first news of a takeover bid to the date on which the final, highest bid was made. This should approximate the actual, blended premium if shareholders accurately anticipate the second-tier value; however, Pound's premiums are likely to be lower than actual value changes in some cases and higher in others. In some cases, particularly in contested offers, the market price may be lower to discount for the possibility that the above-market offer will not succeed. In such a case, Pound's calculations underestimate the premium if the offer succeeds. In other cases, the market price may be higher on the date of the final bid because investors anticipated an even higher bid that never came. These possibilities could cancel out, but do not necessarily do so.
premiums, he does list the ten targets that offered the lowest premiums, ranging from -10.5% to 18.8%.\footnote{Id. at 17. The 10 target companies were Chieftan Development, Data Terminal Systems, Dorsey, Jewel Cos., Jonathan Logan, Midlands Energy, Phone-Mate, Superior Oil, Union Commerce Corp., and Vulcan.} When Pound's methodology is applied to these ten offers, only two involve negative premiums. One of those targets was Data Terminal Systems, discussed by Comment and Jarrel; the other was Phone-Mate, Inc. Asahi Corporation offered $2.75 per share for approximately 7.5\% of Phone-Mate's stock.\footnote{See Asahi Offer for Phone-Mate Stock, Wall St. J., Aug. 3, 1984, at 38, col. 3.} The market price after the offer was $2.00 per share compared to $2.125 one month prior to the offer;\footnote{Id.} thus, although Asahi offered a premium over the market price, Pound's methodology classifies the offer as a negative premium offer. There were other reasons for Phone-Mate's stock decline,\footnote{See Price Wars and Overproduction Spur Shakeout in Phone-Making Industry, Wall St. J., Aug. 2, 1984, at 10, col. 2.} and given the small size of the offer, these other effects probably mask the effect of the offer. Two other studies show \textit{bid} premiums as low as 1.5\% and 3.26\%, but do not calculate blended premiums.\footnote{Walkling & Long, \textit{Strategic Issues in Cash Tender Offers: Predicting Bid Premiums, Probability of Success, and Target Management's Response}, 4 MIDLAND J. CORP. FIN. 57, 58 (1986) (finding a 1.5\% bid premium); Note, \textit{Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study}, 97 YALE L.J. 1193, 1220 Table 6 (1988) (noting a 3.26\% bid premium).} Thus, there is almost no evidence to support the pure coercion argument.

The Data Terminal Systems case points to a more likely explanation of the few negative-premium bids. The studies cited may overestimate the unaffected pre-offer market price and, thus, underestimate premiums. Each of these studies establishes the unaffected pre-offer price by looking twenty to forty days prior to the announcement of the actual bid or merger proposal.\footnote{OFFICE OF THE CHIEF ECONOMIST, SEC, \textit{TENDER OFFERS}, supra note 48, at 9 (twenty days prior to announcement of initial offer); J. POUND, \textit{supra} note 57, at 7 (thirty days prior to first news of takeover bid); Comment & Jarrell, \textit{supra} note 55, at 292-93 (twenty days prior to announcement of initial offer); Note, \textit{supra} note 62, at 1213 (forty days prior to announcement of tender offer).} At that time, Schedule 13D filings, rumors of impending bids, announcements by the target, and a number of other events could have already pushed up the market price in anticipation of a takeover bid. For example, Holderness and Sheehan report statistically significant positive abnormal returns associated with Schedule 13D filings, particularly filings by so-called corporate raiders.\footnote{Holderness & Sheehan, \textit{Raiders or Saviors? The Evidence on Six Controversial Investors}, 14 J. FIN. ECON. 555, 577 (1985).} If these other events occur early enough in relation to the bid, the initial market price already reflects the possibility of a bid, and thus the calculated premiums are too low.\footnote{Jarrell, Brickley & Netter, \textit{The Market for Corporate Control: The Empirical Evidence Since 1980}, J. ECON. PERSP., Winter 1988, 49, 52-53 (1988).}

### III. The Misvaluation Argument

The misvaluation argument claims that tender offers may be coercive and unfair to shareholders even if the second-tier price (or the market value of
minority shares if there is no cashout) exceeds the pre-offer price. Unlike the pure coercion argument, the misvaluation argument is inconsistent with efficient capital market theory. The misvaluation argument assumes that the pre-offer stock market price undervalues the target’s shares and, therefore, presumes that the market is inefficient. If the market were efficient, the pre-offer market price would reflect investors’ estimates of the target’s value under the direction of existing management. Any offer in which the blended price exceeded the pre-offer market price of the stock would represent a gain to the target shareholders. This offer would be fair because shareholders would receive a return in excess of their own collective valuation of the target.

Assume again that the pre-offer market price of the target’s stock is $100 per share and that the bidder offers to buy fifty-one percent of the stock at a price of $110 per share. The second-tier price is $102 per share. The blended price is now approximately $106 per share, well above the original market price. The misvaluation argument nonetheless claims that target shareholders may lose because the true value of the target may be greater than the pre-offer market price; thus, a positive blended premium does not assure target shareholder gains.

The misvaluation argument is inconsistent with the general evidence supporting stock market efficiency. There is no evidence that hostile bidders consistently pick out undervalued companies and take advantage of target shareholders. Even if they did, the premiums paid exceed the amount of inefficiency supported by the strongest empirical evidence favoring the misvaluation argument. Finally, even if the fundamental value exceeds the blended tender offer price in a few selected cases, target shareholders still gain from hostile tender offers because such offers are the only systematic way for target shareholders to realize that unrecognized value.

The proposition that the stock market is efficient is generally accepted by financial economists. Fama wrote in 1970 that “the evidence in support of the efficient markets model is extensive, and (somewhat uniquely in economics) contradictory evidence is sparse.” Jensen concluded in 1978 that “no other proposition in economics . . . has more solid empirical evidence supporting it . . . .” Brealey and Myers recently wrote that “[t]he concept of an efficient market is . . . remarkably well-supported by the facts.” In their examination of market efficiency, Gordon and Kornhauser conclude that “[t]he pattern in the market today appears to produce a very high level of market efficiency.

---

66. See, e.g., Lowenstein, supra note 16, at 307-08. For convenience, I will refer only to the second-tier price. The analysis is equally valid in either case.

67. The only other methods that allow shareholders to realize the unrecognized fundamental value are a restructuring of the target corporation or a friendly transaction. Each of these requires the active cooperation of the target company’s management. If management proposes such action, then management effectively becomes a competing bidder, and shareholders can choose the more favorable offer. If management rejects such action or does nothing, then the only alternative left open to target shareholders is the hostile offer.


The idea that stock is priced at less than its true value is difficult to accept as a matter of theory because of the possibility of arbitrage:

If there were significant divergences between price and value, investors could reap substantial gains by purchasing the undervalued shares and selling the overvalued shares. This process of arbitrage would continue until it became harder and harder to discover bargains; at some point the cost of discovering the bargain would exceed the trading gains that could be realized in the process. Once trading to obtain bargains had occurred, the price of the stock embodies all of the available information about the firm and its prospects.

Nevertheless, as Professor Kraakman points out, hostile bidders act as if they believe the target is undervalued and often say that they believe the target is undervalued; therefore, the claim that target shares are undervalued needs to be carefully examined.

The misvaluation argument states either that the market undervalues all companies or certain classes of companies (systematic undervaluation) or that the market has undervalued the particular target company (firm-specific undervaluation). It is not clear that target shareholders lose in a case of systematic undervaluation by the market even if the fundamental value of the corporation is greater than the blended price of the tender offer. For instance, a possibility of substitution exists because a shareholder who loses surplus when cashed out of the target’s stock can offset that loss by investing in another similarly undervalued stock. The shareholder loses only the transaction cost of reinvesting. If there is persistent, systematic undervaluation, any loss associated with the tender offer is offset by the surplus gained when the investment originally was made.

There is scattered evidence that the stock market may not always be efficient and that profitable trading on public information may be possible. Much of this research is "of questionable validity," but it nevertheless poses an issue that must be addressed. A brief review of the market inefficiency arguments shows that such inefficiency, if it exists, is too inconsequential to explain the large takeover premiums paid to target shareholders. Further, there is no evidence to suggest that any undervaluation which does exist correlates with hostile takeovers. Bidders do not systematically pick out undervalued targets; therefore, premiums paid to target shareholders do represent gains to those shareholders rather than the recapture of market undervaluation.

74. See generally Gordon & Kornhauser, supra note 71, at 834-46 (summarizing studies that confirm and reject the efficient market hypothesis); Wang, Some Arguments that the Stock Market Is Not Efficient, 19 U.C. DAVIS L. REV. 341, 349-62 (summarizing studies that question market efficiency).
75. Wang, supra note 74, at 366-75.
The most commonly cited evidence of market inefficiency is the existence of discounts for closed-end investment company shares and shares in dual purpose funds.76 Since the assets of those funds are fungible shares with market prices, the funds should trade at a price no less than the market values of the securities they hold. The observed discounts are not necessarily inconsistent with market efficiency. Agency costs, tax liabilities, and over-diversification may explain some or all of the observed discounts.77 The strongest argument for present purposes is that inefficiency in the market for closed-end investment companies or dual purpose fund shares provides no evidence that the market for common stocks in publicly-held corporations is inefficient. Shares in closed-end and dual purpose funds are marketed less actively than common stock in public companies, and institutional ownership is lower.78 This market is less likely to be efficient. The leading scholars who have examined these discounts hypothesize that the discounts exist "because they are not supported by an active marketing campaign."79 Actually, the comparison to the prices of the underlying securities held by these funds implicitly assumes that the underlying prices are correct; otherwise, the comparison would be meaningless. These studies therefore fail to show that the stock market misvalues the shares of target shareholders.

A similar response can be made in the case of senior securities convertible to common stock, which often sell at a discount from their conversion value (the market value of the underlying common stock).80 The market for convertible securities is thin with few professionals to engage in arbitrage.81 Some inefficiency is to be expected in this market, but this inefficiency does not support the contention that the market for common stocks is inefficient.82 Kraakman presented similar evidence that the common stock of natural resource companies and companies with large investments in marketable securities may be under-valued,83 but these discounts seem better explained by agency costs than by market inefficiency.84

Professor Shiller argued that stock prices are too volatile to be justified by changes in real dividends.85 He concluded that the stock market must be

76. See id. at 377-86; Kraakman, supra note 73, at 902-05.
77. See Kraakman, supra note 73, at 903-05; see also Wang, supra note 74, at 389-90. Both authors feel that these explanations are inadequate.
79. Malkiel & Firstenberg, supra note 78, at 24; see also the authorities cited in Wang, supra note 74, at 391 n.152. Malkiel now indicates that the discounts on these funds have largely been eliminated because of more attention from investors. Malkiel, Is the Stock Market Efficient?, 243 SCIENCE 1313 (1989).
80. See Wang, supra note 74, at 377-86.
81. See id. at 386 n.138.
82. Even in the market for convertible senior securities, the percentage of clearly underpriced securities is small. Id. at 381.
83. Kraakman, supra note 73, at 906-07.
inefficient and thus overreacts to dividend information. This work might be viewed as evidence that stock prices have no real relation to fundamental values. Yet, it is common practice for managers to try to smooth out dividends, paying dividends at a relatively even pace despite a great variation in earnings. A larger percentage of earnings is paid as dividends in lean years, a smaller percentage in highly profitable years. Since investors are rationally more interested in the variations of real earnings (cash flow), one would expect market prices to vary with changes in the more volatile earnings. Thus, market prices should be more volatile than dividends in an efficient market. In addition, scholars have questioned Shiller's methodology.

Studies reviewing market reaction to earnings performance show some inefficiency, but not of a magnitude large enough to justify the takeover premiums observed. Many studies show systematic excess returns in periods following public announcements of earnings, but after correcting for methodological problems, those abnormal returns are relatively small—no more than one to two percent per quarter over a two quarter period. When transaction costs are considered, ordinary investors could not earn any excess returns trading on these inefficiencies. Other studies that claim to find inefficiencies in market reaction to public announcements also report cumulative abnormal returns far too small to explain much of the observed takeover premiums. There is also some evidence which suggests that these inefficiencies were time-related. Wang, Gordon, and Kornhauser report several studies which indicate that some analysts' recommendations, if followed, would produce above-normal returns. However, the magnitude of these inefficiencies, if they exist, is much too small to explain takeover premiums.

All of these supposed market inefficiencies affect target shareholder returns only if hostile bidders are somehow exploiting them and if the targets of hostile bids are systematically undervalued; however, there is no evidence connecting these market inefficiencies to hostile takeover bids. For example, it is often argued that the market undervalues companies taking a long-term approach through long-term planning, research, and development. Institutional investors are claimed to have a short-term focus that discounts too steeply the potential for any long-term gains; however, the empirical evidence shows statistically significant positive stock price reactions to new research and development.

86. Shiller, Market Prices Move, supra note 85, at 434.
87. For summaries of the responses to Shiller's work, see Gordon & Kornhauser, supra note 71, at 828 n.183; see also Wang, supra note 74, at 360 n.47.
88. See generally Ball, Anomalies in Relationships Between Securities' Yields and Yield-Surrogates, 6 J. Fin. Econ. 103 (1978) (noting that numerous studies reveal consistent, excess returns after public announcements of firms' earnings and setting forth alternative explanations for this phenomena).
89. Watts, Systematic 'Abnormal' Returns After Quarterly Earnings Announcements, 6 J. Fin. Econ. 127, 135-41 (1978).
90. Id. at 141.
91. See generally Gordon & Kornhauser, supra note 71, at 843-45.
92. Id. at 843-45; Watts, supra note 89, at 142-43.
programs. Target firms have lower value-weighted research and development to revenue ratios on the average, and rather than institutional investors shunning firms which make such investments, a positive correlation exists between the level of institutional ownership and research and development ratios.

Professor Pound compared the financial characteristics of hostile takeover targets to a randomly selected control group. He found no evidence supporting the argument that target firms are undervalued in comparison to other firms and concluded that "the data prove unequivocally that the myth of balance sheet superiority among takeover targets is just that—a myth." Takeover targets had lower price to earnings ratios, but that finding is as consistent with market reaction to agency costs as it is with market inefficiency. No significant differences existed between takeover targets and the control group in price-sale ratios, price-book ratios, capital expenditure ratios, debt ratios, return on equity, or earnings growth. A substantial but statistically weak difference in revenue growth existed. Hostile targets had higher revenue growth in the five years prior to the takeover, but this was matched by an offsetting statistically insignificant difference in the opposite direction in earnings growth.

Morck, Shleifer, and Vishny, on the other hand, found sharp differences between the targets of hostile tender offers and other firms, but the differences contradicted the predictions of the undervaluation thesis. Their evidence indicated that "hostile targets are older, poorly performing firms, possibly with many old plants or equipment that should be abandoned or more profitably deployed elsewhere." "They are growing slowly and have heavy debts." Thus, no evidence indicates that any market misvaluation correlates with the premiums paid to target shareholders. Hostile bidders are not able to pick out undervalued targets and pay large premiums because of the undervaluation. Summers, who believes that large valuation errors are theoretically possible and consistent with the available empirical evidence, concedes that speculators, presumably including hostile bidders, would be unable to identify undervalued stocks and profit from that identification. Even if the market persistently

96. Id. at 9.
97. Id. at 6-7.
99. Id. at 24.
100. Id. at 12-13.
101. Id. at 13-25.
102. Id. at 28.
103. Id.
105. Id. at 120.
106. Id. at 117.
misvalues common stock, the net returns to target shareholders would be unaffected. Bidders will bid for both undervalued and overvalued stocks, and the net premiums to target shareholders as a percentage of fundamental values will be close to the premiums measured as a percentage of the pre-offer market price.

The premiums paid to target shareholders might be justified by firm-specific, rather than systematic, undervaluation. Firm-specific undervaluation arises when a particular shareholder or the bidder has specialized knowledge about the firm and its prospects that lead the shareholder or bidder to expect different cash flows. This specialized knowledge might arise from the possession of nonpublic information about the target firm, which would not be reflected in the market price, or from a superior ability to analyze publicly available information about the firm. The latter possibility is foreclosed by the results of the market efficiency studies. In general, the market price of a company's stock fully reflects publicly available information about the company. Investors with superior analytical ability are unable to outperform the market consistently, especially when transaction costs are considered. Thus, on average, those who value the target shares more highly because of a perceived analytical edge are just as likely to be wrong as they are to be right. With tender offer prices fifty percent above the market price, superior analytical ability provides an inadequate explanation.

Nonpublic information might justify a higher valuation of the target than the pre-offer market price. The strongest form of the market efficiency hypothesis does not hold because those with access to nonpublic information can earn abnormal returns. The pre-offer price based on trading by ignorant investors could be lower than the true value of the company if all information were known; however, the nonpublic information would have to be substantial to justify rejecting such large premiums. Further, a shareholder with nonpublic information could protect himself from a below-valuation tender offer in many cases simply by disclosing the nonpublic information so that others would share the higher valuation. Absent coercion, the tender offer would then fail unless it exceeded this common higher valuation, and shareholders would suffer no loss. Finally, to the extent that such nonpublic information also existed at the time the shares were purchased, any loss caused by the tender offer would be offset by the gain received when the shares were originally purchased at the lower market price. In short, the nonpublic information rationale seems insufficient.

Professor Bebchuk argues that new information received by shareholders during a bid might support a valuation exceeding the pre-offer market price. Market participants evaluate the target more thoroughly, the target management
discloses new plans and proposals, and investors draw inferences from the making of the bid itself.112 Target shareholders might increase their estimates of the independent target’s value based on this new information. Even though the bid is at a premium above the pre-offer market price, it might actually be below the shareholders’ revised valuation. To support his thesis, Bebchuk points to studies showing that the market price of target stock remains significantly higher than the pre-offer market price even after a tender offer is rejected.113 Bebchuk offers this data as evidence that tender offers cause target shareholders to revalue their company; otherwise, the stock should return to its pre-offer level. The reason for the continued higher price appears to be the expectation of a further bid for the company. If another bid is not made, the price of the target stock generally returns to its pre-offer level within two years114 or even sooner.115 This is inconsistent with the misvaluation thesis, which predicts that the higher price will persist.

Finally, it is difficult to envision revaluation during the course of the offer of the magnitude that the misvaluation thesis would require. The average blended price in a two-tier tender offer is more than fifty percent above the pre-offer price.116 It is hard to imagine new information raising the value of the target by that percentage even in isolated cases, and it is certainly unlikely to be a common phenomenon.117

Bebchuk suggests that the bidder might have nonpublic information about the target.118 He argues that “the shareholders might believe that the bidder’s

112. Bebchuk, The Pressure to Tender, supra note 45, at 928.
113. Id. at 929; see Bradley, supra note 50, at 368-72; Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers, 11 J. Fin. Econ. 183, 184 (1983).
114. Bradley, Desai & Kim, supra note 113, at 205. Ruback similarly found that almost all of the abnormal returns associated with unsuccessful tender offer bids had vanished after three years. Ruback, Do Target Shareholders Lose in Unsuccessful Control Contests?, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, supra note 104, at 137. See also Easterbrook & Jarrell, Do Targets Gain from Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277, 290 (1984) (stating that unsuccessful takeover targets traded at a 10-20% loss relative to market investment of proceeds if the offer had been successful); Pound, Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study, 4 MIDLAND J. CORP. FIN. 33 (Summer 1986) (finding market-adjusted returns of -30% in the two years following 56 unsuccessful hostile offers).
115. A followup to the Bradley, Desai, and Kim study looked at a sample of 21 failed offers during the period from 1977 to 1983 and concluded that all positive post-announcement returns had vanished by the time the offer was withdrawn and that no trace of the premium reappeared in the following year. Fabozzi, A Note on Unsuccessful Tender Offers and Stockholder Returns, 43 J. Finance 1275, 1282 (1988).
116. OFFICE OF THE CHIEF ECONOMIST, SEC, TENDER OFFERS, supra note 48, at 17-19. Jarrell, Brickley, and Netter report a follow-up study by the Office of the Chief Economist of tender offers in 1985 and 1986 that found lower, blended premiums of 37% in 1985 and 33.6% in 1986. See Jarrell, Brickley & Netter, supra note 65, at 52. They also report an unpublished study by Jarrell and Poulsen that found overall premiums of 30% for successful tender offers in the period from 1980 to 1985. Id. at 51. These lower figures would not significantly affect the conclusion in the text.
117. Writing of management buyouts, Professor Lowenstein argues that, “while one should be prepared at all times to believe in the venality of his fellow man, it is unlikely that corporate executives have consistently hidden enough information and other tricks up their sleeves to justify paying 50% to 100% over market for the stocks of widely followed companies.” Lowenstein, Management Buyouts, 85 COLUM. L. Rev. 730, 749 (1985).
118. Bebchuk, The Pressure to Tender, supra note 45, at 928.
motive for making the bid was the possession of private information that the target’s shares were undervalued by the market; and the shareholders might conclude that the target’s accurate value exceeds the offered acquisition price.”

But why would a hostile bidder possess private information that the target’s stock is undervalued? If this information exists, surely the target’s management also has access to it. They could release it publicly or to another bidder and force the first bidder to pay a competitive price in an auction. The situations in which private information of undervaluation are most likely to exist are in management buyouts or friendly transactions. Hostile bidders are unlikely to have access to significant nonpublic information about targets.

Some scholars circumvent the general conclusion that the stock market is efficient by arguing that what appears to be a single market is actually two different markets: a market for shares and the tender offer market for corporate control. The stock market price reflects what a marginal minority investor would be willing to pay for the stream of dividends expected from the actions of target management. It is not based on the value of the target’s assets because liquidation is not an option to the minority shareholder; thus, the stock market price need not reflect the full value of the target’s assets. The tender offer price, on the other hand, reflects the value of the firm in the hands of someone with majority control. Since liquidation is an option to a successful bidder, the tender offer price should reflect the full value of the target’s assets. Two conclusions follow from this two markets hypothesis. First, stock market efficiency is neither a necessary nor a sufficient condition for the tender offer to be economically efficient. Second, and more important in this context, tender offer premiums above the stock market price may not accurately reflect target shareholder gains since the assets they are giving up may be worth more than the stock market price.

Even if the two markets hypothesis is correct, the tender offer appears to be the only way for target shareholders to unlock these asset values, so the premiums paid in takeovers still represent gains to them. The alternative is a continuation of the target corporation with the same stock price. The argument then collapses into a form of the bargaining argument—how much of the asset value do target shareholders capture and how much do bidders keep as extraordinary returns? As the evidence below indicates, it appears that most of this hidden asset value, if it exists, goes to the target shareholders.

This last point could be made with respect to all of the evidence of undervaluation. Even if the stock market consistently undervalues target shares, tender offer premiums may still represent target shareholder gains. The target shareholders’ alternatives must be considered. “An undervalued stock might

119. Id. at 930.
120. Easterbrook & Fischel, supra note 72, at 1735.
121. Kraakman, supra note 73, at 895.
124. See supra note 114.
remain perpetually undervalued in an inefficient market..."125 If so, takeover premiums clearly do represent gains over what target shareholders would have if the takeover had not occurred since they have no other way of realizing the full value of their shares.126 Target management might act to reduce discounts, but even if possible, this is unlikely. "[L]arge redemptions of equity—the only certain method of reducing discounts—will impose costs on managers, limit corporate growth, and may appear to harm the long-term interests of shareholders."127 Since the alternative for target shareholders, absent a takeover, is the undervalued, discounted price, takeover premiums represent gains.

IV. THE HETEROGENEOUS VALUATION ARGUMENT

Professor Carney advances the heterogeneous valuation argument most forcefully.128 Professor Carney's argument for target shareholder losses in tender offers does not depend on coercion or market inefficiency.129 It can be used even in situations in which a majority of the target shareholders want to tender at the price offered.130 Professor Carney focuses on the possibility of differential valuations among target shareholders and argues that noncoerced tendering by a majority of the target shareholders does not guarantee net shareholder gains.131 If the losses incurred by shareholders who value their shares above the tender offer price exceed the gains realized by low-valuing, tendering shareholders, target shareholders as a group suffer an overall loss if the tender offer succeeds.132

Professor Carney notes that the market price of a stock reflects only the valuations of the stock by those shareholders who choose to sell at the margin.133 He argues that the supply curve for target shares is upward-sloping; shareholders who retain their shares at the market price value those shares more highly than those who sell.134 A bidder desiring to obtain more than a small amount of the target's shares must pay a premium large enough to exceed the individual valuations of shareholders holding the percentage sought.

125. Gordon & Kornhauser, supra note 71, at 801.
126. As Professor Dennis writes,

[P]resumably the target's shareholders should be willing to take the bird in the hand, a sure premium, rather than the potential two birds in the bush, the hope that the irrational market gains its senses and that this produces increased value in excess of the current premium plus the time value of money.


127. Kraakman, supra note 73, at 920-22.
129. Carney, Shareholder Coordination Costs, supra note 128, at 354.
130. Id. at 355-56.
131. Id. at 353-54.
132. Id.
133. Id. at 354.
134. Id.
Assume that the supply curve for a target company's stock is as shown in Figure B. The market price of the stock prior to the tender offer is \( M \). To tender for fifty-one percent of the target stock successfully, a bidder must offer a price \( (M + P) \), which just exceeds the valuation of the shares by the shareholder at the fifty-one percent level.\(^{135}\) Those shareholders whose valuation is less than the tender offer price will tender, and the bidder will receive fifty-one percent of the stock.

Given an upward-sloping supply curve, overall gains to the target shareholders are not measured by the percentage premium even if the market is efficient at the margin. Two modifications are necessary to calculate the effect of the offer on target shareholders. First, since not all tendering shareholders value their shares at the pre-offer market price, the gain to tendering shareholders is less than the simple product of the premium and the number of shares sold. The net gain to tendering shareholders is the cross-hatched area in Figure C\(^{136}\)—the difference between each tendering shareholder's individual valuation and the tender offer price. Second, the gain to tendering shareholders must be offset by a corresponding loss of surplus to the remaining forty-nine percent of the target shareholders, even assuming that they are immediately cashed out at the tender offer price. Since the supply curve is upward-sloping, their individual valuations exceed the tender offer price, and they suffer a loss

\(^{135}\) This assumes that price discrimination is impossible—all tendering shareholders must be paid the same price. This assumption is consistent with the single-price requirement imposed by the Williams Act. See 15 U.S.C. § 78n(d)(7) (1988); 17 C.F.R. § 240.14d-10(a)(2) (1989).

\(^{136}\) This gain, known as producer's surplus, is the sum of the differences between the minimum prices at which each shareholder would be willing to sell and the tender offer price. See generally D. McCloskey, The Applied Theory of Price 196-221 (2d. ed. 1985).
equivalent to the area of the shaded triangle in Figure C. Given these two qualifications, the existence of above-market premiums provides an insufficient condition to guarantee that target shareholders gain from a takeover. Target shareholders gain in the aggregate only if the area of the surplus triangle exceeds the area of the loss triangle.

Professor Carney offers several reasons why individual shareholders might have substantially different valuations of the target shares—why the supply curve might be upward-sloping. First, he argues that the transaction costs of shifting to another investment, including research and brokerage costs, might vary among shareholders. A shareholder expecting to incur higher reinvestment costs might rationally conclude that the premium offered, less reinvestment

\[ M + P \]

\[ M \]

\[ \$ \]

\[ 51 \]

\[ 100 \] Shares

Professor Carney argues that this research into the elasticity of the demand curve does not affect his argument, which posits an inelastic supply curve. Carney, *Shareholder Coordination Costs*, supra note 128, at 354-56. Professor Carney’s distinction does not hold on closer analysis. If investors look upon securities as perfect substitutes when they buy shares and if the demand curve falls within a narrow price range, they will also look upon securities as perfect substitutes when they sell shares. A slight increase in the price offered will prompt a large number of sellers because those sellers know they could reinvest the proceeds in a perfect substitute and pocket the profit. Thus, since the buyers and sellers are the same people, elastic demand does imply elastic supply.

137. *See id.*

138. Some of the finance literature has focused on the elasticity of demand for stocks. *See, e.g.*, Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. Business 179 (1972). The general conclusion of this work is that demand is highly elastic—that different investors’ valuations are relatively uniform. *See generally R. BREALEY & S. MYERS, supra note 70, at 296-98.* The theoretical reason for this result is that shares are not unique. They represent a right to a particular income stream, and alternative income streams (other securities) should be nearly perfect substitutes. Scholes, *supra*, at 179, 181-82.

Carney argues that this research into the elasticity of the demand curve does not affect his argument, which posits an inelastic supply curve. Carney, *Shareholder Coordination Costs*, supra note 128, at 354-56. Professor Carney’s distinction does not hold on closer analysis. If investors look upon securities as perfect substitutes when they buy shares and if the demand curve falls within a narrow price range, they will also look upon securities as perfect substitutes when they sell shares. A slight increase in the price offered will prompt a large number of sellers because those sellers know they could reinvest the proceeds in a perfect substitute and pocket the profit. Thus, since the buyers and sellers are the same people, elastic demand does imply elastic supply.

costs, is less than the pre-offer target stock price. Given the size of the premiums offered, this seems relatively trivial.

Second, Carney argues that tax differences might explain differing valuations. After-tax gains to shareholders will vary depending on the tax basis of each shareholder's stock. Some shareholders might have purchased their shares long ago at lower market prices or might have acquired their shares in tax-free exchanges for other securities which had a low tax basis. Shareholders who acquired their shares more recently for cash would have a higher tax basis and thus lower tax costs when they sell to the tender offeror. Timing considerations could also affect the tax cost. The presence or absence of other taxable income in a particular year would affect shareholders' marginal tax rates and hence their tax costs; however, tax considerations are unlikely to be large enough to make shareholder reservation prices exceed the premiums typically paid in takeovers. Assuming unrealistically, for illustration, that a target shareholder had a zero basis in the target shares and a twenty-eight percent marginal tax rate, any premium greater than thirty-nine percent would still produce a gain. An SEC study found that seventy percent of any-or-all offers and seventy-one percent of two-tier offers involved a blended premium in excess of forty percent. Thus, even with the unrealistic assumption that some shareholders have a zero basis in their shares, not a single shareholder would reject solely for tax reasons the premium offered in almost three-quarters of all tender offers. Making a more realistic assumption about tax bases and discounting any tax costs for their later time of payment, it is almost impossible that tax costs would produce valuation differences sufficient to create overall shareholder losses. Further, if tax costs were high, the bidder could reduce

140. Id.; Carney, Fundamental Corporate Changes, supra note 128, at 115 n.186.
141. Carney, Shareholder Coordination Costs, supra note 128, at 356.
142. Id.
143. With a zero basis, the entire tender offer price would be taxable income. The shareholder would gain if the 72% of the price received after taxes exceeds the original pre-offer price. Solving for the tender price:

\[
0.72 \times (\text{Tender offer price}) = \frac{(\text{Pre-offer market price})}{0.72}
\]

(Tender offer price) = 1.389 (Pre-offer market price)

Thus, even in the extreme case when the tax basis of the target shares is zero, the shareholder would still gain after taxes if a 39% premium were received.

144. Office of the Chief Economist, SEC, Tender Offers, supra note 48, at Table 5.
145. Assume, for example, that the market price has doubled since the shareholder bought the stock; the tax basis in the stock is therefore one-half the pre-offer market price. Ignoring differences in the timing of payments, the shareholder would gain if the tender offer price, less the tax, exceeds the pre-offer market price. Assuming a 28% marginal tax rate, the shareholder breaks even when the following equation holds:

\[
(\text{Tender offer price}) - 0.28 \left[ (\text{Tender offer price}) - \text{Basis} \right] = (\text{Pre-offer market price})
\]

Simplifying,

\[
0.72 \times (\text{Tender offer price}) + 0.28 \times (\text{Basis}) = (\text{Pre-offer market price})
\]

Since the tax basis is one-half the pre-offer market price,

\[
0.72 \times (\text{Tender offer price}) + 0.28 \times 0.5 \times (\text{Pre-offer market price}) = (\text{Pre-offer market price})
\]

\[
0.72 \times (\text{Tender offer price}) + 0.14 \times (\text{Pre-offer market price}) = (\text{Pre-offer market price})
\]

\[
0.72 \times (\text{Tender offer price}) = 0.86 \times (\text{Pre-offer market price})
\]
them and make gains more likely by offering an exchange of stock in lieu of cash.\textsuperscript{146}

Carney's third argument for a higher reservation price is that some shareholders might suffer from the externalities of a successful takeover.\textsuperscript{147} For example, a shareholder-employee might be terminated, or a shareholder might face the costs associated with the closing of a local plant.\textsuperscript{148} The effect of takeovers on employees and local communities is beyond the scope of this paper, but the costs imposed appear to be relatively minor.\textsuperscript{149} In any event, these are not losses to target shareholders \textit{qua} shareholders. The fact that a shareholder is also an employee does not make the loss of the shareholder's job a shareholder loss any more than a firing of the shareholder-employee in the absence of a takeover would be a shareholder loss. Community losses associated with the closing of a local plant are not shareholder costs just as the gains to the community where the plant relocates are not shareholder gains.

Fourth, Carney argues that some shareholders might have emotional ties to the company which would make them reluctant to sell.\textsuperscript{150} He gives as an example shareholders who previously sold their business to the corporation for stock.\textsuperscript{151} It is unclear why an emotional attachment would exist in such a case. Those shareholders have already sold the business once despite the emotional ties. If they desire to maintain indirect ties with the business, they can use the proceeds of the tender offer to buy stock in the bidder.

Fifth, Carney argues that shareholders who paid a higher price for their stock, only to see its price drop (for example, those who bought a new issue in a bullish market), might be unwilling to recognize the loss that acceptance of the tender offer would entail;\textsuperscript{152} however, this proposition is economically irrational, as Carney apparently concedes.\textsuperscript{153} The initial purchase price is a sunk cost at the time of the tender offer, and the shareholder must choose between the tender offer price and the value of the company under current management. The original purchase price, however high, should not affect the current valuation of the shares. In addition, this theory requires that the price offered in the tender offer be less than the shareholder's initial purchase price. Given the size of average tender offer premiums, this is unlikely in most cases. This argument seems rather narrow, and Carney admits that he suspects "the majority of shareholders are not so attached to their shares."\textsuperscript{154}

\[(\text{Tender offer price}) = 1.194 \text{ (Pre-offer market price)}\]

Thus, the shareholder would gain after taxes if a 19.5% premium over the pre-offer market price were received. The required premium would be even smaller if tax payments are discounted back to the time that the premium is received.

\textsuperscript{147} Carney, \textit{Shareholder Coordination Costs}, supra note 128, at 356.
\textsuperscript{148} \textit{Id.}
\textsuperscript{149} For a general discussion of the effect of takeovers on employees and the community, see Bradford, supra note 1, at 529-34.
\textsuperscript{150} Carney, \textit{Fundamental Corporate Changes}, supra note 128, at 115 n.186.
\textsuperscript{151} \textit{Id.}
\textsuperscript{152} \textit{Id.}
\textsuperscript{153} \textit{Id.}
\textsuperscript{154} \textit{Id.}
Carney concedes that "all of these are relatively trivial explanations of differences between investors' valuations of the same securities." According to Carney, the most likely explanation for differences in reservation prices is that investors have different expectations concerning the future performance of the target company. He offers two plausible explanations for why shareholders might disagree with the market valuation of the target company. First, investors might have "different preferences or expectations in the long run versus the short run." Even if the market price accurately incorporates the future cash flows expected for the target, different investors might apply different discount rates to those expected cash flows. These discount rate differences could arise from differing personal needs, different investment alternatives, age differences, and a variety of other causes. With different discount rates, the present value to investors of the same stream of expected cash flows would vary, and hence, individual valuations of the stock would also vary.

This type of undervaluation argument fails for two reasons. First, it fails to consider the possibility of substitution. If the market discount rate is higher than that of an individual shareholder, it would be higher across the range of possible investments and not just with respect to the price of the target corporation's shares. A shareholder cashed out of his investment in the target at a loss could take his proceeds and put them in some other investment with similar cash flows and a similar market price. The loss from being cashed out of the target corporation would be offset by a corresponding gain when the shareholder acquired a substitute investment at a market price lower than his own valuation. The same conclusion results from viewing the shareholder's returns ex ante rather than ex post. If the shareholder's individual discount rate remained constant relative to the market discount rate, the shareholder also received a bargain when the shareholder acquired the target shares because their valuation exceeded the market price. This gain in surplus exactly offsets any loss incurred with the tender offer cash-out. An investor would have a net loss only if the investor's discount rate decreased drastically relative to the market rate after the shareholder acquired the target shares.

Carney's second explanation for shareholder disagreement with the market valuation is shareholders' perceptions that the market price is simply wrong—that target shares are undervalued by the market. Whatever the discount rate, shareholders determine the market is incorrect in its valuation of future cash flows. This is simply a variation of the misvaluation argument with the same problems noted in the earlier discussion of that argument.

Why do shareholders who value their shares at prices above the market price, and especially those who value their shares above the tender offer price,
not purchase shares at the lower price? If such purchases were made prior to the tender offer, the price would be bid up to the point at which a below-value tender offer could not be made. 

Alternatively, higher-valuing shareholders could make a competing tender offer in excess of the tender offer price but lower than their own valuation. Carney's response to this objection focuses on risk. 

Holding more of the target stock would decrease the diversification of the shareholders' portfolios, thus increasing the risk of their portfolios. The benefit of buying more stock (the difference between their individual valuations and the market price) may not exceed the cost to them in terms of the additional risk assumed. Each shareholder would purchase only to the extent that the marginal gain in valuation equals the marginal loss due to increased risk, and this is not necessarily the same point that market price equals individual valuation. The validity of Carney's response depends on both the company-specific risk of the target stock and the individual shareholder's risk-return tradeoff (how risk averse the shareholder is). For most publicly traded companies, it is hard to imagine a shareholder so risk averse that a market price more than fifty percent below the stock's individual valuation would not prompt additional purchases. However, without further evidence of risk-return tradeoffs, it is impossible to reject Carney's argument.

Professor Carney also argues that those who believe that the benefits exceed the risk might not possess sufficient resources to raise the market price to their private valuations. He might also have pointed out that the strategy of additional purchases does not work for some higher-valuing investors. For example, shareholders who value their shares at a higher price because of a low tax basis cannot correct that problem through additional market purchases. Those who value their shares at a higher price because of inside, nonpublic information cannot purchase additional shares without risking insider trading liability. Thus, although market purchases by higher-valuing shareholders partially solve the problem posed by Professor Carney, the solution is not complete.

Individually, none of Carney's arguments sufficiently justifies a target shareholder's rejection of the large premiums offered in tender offers. But what if the factors are aggregated? What about the shareholder-employee with access to significant nonpublic information who has a low tax basis, a low discount rate, and higher than average transaction costs? These factors, aggregated in a single shareholder, might justify a rational valuation higher than some tender offer premiums, but the losses suffered by the occasional shareholder who fits these criteria are likely to be small compared to the gains realized by the vast majority of other shareholders. Thus, overall gains to target shareholders in any given takeover would remain positive.

162. See Easterbrook & Fischel, supra note 40, at 726-27.
163. Carney, Shareholder Coordination Costs, supra note 128, at 356-57; Stout, supra note 122, at 688 n.373.
165. The position of such investors is asymmetrical. The securities laws prohibit additional purchases on the basis of undisclosed inside information, but do not prohibit these investors from holding existing shares without disclosing inside information.
Using the empirical research into tender offers, one can estimate the relative magnitude of shareholder surplus and shareholder loss. Assume that, prior to any action by the bidder, the target has one hundred outstanding shares trading at a market price of $100 per share.\textsuperscript{166} Prior to making a tender offer, the bidder purchases twelve percent of the target's stock in market purchases at the market price.\textsuperscript{167} Given the assumption of an upwardly sloping supply curve, these purchases will drive up the market price, but assume that the initial sellers will receive no gain because of rumors of an impending takeover. In other words, the market sellers capture no surplus above their initial reservation prices. After completing the initial market purchases, the bidder announces a tender offer for any or all of the target's remaining shares at a price of $155 per share, fifty-five percent above the pre-offer, pre-purchase price.\textsuperscript{168} Sixty percent of the target stock is tendered and purchased by the bidder, leaving the bidder holding seventy-two percent of the target stock at the conclusion of the offer.\textsuperscript{169} The remaining shareholders are then immediately cashed out at the same $155 per share price.\textsuperscript{170}

Two further assumptions are necessary. First, to test the heterogeneous valuation argument independently of the coercion argument, assume that shareholders were not coerced to tender. Second, for simplicity of analysis, assume that the target shareholders' supply curve is a straight line. Every dollar change in price produces the same change in the number of shares tendered no matter where one is on the supply curve. The resulting supply curve is shown in Figure D.

\textsuperscript{166} Neither of these numbers is crucial. One hundred is chosen as a starting point because it makes it easier to work with the percentages given in the empirical studies.

\textsuperscript{167} The empirical studies indicate initial holdings by the bidder in the 9-12% range. See Office of the Chief Economist, SEC, Tender Offers, supra note 48, at Table 9 (finding 13% for any-or-all offers); Bradley, Desai & Kim, Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms, 21 J. Fin. Econ. 3, 6 (1988) [hereinafter Bradley, Desai & Kim, Synergistic Gains] (finding 9.8%); Bradley, Desai & Kim, supra note 113, 188 (noting 12.81%); Comment & Jarrell, supra note 55 (finding 12.6% for any-or-all offers).

\textsuperscript{168} The studies of bid premiums are more varied, but 55% seems relatively conservative. Although Black and Grundfest observed an average premium of only 47.8%, Black & Grundfest, Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: $162 Billion Is a Lot of Money, 1 Continental Bank J. Applied Corp. Fin. 5 (1988), most studies indicate a higher figure. See, e.g., Office of the Chief Economist, SEC, Tender Offers, supra note 48, at Table 6 (noting a 59.6% bid premium for any-or-all offers); Herman & Lowenstein, The Efficiency Effects of Hostile Takeovers, Knights, Raiders & Targets: The Impact of the Hostile Takeover (J. Coffee, Jr., L. Lowenstein & S. Rose-Ackerman, eds. 1988) (finding 80%); Comment & Jarrell, supra note 55 (finding 57.4% bid premium for any-or-all offers).

\textsuperscript{169} Again, this is a relatively conservative estimate. The empirical studies indicate average purchases of from 58.8% to 75.1%. See Office of the Chief Economist, SEC, Tender Offers, supra note 48, at Table 9 (finding 73% in any-or-all offers); Bradley, Desai & Kim, Synergistic Gains, supra note 167, at 6 (finding 60.4%); Bradley, Desai & Kim, supra note 113, at 188 (finding 58.8%); Comment & Jarrell, supra note 55, at 295 (finding 75.1% in any-or-all offers).

\textsuperscript{170} Although somewhat unrealistic, this assumption is made to limit the potential coercion problem and to focus solely on the effect predicted by Carney. This assumption is relaxed later in this Article.
The surplus to the tendering shareholders is represented by the cross-hatched portion of the graph. The loss to non-tendering shareholders is represented by the shaded portion of the graph. Using simple geometry, one can calculate that the gain is approximately $1375 and the loss is approximately $300, resulting in an overall gain to all target shareholders of $1075.\textsuperscript{171} The average transaction, based on figures provided by empirical studies, is therefore Kaldor-Hicks.

\textsuperscript{171} The formula for the area of a right triangle is 1/2 its base times its height. The base of the gains triangle is 60 (72-12), and the base of the loss triangle is 28 (100-72). We can calculate the height of each triangle by estimating the slope of the supply curve:

\begin{align*}
\text{Slope} &= \frac{\text{Change in price}}{\text{Change in quantity}} \\
&= \frac{155-100}{72-0} \\
&= \frac{55}{72} \\
&= 0.7638889
\end{align*}

Every one-unit change in quantity is associated with a 0.7638889-unit change in price. Thus, since the horizontal quantity increase from point A to point B is 60, the vertical price increase must be $60(0.7638889) = 45.83333$. Since the horizontal quantity increase from point B to point C is 28, the vertical price increase must be $28(0.7638889) = 21.39$.

The overall shareholder gain (the area of the cross-hatched triangle) is then:

\begin{align*}
\text{Gain} &= 0.5(60)(45.83333) \\
&= 1374.99
\end{align*}

The overall shareholder loss (the area of the shaded triangle) is:

\begin{align*}
\text{Loss} &= 0.5(28)(21.39) \\
&= 299.46
\end{align*}

The net gain is the difference between these two figures.
efficient, looking at the tender offer only from the viewpoint of target shareholders. This conclusion holds even if one assumes a front-end loaded bid in which the second-tier premium is lower than the bid premium. Assume that the non-tendering shareholders are cashed out at a price of $140. This increases the loss to nontendering shareholders to $720, but still leaves an overall gain of $655.

Carney argues that a straight-line model like this understates the losses to high-valuing shareholders who do not tender. Carney argues that a more realistic supply curve would slope more steeply upward as it approaches the higher-valuing shareholders. A supply curve that is discontinuous at the point where the tender offer price intersects it approximates this change in slope. (See Figure E.) One can then ask how steep the supply curve of nontendering shareholders must be before the losses outweigh the gains in the average case.

The gain to tendering shareholders, whose supply curve has a slope of ap-

---

172. The SEC study indicates that second-tier premiums average 44.8%. Office of the Chief Economist, SEC, Tender Offers, supra note 48, at Table 7.

173. The loss to non-tendering shareholders is now the shaded triangle in Figure D plus a rectangle immediately below it 15 units high (155-140) and 28 units long (100-72). The area of this rectangle is simply the product of its height and its length: 420.


175. Id.
proximately 0.764, is approximately $1375. For the losses of high-valuing shareholders to exceed the gains of tendering shareholders, the slope of the high-valuing shareholders' supply curve must exceed 3.51.\footnote{176}

The net gain to shareholders may be even greater than indicated above because the assumption that the bidder can make market purchases without any information leaks appears unrealistic. If information about the upcoming takeover leaks before the market purchases are completed, shareholders selling in the market will demand a premium equivalent to the expected tender offer premium, discounted by the likelihood of failure. The initially selling shareholders, given leaks, will themselves capture surplus, increasing the overall shareholder gains.

The net gain is also likely to be even greater because the calculations above assume that all shareholders who do not tender place a higher value on the target shares than the tender offer price. In reality, there is evidence that some shareholders take no action regardless of the bid.\footnote{177} Some of the nontendering shareholders probably did so for these structural reasons and not because they placed a higher value on the target. Also, some of the nontendering shareholders may have refused to tender, not because they valued the stock higher than the offer price, but because they wanted to encourage an even higher bid or a competing offer, feeling that there was even more surplus to capture and mistakenly believing that enough of their fellow shareholders would also engage in this strategic behavior.\footnote{178} Non-tendering shareholders might also attempt to maintain a minority interest in the target corporation and to enjoy a free ride on gains expected from the bidder's operation of the target.\footnote{179}

The fact that shareholders gain in the average transaction does not mean that shareholders gain in all tender offers. Overall shareholder gains would decrease under the model presented as the percentage of the bidder's initial holdings increased, the blended premium decreased, and the amount of stock

\begin{align*}
\text{176.} & \quad \text{The area of the shareholder loss triangle is:} \\
& \quad \quad \text{Area} = (0.5)(\text{base})(\text{height}) \\
& \quad \text{The base of the triangle has a length of 28 (100-72). To solve for height so that the area equals 1375, the amount of gains to tendering shareholders is:} \\
& \quad \quad (0.5)(28)(x) = 1375 \\
& \quad \quad 14x = 1375 \\
& \quad \quad x = \frac{1375}{14} \\
& \quad \quad = 98.21 \\
& \quad \text{Thus, for losses to exceed gains, the slope of the high-value supply curve must be:} \\
& \quad \quad \text{Slope} = \frac{\text{Change in price}}{\text{Change in quantity}} \\
& \quad \quad = \frac{98.21}{28} \\
& \quad \quad = 3.51 \\
\text{177.} & \quad \text{Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, supra note 3, at 278 (statement of John Shad, Chairman of the SEC).} \\
\text{178.} & \quad \text{Of course, this is inconsistent with the coercion model described earlier. See supra notes 29-65 and accompanying text.} \\
\text{179.} & \quad \text{See Grossman & Hart, supra note 40, at 43.}
\end{align*}
tendered decreased (as long as the bidder still acquired enough stock to gain control). The SEC Office of the Chief Economist found that eleven percent of any-or-all offers and sixteen percent of two-tier offers involve blended premiums of less than twenty percent.\textsuperscript{180} Of course, with a lower premium and all else being equal, the amount tendered is likely to be less. Assume that a bidder manages to acquire twenty percent of the target's stock in market purchases before the takeover plan is discovered so that the price paid is unaffected by the impending tender offer.\textsuperscript{181} The bidder then offers a twenty percent premium for any-or-all of the target stock and receives an additional thirty percent, just enough to guarantee control.\textsuperscript{182} The tendering shareholders have a total gain of $180, and the higher-valuing, nontendering shareholders have a loss of $500, for an overall loss of $320.\textsuperscript{183} Such a transaction is not

\begin{wrapfigure}{r}{0.4\textwidth}
\centering
\includegraphics[width=\linewidth]{figureF}
\caption{Figure F}
\end{wrapfigure}

\begin{equation*}
\begin{align*}
\text{Change in price} & = 0.7638889 \\
\text{Change in quantity} & = 0.7638889 \\
\text{Change in quantity} & = 0.7638889(\text{Change in quantity}) \\
\text{Change in quantity} & = 0.7638889
\end{align*}
\end{equation*}

This Article will assume that the bidder gets the desired control and acquires 30% of the stock.

\textsuperscript{183} Graphically, this offer looks like this:

The slope of this supply curve is $20/50 = 0.4$. Thus, the height of segment $A$ is $30 \times 0.4$
Kaldor-Hicks efficient;\textsuperscript{184} however, over seventy percent of any-or-all or two-tier offers involve premiums in excess of forty percent, and a larger percentage of offers have premiums greater than eighty percent than those having premiums of less than twenty percent.\textsuperscript{185} Since we are dealing in percentages, the possibility exists that small losses for big companies could dwarf large percentage premiums in offers for small companies, but no evidence supports this possibility. It appears that, on average, tender offers are Kaldor-Hicks efficient and result in overall gains to target shareholders, even assuming an upward-sloping supply curve.

On closer examination, Professor Carney's argument is not against tender offers; it is against the long-standing notion of corporate governance by majority rule. In Professor Carney's words,

\begin{quote}
[t]he long and painful development of the law of fundamental corporate changes . . . has been designed to assure majority rule and to provide methods for bringing the minority along or at least making certain that they do not frustrate the desires of the majority. To conclude that these transactions, accomplished over the objections of some minority stockholders, have all of the benefits of freely bargained exchanges involves an unwarranted leap.\textsuperscript{186}
\end{quote}

Professor Carney's argument, to the extent that it holds, is not limited necessarily to fundamental changes to the corporation. An organized majority with control of the board could make operational decisions that benefit the majority at the expense of higher-valuing shareholders. Viewed in this light, it is unclear that Professor Carney's thesis points to any prescriptions for corporate takeover policy. If higher-valuing shareholders can suffer such losses even in the absence of a takeover, the effect of the takeover is indeterminate. One cannot know whether higher-valuing shareholders are better or worse off than they would have been. Also, if such losses are likely, higher-valuing shareholders should demand a risk premium when they purchase their shares to compensate them for the expected takings by the minority. This risk premium would fully compensate them \textit{ex ante} for any losses they would expect to incur in a takeover.

\begin{itemize}
\item \textsuperscript{12} The height of segment B is $50 \times 0.4 = 20$.
\item The total gain to tendering shareholders is:
\[
\text{Total Gain} = (0.5)(30)(12) = 180
\]
\item The total loss to nontendering shareholders is:
\[
\text{Total Loss} = (0.5)(50)(20) = 500
\]
\item The net loss to all shareholders is the difference between these two figures: $500 - 180 = 320$.
\item \textsuperscript{184} A resource allocation is Kaldor-Hicks efficient "if, and only if, welfare gains on tendered shares are not exceeded by welfare losses to shareholders on those shares subsequently taken by merger." Carney, \textit{Shareholder Coordination Costs}, supra note 128, at 344.
\item \textsuperscript{185} Office of the Chief Economist, SEC, \textit{Tender Offers}, supra note 48, at Table 5. Twenty-four percent of any-or-all offers and 10% of two-tier offers had blended premiums in excess of 80%.
\item \textsuperscript{186} Carney, \textit{Fundamental Corporate Changes}, supra note 128, at 110.
\end{itemize}
V. THE BARGAINING ARGUMENT

Unlike the arguments presented so far, the bargaining argument does not deny that tender offers produce net gains to target shareholders. The bargaining argument recognizes that gains occur, but questions their allocation between the hostile bidder and target shareholders.\(^{187}\) The bidder wants to acquire the target company to produce gains that result from synergy or the displacement of inefficient target management. Even in an efficient market, the bidder can offer a premium because the value of the target to the offeror is greater than the discounted value of future earnings if the company is not sold. In the words of Professor Leebron:

The sale value \(S\) can be viewed as a function of the acquisition value \(A\), . . . the value of the corporation in the hands of the acquirer (or alternatively the maximum price an acquirer should be willing to pay). The bidder presumably is willing to pay any amount up to \(A\), and the target corporation (or its shareholders) presumably is willing to accept any amount greater than \(D\) [the discounted value of future earnings if the target is not sold]. The difference between \(A\) and \(D\) represents the gain arising from the acquisition. If all the gains from the combination are paid as a premium to the shareholders of the target, then \(S\) will be the same as \(A\). If the gains are divided, then \(S\) will be less than \(A\) and will depend on how the gains are distributed between the acquiring and acquired corporations. If none of the gains are allocated to the acquired corporation, then \(S\) will be no greater than \(D\), and the price of the shares of the corporation will in effect reflect only their dividend value.\(^{188}\)

The bargaining theorists do not claim that the existing investment of the target shareholders is undervalued; they claim that "the market price does not reflect value which may arise from the acquisition, and that the shareholders of the acquired company are entitled to some, or perhaps even all, of that value."\(^{189}\) Target shareholders might rationally want to reject a bid above their pre-offer valuation of the target because they believe they could receive an even higher bid either from the same bidder or a competing bidder.\(^{190}\) Unlike the sole owner of a business who might negotiate for a better deal, they are hindered by a collective action problem and the coercion inherent in tender offers.\(^{191}\) Thus, the bargaining argument concludes that target shareholders receive less for their shares than they might if they had the power to negotiate with the bidder.

---

187. See authorities cited infra notes 189-91.
188. Leebron, supra note 31, at 170.
189. Id. at 174.
The bargaining argument appears incompatible with the empirical evidence, which indicates that target shareholders capture a predominant amount of the gains associated with takeovers. Most recent studies have found either negligible or negative cumulative abnormal returns to bidding firms in tender offers. Mitchell and Lehn found a statistically significant abnormal return of -0.21% on the date the tender offer was announced, but no returns were significantly different from zero in any other period after the tender offer commenced. Magenheim and Mueller found no significant abnormal returns to bidding firms in tender offers regardless of the baseline price used. Bradley, Desai, and Kim reported statistically significant positive returns to successful bidders over the period of 1963-1984, but the amount of those returns was small, only 0.97%. They also found that returns to successful bidders were decreasing over time. Bidders earned statistically significant positive returns of 4.09% in 1963-1968, returns insignificant from zero in 1968-1980, and statistically significant negative returns of -2.93% in 1981-1984. Varaiya and Ferris report a statistically significant average negative abnormal return to bidders of -3.9%. Using the total excess returns to target shareholders and bidder shareholders as an approximation of the value created by the transaction, they calculate that on average the premium offered is 73.8% above the bidder's break-even point. Varaiya estimates that each successful bidder loses an average of $83.8 million. These are not the kinds of returns to bidders that the bargaining argument supposes. It is difficult to imagine negotiation resulting in better average results to target shareholders.

Of course, these averages do not mean that individual bidders never gain in tender offers. Only 46.8% to 57.3% of the acquiring firms in the Mitchell and Lehn study had negative cumulative abnormal returns. Approximately

192. See infra text accompanying notes 193-205.
195. Bradley, Desai & Kim, Synergistic Gains, supra note 167, at 11, Table 2.
196. Id. at 11, 13.
197. Id. For arguments explaining why bidders might overpay in takeovers, see Black, Bidder Overpayment in Takeovers, 41 STAN. L. REV. 597, 623-34 (1989); Roll, The Hubris Hypothesis of Corporate Takeovers, 59 J. BUSINESS 197 (1986).
198. Varaiya & Ferris, Overpaying in Corporate Takeovers: The Winner's Curse, FIN. ANALYSTS J., May-June 1987, at 64, 66. The Varaiya and Ferris study includes both mergers and tender offers. Magenheim and Mueller find lower bidder returns for mergers than for tender offers, Magenheim & Mueller, supra note 194, at 181, so the Varaiya & Ferris study may not be directly comparable.
199. Varaiya & Ferris, supra note 198, at 65.
200. Varaiya, The "Winner's Curse" Hypothesis and Corporate Takeovers, MANAGERIAL & DECISION ECON. 209, 214-15 (1988). The 91 acquisitions Varaiya examines include 51 mergers, id. at 213, so these results may not be directly comparable to those that look only at tender offers.
201. M. MITCHELL & K. LEHN, supra note 193, at 36. The exact percentage depends on the period over which cumulative, abnormal returns (CARS) are calculated. Of all bidders, 57.3% had negative CARS on the announcement date, 50.2% during the period from five days before to one day after the announcement date, and 46.8% during the period from five days before to 40 days after the announcement date.
Stampeding Shareholders

fifty-eight percent of the acquiring firms in the Varaiya and Ferris study\textsuperscript{202} and sixty-seven percent of those in the Varaiya study overpaid.\textsuperscript{203} The average return figures clustering around zero mask a significant dispersion among bidders. The cumulative excess returns to the overpayers in the Varaiya and Ferris study averaged \(-14\%\), whereas the average returns to the 42\% of the bidders who did not overpay were a positive 13.4\%.\textsuperscript{204} however, positive bidder returns do not make those tender offers detrimental to target shareholders. Bidders receive some of the gains associated with some tender offers, but target shareholders receive some of those gains as well. Varaiya indicates that the excess returns to target shareholders average \$93.5 million and are positive in eighty-seven percent of all the acquisitions he studied.\textsuperscript{205}

VI. Competition and Bargaining Power

One reason why target shareholder gains might approximate the negotiated solution is because of competition among bidders. Returns to target shareholders can be affected both by actual competition and by potential competition. If there is another potential bidder to whom the target is more valuable, that other bidder could be expected to come forward with a higher offer rather than let the first bidder succeed.\textsuperscript{206} Assume that the pre-offer market price of the stock is \$100 per share. Offeror \textit{A} makes a tender offer for fifty-one percent of the stock at a price of \$130 per share and announces a cash-out of the remaining forty-nine percent of the shareholders at a price of \$100 per share. The blended price is approximately \$115 per share. Assume, in accordance with the misvaluation thesis, that for some reason the pre-offer price was below the true value of the target in the hands of existing management and that its actual value is \$125 per share. The target shareholders would prefer to reject the below-value offer, but, according to the misvaluation theorists, they would be coerced to accept the offer;\textsuperscript{207} however, a competing bidder would find it profitable to make an offer with a blended price greater than \$115 per share but less than \$125 per share. Competition in the market would dissipate the difference between the true value of the firm and the price offered to the shareholders until the two-tier, blended price equalled or exceeded the shares' true value. Even if the company was worth \$125 per share only in the hands of existing management, competition would still exist. Management would have an incentive to outbid Offeror \textit{A} by means of a management buyout. Alternatively, other investors would find it worthwhile to buy the stock and leave the existing management in power. Competition should drive the bid price to a point at which shareholders could not rationally expect a higher price.

\begin{itemize}
\item \textsuperscript{202} Varaiya & Ferris, \textit{supra} note 198, at 65.
\item \textsuperscript{203} Varaiya, \textit{supra} note 200, at 214-15.
\item \textsuperscript{204} Varaiya & Ferris, \textit{supra} note 198, at 66.
\item \textsuperscript{205} Varaiya, \textit{supra} note 200, at 214-15.
\item \textsuperscript{206} But cf. D. Hirschleifer & I. Peng, \textit{Facilitation of Competing Bids and the Price of a Takeover Target} (U.C.L.A. Graduate School of Management Business Economics Working Paper \#87-10, Dec. 14, 1988) (arguing that, when bidding is costly, the price at which the target is sold may be well below the minimum of the bidders' valuations less the bidding cost).
\item \textsuperscript{207} See \textit{supra} text accompanying notes 66-67.
\end{itemize}
The Williams Act provides a minimum delay period of twenty business days for competing bids to arise, and existing management has broad discretion under existing law to solicit additional bids. The Williams Act delay period is often sufficient to bring forth competing bids, and no evidence exists that it is ever insufficient.

Misvaluation theorists often point to situations in which an initial bid is rejected and shareholders later receive a higher bid. Three responses are appropriate. First, a later, higher bid is more valuable to target shareholders only if it exceeds the present value of the initial bid. Because of the delay between the bids, this is often not the case. Second, the existence of these situations provides evidence that shareholders are able to reject inadequate initial bids. Finally, such arguments often fail to account for general price changes during the time separating the two bids. A superficially higher second bid may not be higher, in real terms, than the initial bid.

The number of tender offers that involve multiple bidders has increased although scholars differ as to the exact magnitude of the increase. Bradley, Desai, and Kim report that the relative frequency of multiple bidder contests increased from eighteen percent of all offers in 1963-1968, to thirty percent in 1968-1980, and to forty-six percent in 1981-1984. Walkling and Long report that twelve percent of the cash tender offers they studied in 1972-1977 involved multiple bidders, but their methodology probably understates this number. They classify an offer as multiple-bidder only if an opposing bidder existed at the time the bidder filed its last bid revision. This understates competition because competitors may drop out before the final bid is made. Guerin-Calvert, McGuckin, and Warren-Boulton report that the percentage of multiple bidders rose from 8.5% prior to the Williams Act to 15.15% after

---

208. See Leebron, supra note 31, at 194; Lehn, Blackwell & Marr, supra note 84, at 183-84; Lowenstein, supra note 16, at 307.
210. Challenges to management’s power to seek competing bids, in the absence of any tactics designed to favor one bid or another, are virtually nonexistent. Takeover cases focus on the validity of defensive tactics which favor one bidder over another; the ability of management to solicit competing bids is unquestioned and often implicitly affirmed. See, e.g., Hanson Trust PLC v. MSLMC Acquisitions, 781 F.2d 264, 274 (2d Cir. 1986) (noting that lockup options may be beneficial to shareholders if they induce competing bids); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286 (Del. 1988) (noting the benefit of lockout options); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986) (noting the benefit of lockout options); Smith v. Van Gorkom, 488 A.2d 858, 878-80 (Del. 1985) (active solicitation of competing bids might have excused the directors’ failure to make an informed judgment in accepting the buyout offer). Revlon imposes a duty on directors to get the best possible price once a decision to sell the company is made. Revlon, 506 A.2d at 182. The most obvious way to fulfill that duty is to solicit competing bids.
211. Bebchuk, The Pressure to Tender, supra note 45, at 929.
212. Bradley, Desai & Kim, Synergistic Gains, supra note 167, at 29. Bradley, Desai, and Kim classify a contest as multiple-bidder if a second bidder’s name is mentioned in the press and that bidder engages in at least one of the following activities: “(1) making a formal tender offer or merger proposal, (2) negotiating a merger possibility with the target management, or (3) announcing its plans to make a bid.” Id.
214. Id.
the Act and rose even higher in states which regulated tender offers.\textsuperscript{215} The authors of a Note published in the Yale Law Journal studied not only contests involving multiple bidders, but also contests involving multiple offers by a single bidder.\textsuperscript{216} They reported an incidence of multiple bids in the fifteen to twenty-two percent range and an incidence of auctions in the nine to twenty-six percent range, depending on the time period and whether the target’s state of incorporation had a second generation takeover statute.\textsuperscript{217}

Each of these studies of competition examined both hostile and friendly offers. A better measure of competition limited to hostile offers is provided by Professor Jarrell.\textsuperscript{218} Professor Jarrell examined offers for 103 targets that filed lawsuits in response to the offer.\textsuperscript{219} This presents a good proxy for hostile offers because the vast majority of hostile offers involve defensive litigation by the target; the target is unlikely to file a lawsuit in response to an initially friendly offer.\textsuperscript{220} Professor Jarrell found that over sixty-two percent of such offers involved an “auction,” defined as a substantially higher offer by the same bidder or a competing offer by another bidder.\textsuperscript{221} In contrast, only eleven percent of the nonlitigious targets were involved in auctions.\textsuperscript{222} Thus, there seems to be even greater competition in hostile offers than in friendly offers. This difference may be more apparent than real because, in friendly deals, negotiations between bidders and targets can substitute for competitive bidding.\textsuperscript{223}

Bebchuk contends that the initial offeror may have a strategic advantage that would inhibit other bids and therefore lower the price paid to target shareholders.\textsuperscript{224} He offers the following example:

[C]onsider a case in which both A, the first bidder, and B, another potential offeror, value the target . . . [at] . . . $X per share, and B is aware of A’s valuation of the target. A has already incurred the transaction costs involved in making a tender offer, and now

\textsuperscript{216} Note, supra note 62, at 1219.
\textsuperscript{217} The percentage of multiple bids by the same bidder increased from 15.38% to 22.22% in states that adopted second generation statutes and decreased from 19.05% to 15.38% in states without second generation statutes. The percentage of auctions (multiple bidders) decreased from 26.92% to 19.44% in states that adopted second generation statutes and increased from 9.52% to 20.51% in states without second generation statutes. Id.
\textsuperscript{218} Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?, 28 J.L. Econ. 151 (1985).
\textsuperscript{219} Id. at 160.
\textsuperscript{220} Professor Rosenzweig found that target lawsuits followed the announcement of the tender offer in 60 of 95 initially hostile bids in the period from 1982 to 1985. Rosenzweig, Target Litigation, 85 Mich. L. Rev. 110, 114 (1986). Comparing his data to Jarrell’s, he concludes that targets almost always sue bidders as a defensive response to unwanted offers. Id. at 115. Rosenzweig also quotes a letter from Jarrell equating litigation with hostility. Id. at 115 n.20.
\textsuperscript{221} Jarrel, supra note 218, at 160-61.
\textsuperscript{222} Id.
\textsuperscript{223} See Office of the Chief Economist, SEC, Tender Offers, supra note 48, at 18 (noting no substantial differences between negotiated and non-negotiated offers in bid premium received).
\textsuperscript{224} Bebchuk, supra note 191, at 1036 n. 45.
B is considering whether to make these expenditures and advance a rival bid. Because the transaction costs involved in A's bid are sunk, A will be prepared to raise its bid for the target to anything less than $X per share. Thus, to win a contest over the target, B will have to bid $X per share in addition to spending the transaction costs involved in making a bid. Consequently, B's rational decision will be not to enter into a contest with A, even though B's valuation of the target is the same as A's. 225

There are two problems with this argument. First, Bebchuk assumes that the second potential bidder knows the first bidder's valuation of the target. This is unlikely because the tender offerors' valuations of the target company are closely guarded and hard to estimate. If B is not aware of A's valuation, it makes perfect sense for B to bid in the hope that A places a lower value on the company than B does. Second, Bebchuk assumes that both bidders place the same value on the target. 226 If B's valuation is higher than A's by at least the amount of the transaction costs involved in making a second bid, B would bid even if B knows A's valuation.

The empirical evidence shows that, on average, the best proposal wins when competition arises. A study conducted by the Office of the Chief Economist of the SEC concluded, contrary to the arguments of some scholars, 227 that during the 1981-1984 time period surveyed, "no (non-negotiated) partial or two-tier tender offer beat any (unenjoined) any-or-all tender offer or merger proposal offering a higher premium." 228 Professor Ruback found that, in most of the forty-eight multiple bidder tender offers which he studied, the unsuccessful bidder could not have outbid the winning bidder without a loss to the unsuccessful bidder. 229 In twenty-nine of the contests that he studied, a higher offer unambiguously would have caused a loss to the unsuccessful bidder; 230 however, if it was assumed that the market believed that the probability of the initial bid's success was greater than fifty percent, a higher offer in an additional twelve cases would have caused a loss to the unsuccessful bidder. 231 The initial positive abnormal return to the unsuccessful bidder would have justified a higher offer than the successful bidder's offer in only seven cases. 232

Failure to observe more than one bidder in contests for control does not necessarily mean that shareholders are receiving a lower price in an uncompetitive market. The threat of competition may have forced the lone bidder to make a pre-emptive bid high enough to make an offer unprofitable to potential competitors. A high-valuing bidder has an incentive to make a high

225. Bebchuk, supra note 191, at 1036 n.45; accord, Carney, Shareholder Coordination Costs, supra note 128, at 370-72.
226. See supra text accompanying note 225.
228. OFFICE OF THE CHIEF ECONOMIST, SEC, TENDER OFFERS, supra note 48, at 22-23.
230. Id. at 150.
231. Id. at 151.
232. Id. at 150.
initial pre-emptive bid to discourage competition, avoid the transaction costs of a bidding war, and encourage shareholders not to hold out.\textsuperscript{233} An actual opposing bid would arise only when the first bidder’s offer was too low.

The evidence on this question is mixed. Bradley, Desai, and Kim found that the average initial abnormal returns to target shareholders were approximately equal in situations in which another person later bid and those in which no other bidder came forward.\textsuperscript{234} As Bradley, Desai, and Kim point out, “\textit{[t]hese findings are not consistent with the alternative hypothesis that multiple-bidder contests arise because the initial bid was too low.}”\textsuperscript{235} In his study of litigious targets, however, Jarrell found that those targets ultimately involved in an auction received significantly lower initial premiums than those which received only a single bid.\textsuperscript{236} He concludes that “\textit{[t]he lack of auctions for this latter group could be caused in part by the higher initial premiums, which would deter potential competition from other bidders.}”\textsuperscript{237} One possible explanation of the difference in these studies is that Jarrell, focusing on litigious targets, is looking only at initially hostile bids whereas Bradley, Desai, and Kim include friendly deals. Prior negotiation of friendly offers may raise returns to a competitive level before the bid is announced whether or not another bid is made. Given the greater number of negotiated offers, the effect of low bids in hostile offers could be masked.\textsuperscript{238}

The empirical studies also disagree as to the effect of competition on target shareholder returns. Bradley, Desai, and Kim find that the cumulative abnormal returns to target shareholders after forty days are almost twenty percent higher in multiple-bidder contests than in single-bidder contests.\textsuperscript{239} They admit that some of this difference may result from timing differences between the two categories.\textsuperscript{240} Nevertheless, they conclude, “\textit{Clearly, target shareholders earn greater returns from multiple-bidder contests than from single-bidder offers.}”\textsuperscript{241} This is also consistent with their finding that bidders’ shareholders earn higher returns in single-bidder offers than in multiple-bidder contests.\textsuperscript{242} Regression results of both Walkling and Long, and Varaiya and Ferris also


\textsuperscript{234} Bradley, Desai & Kim, \textit{Synergistic Gains}, \textit{supra} note 167, at 22.

\textsuperscript{235} \textit{Id.} at 22.

\textsuperscript{236} Jarrell, \textit{supra} note 218, at 165.

\textsuperscript{237} \textit{Id.}

\textsuperscript{238} Another possibility lies in their respective definitions of competition. Jarrell’s definition of auction includes both multiple bidders and multiple bids by a single bidder. The definition of Bradley, Desai, and Kim includes only multiple bidder offers; however, Bradley, Desai, and Kim report that changing the focus to the number of bids rather than the number of bidders does not significantly affect their results. Bradley, Desai & Kim, \textit{Synergistic Gains}, \textit{supra} note 167, at 20 n.17.

\textsuperscript{239} \textit{Id.} at 21, Table 3.

\textsuperscript{240} They find a drop in the price of any outstanding target shares after the execution of the tender offer. Since 73% of single-bidder bids are executed within the 40-day period, but only 44% of multiple-bidder contests, the differences on day 40 may in part reflect this post-execution drop. \textit{Id.} at 22 n. 18.

\textsuperscript{241} \textit{Id.} at 22.

\textsuperscript{242} \textit{Id.} at 29.
indicate substantial shareholder gains from competition. Walking and Long found that premiums average 33.5% higher in multiple-bidder contests. Varaiya and Ferris found that the presence of multiple bidders was associated with a statistically significant 26.5% increase in premiums; however, the presence of other bidders had no significant connection to the amount of overpayment by the bidder. Jarrell also found gains in auction situations as the auctions developed, but these gains merely cancelled out the initial disparity he found between auction and non-auction initial bids, leaving the auction and single-bid portfolios relatively equal. In addition, a regression by Pound, which examined the relationship between premiums and the number of bidders, found only a marginally significant, relatively unimportant effect.

The argument that shareholders are coerced into accepting unprofitable, below-value tender offers also disregards the presence of institutional investors and arbitrageurs, who purchase substantial positions from existing shareholders after the tender offer is made. Large institutional owners hold sufficient blocks of stock in major corporations to prevent a takeover, or at least make one very difficult. In a 1987 sample of New York Stock Exchange securities, it was found that pension funds, mutual funds, and other institutional investors owned a majority in thirty-eight percent of the firms and owned more than forty percent of the securities in fifty-eight percent of the firms; furthermore, the number of pension funds, mutual funds, and other institutional investors is few enough that a coordinated response to an unwanted tender offer is possible. In most cases, twenty or fewer funds make up those percentages. The largest holders have both the incentive and the power to respond forcefully to takeovers. In large corporations, the largest institutional holder often owns more than five percent of the stock, and the five largest institutional holders usually own more than ten percent. Some studies have found that institutional ownership is lower on average for target firms than for the market as a whole. These numbers are misleading because purchases by arbitrageurs, when tender offers are made, increase the power of the large owners. Frequently,

243. Walking & Long, supra note 62, at 60-61. This result is significant at the 0.10 level.
244. Varaiya & Ferris, supra note 198, at 67.
245. Id. at 67-68; accord, Varaiya, supra note 200, at 215-16.
247. J. POUND, supra note 57, at 11-12, 21.
249. Id.
250. As of 1969, in 125 companies with a market value exceeding $500 million, the largest institutional holder owned 5% or more of the stock in 44.8% of the companies; the five largest institutional investors owned 10% or more in 72.0% of the companies. E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 141-42 (1981). For companies with a market value in the $100-249 million range, the equivalent percentages were 43.2% and 58.5%. Id. Shleifer and Vishny surveyed 456 of the Fortune 500 companies for 1980 and found that 354 of them had at least one shareholder who owned 5% or more of the firm. Shleifer & Vishny, Large Shareholders and Corporate Control, 94 J. Pol. Econ. 461, 462 (1986). The average holding for the largest shareholder was 15.4%, and the average holding of the five largest shareholders was 28.8%. Id.
251. Professor Pound found that a sample of 100 takeover targets had an average institutional ownership of 22.2% compared to the market average of 35%. J. POUND, supra note 57, at 5. A study by the Office of the Chief Economist of the SEC found similar results. The average institutional ownership in 177 target firms was 19.3% compared to an average of 33.7% for industry control groups. OFFICE OF THE CHIEF ECONOMIST, SEC, INSTITUTIONAL OWNERSHIP, supra note 95, at 10.
institutions and arbitrageurs end up with more than fifty percent of the target "and thus have the ability to determine its destiny." Arbitrageurs serve a valuable risk-taking function, allowing risk averse shareholders to sell at a favorable price without incurring the risk that the tender offer will not succeed. They also help protect against coercion of the target's shareholders. The coercion argument is premised on the inability of target shareholders to coordinate their response and negotiate with the offeror. Arbitrageurs, in concert with institutional investors, have much greater bargaining power and much lower costs of coordination and cooperation. Their cooperative response to tender offers makes coercion less likely.

Pound found no significant relationship between the size of takeover premiums or the defeat of takeovers and the level of institutional ownership; however, this result is difficult to interpret. It may be that a high level of institutional ownership does not correct for any coercion problem, or it may be that there is no remaining coercion problem for institutional ownership to protect against. It is also possible that Pound focuses on the wrong statistic. What is important for bargaining purposes is not the level of institutional ownership prior to the takeover but the level of ownership of both institutions and arbitrageurs during the takeover. If, when a takeover occurs, arbitrageurs and institutions buy a large percentage of the stock of companies with low institutional ownership, there really is no difference in terms of bargaining power. The evidence indicates that the size of the tender offer bid premium has a significant, positive influence on the outcome of the bid. Far from being coerced, target shareholders seem quite able to reject two-tier offers when they want. Only 47.4% of all two-tier offers initiated in 1978-1984 succeeded, as opposed to 74.2% of any-or-all offers. These results make sense only if target shareholders have some meaningful bargaining power and can reject unfavorable bids.

VII. POLICY IMPLICATIONS

The foregoing analysis demonstrates the invalidity of the argument that target shareholders are unfairly treated or coerced in hostile takeovers. Although

---

252. Lipton, supra note 4, at 114.
253. Gilson, supra note 52, at 855-56; Easterbrook & Fischel, supra note 72, at 1744.
254. There are a smaller number of such investors, and each has a large stake in the outcome, which makes collective action more likely. See M. Olson, supra note 33.
255. Professor Bebchuk's arguments on this point are somewhat inconsistent. He argues that the intervention of arbitrageurs and other buyers should not matter because, no matter how many times the shares change hands, whoever holds them at the moment of truth is faced with the same coerced decision. Bebchuk, supra note 14, at 1727. In an earlier work, however, he admitted that the existence of large shareholders who could take into account the effect of their tender decision on the success of the offer would strengthen the bargaining position of the target's shareholders. Bebchuk, supra note 191, at 1040.
256. J. Pound, supra note 57, at 7-14.
there may be a few such cases, the great majority of hostile tender offers result in large gains to target shareholders. The argument made so far assumes the existing legal and structural regime without describing what that regime is or how it affects target shareholders. It might be argued that target shareholder returns are high only because management resistance or state antitakeover statutes force bidders to compensate target shareholders fairly. The evidence presented earlier in this Article might be seen as a reaffirmation of the value of such defensive tactics rather than proof that the unrestricted tender offer process works. Although this Article does not discuss fully the arguments against management resistance or state takeover statutes, a brief look suffices to cast doubt on the idea that these tactics are causing target shareholder gains.

A. Target Management Resistance

Many of the available studies show that opposition by target management has no significant effect on the premiums paid to target shareholders. In the tender offers studied by Walkling and Long, bid premiums were 48.8% in uncontested offers and 45.5% in contested offers. In a multiple regression, Walkling and Long found no significant relationship between target management opposition and bid premiums. The SEC's Office of the Chief Economist and Comment and Jarrell similarly found no significant differences between the average blended premiums in negotiated and unnegotiated offers. Comment and Jarrell concluded that, "[i]growing partial offers, . . . the shareholder wealth effects of tender offers do not materially depend on whether the offer is . . . negotiated or unnegotiated, either initially or at execution."  

Professor Jarrell, in his study of litigious targets, found a much higher percentage of auctions for litigious targets than for uncontested offers—sixty-two percent versus eleven percent. These auctions produced a substantial seventeen percentage point gain over the abnormal returns associated with the initial offer; however, these gains appear to result from the competition inherent in an auction rather than from management resistance. When no auction developed, management resistance caused no substantial change in the abnormal returns associated with the offer. Jarrell found auctions occurring when the initial bid was low, and it seems probable that target management resistance is more likely to develop in these low bid cases. One cannot definitely say that management resistance creates the auction. Viewed in this light, Jarrell's finding is simply consistent with the Walkling and Long finding that competing bids were associated with higher premiums. Management resistance may have

260. Id. at 60.
261. OFFICE OF THE CHIEF ECONOMIST, SEC, TENDER OFFERS, supra note 48, at 18, Table 4c; Comment & Jarrell, supra note 55, at 297.
262. Comment & Jarrell, supra note 55, at 299.
264. Id. at 165-71.
265. Id. at 167.
266. Id.
267. See Walkling & Long, supra note 62, at 60.
Stampeding Shareholders

little to do with it. A similar problem affects the Lipton and Steinberger observation that, in fifty-one percent of all contested offers, the target is eventually acquired by the original bidder or a white knight at a higher price than the initial bid. 268 Without a comparative statistic indicating what happened in uncontested offers, this percentage is virtually meaningless.

Even if management opposition produces higher premiums for target shareholders in some cases, there are countervailing considerations. The possibility of management opposition, by lowering the probability of a successful offer and raising the cost of the offer, would undoubtedly deter some positive-value takeovers from occurring. 269 Jensen and Ruback hypothesize that any higher average returns associated with management resistance could merely be the product of the reduced incidence of offers:

For example, the higher returns could arise because only the more highly profitable takeovers are pursued when bidders believe managerial opposition will lower the probability of success and raise the expected costs. If managerial opposition simply raises costs, bids will be lower than they would be otherwise and low profit takeovers would not occur . . . [T]his truncation of the distribution of takeovers would raise the measured average profitability of manager-opposed takeovers. 270

For the same reason, management opposition makes a hostile tender offer less likely to succeed. Walkling and Long found a statistically significant negative relationship between management opposition and the success of a takeover bid. 271 The average success rate for offers they studied that were contested by target management was thirty-seven percent, compared to eighty-eight percent for uncontested offers. 272 Similarly, although the twenty-one contested offers at which Kummer and Hoffmeister looked offered higher premiums than the uncontested offers, fifteen of those had not been completed within ten months of the offer. 273

Target shareholders obviously do not gain if a beneficial offer is never made or fails. Studies by Professors Dodd, Ruback, and Yen have found evidence even more damaging to the proposition that managerial resistance creates shareholder gains. Professor Ruback found that the announcement that a corporate control contest was being unsuccessfully terminated resulted in a two-day abnormal loss of 10.69%. 274 Abnormal returns were negative in ninety-one percent of the cases he studied. He concluded that "the significant stock

269. See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1174-82, 1188-90 (1981). Easterbrook and Fischel's conclusion that all resistance by target management should be prohibited has been strongly challenged by others. See, e.g., Bebchuk, supra note 191; Gilson, supra note 52; Oesterle, supra note 191.
272. Id. at 63.
274. Ruback, supra note 229, at 150-52.
price decline at the termination announcement suggests that the expected value of the failure is negative and therefore not in the interests of the existing stockholders.” 275 Professor Dodd studied 151 merger proposals during the period of 1971-1977 and found that target managements’ termination of such proposals resulted in a two-day abnormal return to shareholders of $-5.53%.276 In a study of merger proposals during the period of 1971-1980, Professor Yen found that when the target’s management accepted the proposal, the average wealth gains to shareholders were significantly higher than the gains experienced by shareholders in those cases in which management rejected the proposal.277 Average abnormal returns were 38.92% for the accepting group and only 11.34% for the rejecting group.278 Furthermore, when Yen looked at the value target shareholders would have received if the merger had been accepted, he found that it was a statistically significant 3.2 times greater than the actual returns when management rejected the proposal.279 He concludes: “The comparisons suggest that shareholders would realize a larger wealth gain had the rejected merger proposals been accepted. The results suggest that top managers are engaged in wealth-reducing resistance.” 280 Thus, the net effect of management resistance is indeterminate, even if it does result in higher premiums.

These general results hold when poison pills, one of the most popular and effective forms of target defense, are examined separately. Malatesta and Walkling studied 132 firms adopting poison pill defenses in the period 1982-1986.281 They found statistically significant abnormal stock price returns of from $-0.9% to $-1.3% when such plans were announced. This represents a wealth loss to shareholders of $21 million to $29 million.282 The abnormal loss was even greater—2.3%—when they limited their inquiry to firms already subject to takeover bids.283 Ryngaert found that the adoption of poison pill plans had no significant effect on stock prices across his sample of 380 firms; however, when such plans were adopted by firms already subject to takeover speculation for which there were no confounding events, the announcement of poison pills resulted in a statistically significant abnormal loss of 1.51%.285 Ryngaert also found that market prices reacted to court decisions upholding or invalidating poison pills.286 Pro-management decisions were accompanied by a statistically significant average excess return of $-2.23% compared to a

275. Id. at 150.
278. Id.
279. Id. at 262.
280. Id.
282. Id. at 360.
283. Id. at 362.
284. Id. at 392.
285. Id. at 404-05.
positive average excess return of 3.36% for pro-bidder decisions. Finally, contrary to prevailing notions, Ryngaert found that increased bids were less likely for targets with poison pills. Increased bids occurred in 51.8% of the cases in which target management had adopted poison pills compared to 68.4% of the control group cases. Tender offers were also twice as likely to be defeated when the target had a poison pill. All offers were defeated in 31% of the cases when the target had a poison pill, but only 15.8% of the control group targets defeated all offers.

At best, the empirical evidence on managerial resistance justifies a limited management response designed to promote competition and increase the amount of the offer. It would support a value-enhancement rule such as that proposed by Professor Gilson. It would not support scorched earth tactics or unlimited use of poison pills and other offer-barring devices.

**B. Antitakeover Regulation**

The gains to target shareholders might also be attributed to state and federal regulation. The federal Williams Act has undoubtedly increased the average premiums paid in tender offers. Jarrell and Bradley found that average cash tender premiums increased from thirty-two percent before the Williams Act to between fifty-three percent and seventy-three percent after the Act depending on whether the target was also subject to state regulation. Guerin-Calvert, McGuckin, and Warren-Boulton found similar increases, from forty percent premiums before the enactment of the Williams Act to an average of sixty-one percent after the Act. Jarrell and Bradley observed similar increases in cumulative abnormal returns after the passage of the Williams Act. Guerin-Calvert, McGuckin, and Warren-Boulton provide evidence that the Williams Act also may have increased the level of competition in takeover contests. There were multiple bidders in 15.1% of the takeover offers after the enactment of the Williams Act, compared to 8.5% before the Act. The Williams Act, and particularly the 1970 amendments strengthening the Act, however, also appear to be associated with a general decrease in takeover activity.

287. Id. at 405.
288. Id. at 408.
289. Id. at 407.
290. Id.
291. Id.
292. See Gilson, supra note 52, at 865-75, 878-79.
293. A recent Delaware Chancery Court opinion illustrates how such a value-enhancement rule might be drawn with respect to poison pills. See City Capital Assocs. Ltd. Partnership v. Interco, Inc., 551 A.2d 787, 799-800 (Del. Ch. 1988) (holding that the target's defensive recapitalization was not a reasonable response to the hostile bidder's all-cash tender offer).
296. Cumulative, abnormal returns over the period from 40 days before the offer to 80 days after the offer averaged 20.4% prior to the Williams Act, 32.8% after the Williams Act for targets not subject to state regulation, and 35.3% after the Williams Act for targets subject to state regulation. Jarrell & Bradley, supra note 294, at 389.
298. Jarrell & Bradley, supra note 294, at 399-400.
These studies also show that state legislation had a positive effect on returns to target shareholders. Post-Williams Act premiums were approximately twenty percentage points higher for targets subject to state takeover regulation than for non-regulated targets, a statistically significant difference.\textsuperscript{299} Competition among bidders was also more likely for regulated targets. After the enactment of the Williams Act, there were multiple bidders in 13.5\% of the offers for targets not subject to state tender offer regulation and in 17.6\% of the offers for regulated targets.\textsuperscript{300}

One might be tempted to conclude from these studies that state regulation of takeovers is efficacious in protecting target shareholders; however, Jarrell and Bradley also found evidence that state tender offer laws moderately reduced the frequency of tender offers.\textsuperscript{301} It is more important that both of these studies covered a period before the United States Supreme Court significantly restricted state antitakeover statutes in \textit{Edgar v. MITE Corp.}.\textsuperscript{302} The Jarrell and Bradley study involved offers during the period of 1962-1977,\textsuperscript{303} and the Guerin-Calvert, McGuckin, and Warren-Boulton study involved offers during the period of 1962-1980.\textsuperscript{304} The state statutes at issue were therefore predominantly of the first generation, merit review type, now unconstitutional under \textit{MITE}.\textsuperscript{305}

Evidence of the effect of second generation statutes on shareholder returns is much less favorable.\textsuperscript{306} A recent study in the \textit{Yale Law Review} found no statistically significant difference in the average premiums offered for firms covered by second generation statutes compared to firms not covered by these statutes.\textsuperscript{307} Although the percentage of multiple bids by the same bidder increased in states with second generation statutes, the percentage of auctions (multiple bidders) decreased.\textsuperscript{308} The total percentages of targets experiencing multiple bids or auctions declined from 42.31\% to 41.67\% in states adopting second generation statutes and grew from 28.57\% to 35.9\% in states without such statutes.\textsuperscript{309} Companies subject to control share statutes fared particularly poorly.\textsuperscript{310} Finally, the adoption of these statutes apparently had a negative effect on the

\textsuperscript{299} Post-Williams Act premiums were approximately 53\% for targets that were not subject to state tender offer regulation and 73\% for regulated targets. M. GUERIN-CALVERT, R. McGUCKIN & F. WARREN-BOULTON, \textit{supra} note 215, at 17-18; Jarrell & Bradley, \textit{supra} note 294, at 389-90. The differences were statistically significant at the 0.01 level in the Jarrell and Bradley study and at the 0.05 level in the other study.

\textsuperscript{300} M. GUERIN-CALVERT, R. McGUCKIN & F. WARREN-BOULTON, \textit{supra} note 215, at 18-19.

\textsuperscript{301} Jarrell & Bradley, \textit{supra} note 294, at 401-02.

\textsuperscript{302} 457 U.S. 624 (1982).

\textsuperscript{303} Jarrell & Bradley, \textit{supra} note 294, at 388.

\textsuperscript{304} M. GUERIN-CALVERT, R. McGUCKIN AND F. WARREN-BOULTON, \textit{supra} note 215, at 16.

\textsuperscript{305} \textit{Edgar v. MITE Corp.}, 457 U.S. 624, 643-46 (1982).

\textsuperscript{306} For a general review of a typical state takeover statute and its effects, see Bradford, \textit{supra} note 1.

\textsuperscript{307} Note, \textit{supra} note 62, at 1220-21. The difference, although not significant, favored states without second generation statutes, where premiums averaged 50.89\%, over states with second generation statutes, where premiums averaged 47.76\%.

\textsuperscript{308} \textit{Id.} at 1219. The percentage of multiple bids increased from 15.38\% to 22.22\% in states that adopted second generation statutes and declined from 19.05\% to 15.38\% in states without such statutes. The percentage of auctions declined from 26.92\% to 19.44\% in states that adopted second generation statutes and increased from 9.52\% to 20.51\% in states without such statutes.

\textsuperscript{309} \textit{Id.}

\textsuperscript{310} \textit{Id.}
number of takeover offers made. The number of takeover attempts increased by only thirty-eight percent after the adoption of state antitakeover statutes while increasing almost eighty-six percent over a comparable period in those states which did not adopt these statutes.311 This difference persisted when adjusted for the number of publicly-traded firms in each state.312 If the Yale study is accepted, second generation state statutes offer only grief to target shareholders. They do not increase premiums, they do not increase competitive bidding, and they reduce the number of offers being made. With protection like this, shareholders may long for the days of "coercion".

Studies of the effect on stock prices of the introduction and adoption of these statutes provide further evidence of the negative effects of such statutes on target shareholders. Schumann studied the reaction of the stock prices of ninety-four New York Stock Exchange and American Stock Exchange firms to two proposed New York takeover bills. The first bill was a control share statute that also provided redemption rights, and the second bill was the present five-year prohibition on business combinations with interested persons.313 Schumann found an insignificant negative abnormal return associated with the announcement of the first proposal but a statistically significant positive return of 0.76% when the governor vetoed the bill.314 He found a statistically significant negative abnormal return of -0.97% associated with the announcement of the second bill, representing a capital loss to shareholders of approximately $1.2 billion.315

Ryngaert and Netter examined the effect of antitakeover legislation in Ohio on the stock prices of thirty-seven firms incorporated in Ohio.316 They found statistically significant negative cumulative abnormal returns of -1.94% to -3.48% depending on the time window used.317 This represents a dollar loss to these firms' shareholders of from $750 million to $1.5 billion.318 The most favorable evidence for such statutes is provided by Professor Romano, who found no statistically significant effects, positive or negative, associated with the introduction and approval of takeover legislation in Connecticut, Missouri, and Pennsylvania.319 In conclusion, the empirical research provides almost no evidence to support second generation state takeover statutes as a means to further the interests of target shareholders.

311. Id.
312. Id.
314. Id. at 33.
315. Id. at 39.
VIII. CONCLUSION

Whatever the reason for the huge gains to target shareholders in hostile tender offers, one thing is clear. The myth of target shareholder mistreatment in takeovers is as unfounded as the myths of the tooth fairy, Santa Claus, and the Easter bunny.320 Target shareholders are the clear winners in the corporate takeover game. There may be other reasons for further regulation of hostile takeovers, but protection of target shareholders is not one of them. No further restrictions are needed on their behalf. From the standpoint of the target shareholder, the present avalanche of state statutes has gone too far. Policymakers and academics should recognize that the myth of the stampeding shareholder is entertaining but untrue.

320. With apologies to Jason, Allison, John, and Anne Bradford, should any of them ever read this.