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BUSINESS ESSAY

RAIDING THE ESTABLISHMENT: NEW PERSPECTIVES ON TAKEOVER LAW

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I. Upstart Entrepreneurs and Noblesse Oblige

This essay offers a brief description of certain factors influencing the development of the law governing corporate acquisitions. In its most basic terms, the central issue in this field boils down to who should control the wealth and power of our country. The issue encompasses choices based on political, economic and social values. It is my thesis that implicit favoring of establishment groups over "outsiders" underlies recent judicial and legislative actions bolstering management's ability to fend off unwanted acquisitions.

The main political and economic movement of the 1980's was conservative. There are two competing visions held by people who call themselves "conservative." The first vision, what I refer to as the "entrepreneurial" ideal, maintains that every individual should be free to succeed; there should be social mobility; and private property rights and free markets should be protected. This is the Horatio Alger vision, which at its best fosters ingenuity, optimism and economic development, and at its worst engenders greed and materialistic excess. The entrepreneurial ideal reached its apogee in the early years of the 20th Century when the founders of the great industrial dynasties — Ford, Rockefeller, Vanderbilt and Carnegie (all outsiders from humble backgrounds) built and owned

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vast corporate enterprises.[1] This entrepreneurial spirit resurfaced in the 1980's, with a wave of men who acquired major portions of the economy, such as Ronald Perelman, Carl Icahn and Carl Lindner, who were all outside the establishment community.

The second conservative vision, in direct opposition to the entrepreneurial ideal, is the establishment vision. The establishment vision favors control of institutions by elite insiders who supposedly operate the institutions for the betterment of society. The establishment vision stresses tradition, stability and authority. The patricians do not claim victory in a Darwinistic contest as the basis for their status, but base their legitimacy on social breeding or adherence to "community values." To its credit, the establishment ideal may bring forth talented people who volunteer for public service. Men such as Franklin Roosevelt and George Bush followed the path of the English aristocracy which believed that gentlemen should serve (and govern) the nation. However, the establishment ideal tends to exclude outsiders, particularly women and minorities. It may be that the residual strain of cultural and social elitism in our society is a legacy of its pre-Revolutionary English heritage.

Although entrepreneurs built the American industrial machine, we remember them as "robber barons." Carnegie was a "robber baron" even though he gave away virtually all of his wealth. Underneath the establishment vision lies a strong cultural dislike of outsiders who pose a challenge. To some extent, this dislike is based on the upstarts' roughness of character. The establishment did not like Commodore Vanderbilt, for he was a rough-neck. Founders of industrial dynasties were not clubmen. Yet, their nonfinancial contributions to society are hallmarks. They left behind Carnegie Hall and Morgan Library, splendid country estates, the soaring towers of the Jazz Age in New York and Chicago and, ironically, very establishment grandchildren.

There is, however, something more objectionable to the establishment's dislike of entrepreneurs. In *The Predator's Ball*, Connie Bruck's book about the rise of corporate raiders, one participant recounts the time when Ronald Perelman went to discuss a friendly acquisition of Revlon with its CEO, Michele Bergerac. "Bergerac checked with his friends, and most of them had never heard of Ron Perelman, or if they had, they said he was young,

1. Even J.P. Morgan was an outsider. When Morgan was an undergraduate, none of the Harvard "final" clubs would admit him. He built his own.

really aggressive, and Jewish. I think it was just beneath him [to deal with Perelman]."[2] Bruck notes that the contest for control of

> Revlon was indeed a class war, between the corporate America and Wall Street elite, and the Drexel arrivistes. . . . Beneath these complaints of principle lay something more visceral: the age-old hatred for the outsider, always exacerbated when that undesirable other dares to venture beyond his confines and encroach upon the elite's preserve.[3]

Although Perelman was extremely wealthy, he was — by temperament, business practice and cultural background — not a member of the club.

II. THE 1980'S REVOLUTION

In the 1980's, President Reagan became the chief political proponent of the entrepreneurial ideal. He was an outsider who preached the liberating force of freedom, individualism and private property. In tandem with Reagan's attack on bloated government and bureaucrats out of touch with the people, corporate raiders challenged managements that amassed crazy quilt conglomerates in the 1960's and 1970's, more as monuments to their egos than because of good business sense.[4] The raiders asserted that these custodians of the shareholders' wealth used it to acquire headquarters, personal staffs and trappings that Napoleon would envy.[5]

A. *The Establishment at Revlon*

Revlon was one of the most celebrated conglomerates later acquired by hostile takeover. It was founded by entrepreneur Charles Revson and later managed by Michele Bergerac, an ex-ITT executive. ITT was a classic 1960's conglomerate, and Bergerac transformed Revlon from a cosmetics giant into a conglomerate which owned blood testing laboratories, a pharmaceuticals division and a contact lens manufacturer. Revlon, once a model of en-

2. CONNIE BRUCK, THE PREDATOR'S BALL 194 (1988).
3. *Id.* at 197.
4. Examples of 1960's conglomerates include ITT, Gulf & Western and Teledyne.
5. Michael Jensen pointed out that, "Corporate growth enhances the social prominence, public prestige, and political power of senior executives . . . the perquisites of the executive suite can be substantial, and they usually increase with company size." Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. Sept.-Oct. 1989 at 61.

trepreneurial success, became a bastion of the establishment. Bergerac's headquarters consisted of the top ten floors of the General Motors Building at 767 Fifth Avenue — the most expensive location in New York. In addition to a fleet of cars and servants, he had a Boeing 727 jet with a kingsize bed. The directors agreed that if anyone bought the company Bergerac would receive $35 million in golden parachute payments. After he was ousted and Ronald Perelman bought the company, I spent two years working amidst the luxury that Bergerac had amassed. I drank from his $300 glasses, and was served by liveried servants and an English butler. The main dining room at Revlon looked like something from the Czar's summer palace and the room where I held meetings could have been used to film "The Last Emperor."

B. *Storming the Bastion*

In the 1980's marketplace for corporate control, billions of dollars could be made and the lives of millions of workers, consumers and investors affected. A massive shift occurred away from control by non-owner managers (the leaders of the establishment) and toward individuals who wanted to purchase corporations and return them to private ownership. The value of leveraged acquisitions rose from $4 billion in 1981 to $43 billion in 1988.[6] From Beatrice and Bell & Howell to Revlon and RJR, one after another, corporate citadels fell to the outsiders.[7]

The entrepreneurial acquirors offered to purchase the shareholders' stock at a premium price. They believed that conglomerates amassed by managers in the 1960's and 1970's failed to deliver promised synergies, thereby forcing stronger divisions of the company to carry weaker ones. The acquirors felt they could sell off non-core assets to other companies or individuals who could put them to better use. Through selling subsidiaries and cutting expenses, the acquirors sought to make a profit. Sometimes they succeeded (Perelman made over a billion dollars on Revlon); other times, as was the case with Campeau, Farley and Lorenzo, they did not.

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6. Douglas R. Ernst, *Beating the LBO Odds: Safe Bets for Trade Creditors*, CORP. CASHFLOW, May 1990, at 54.

7. One firm, KKR, acquired RJR/Nabisco, Safeway Stores, Beatrice, Duracell, Owens-Illinois, Motel 6, Stop & Shop, Auto Zone and Hillsborough Holdings.

Incumbent managements, who stood to lose their places at the helm of society, were not wildly in favor of unsolicited offers to purchase their companies. They instituted poison pills, golden parachutes, and staggered boards. Their actions made it harder for acquirors to step forward with tender offers, even though this deprived the shareholders of the right to decide whether to sell their company. Management, the press, politicians and judges adopted the establishment viewpoint, and referred to people who wanted to buy companies over management's objections as "raiders." They branded owners who challenged management as "speculators," "insurgents" or "dissidents." The decision to sell off parts of a conglomerate became "asset stripping" or a "bust-up." Finally, although it merely referred to an offer to the shareholders which management did not support, the term "hostile tender offer" sounded positively evil, if not illegal.

The entrepreneurial raiders who sought to buy major corporate enterprises allied with individual shareholder plaintiffs seeking to enforce the right to sell their property. They squared off in the Delaware courts against the forces of stability and establishment, the directors and managements of large public companies. The core legal issue was whether management could act to prevent the shareholders from receiving unsolicited offers to buy the company. The core issue was not whether a given offer should succeed, but who would decide whether the company may be sold, its owners or the management.

III. The Battle in the Courts

A. *Building the Ramparts*

In *Unocal v. Mesa Petroleum*,[8] the Delaware court faced a challenge to the Unocal board's actions to stop T. Boone Pickens from completing a hostile tender offer for the company. The court noted the "omnipresent specter" that, in adopting defensive measures, management may act to keep itself in office, unconcerned with the company's best interests. The *Unocal* court adopted a two-part test to review directors' actions aimed at staving off an acquiror. First, the board had to show reasonable grounds for believing that the offer threatened the shareholders or corporate policy and effec-

8. 493 A.2d 946 (Del. 1985).

tiveness. Second, the board's response had to be reasonable in relation to the threat posed.

In *Unocal,* Pickens offered to pay cash for the first 51% of shares tendered and junk bonds for the remainder. The court agreed with the board in characterizing the offer as "coercive" in that the offer could stampede the shareholders into tendering, even if they felt the price was too low. If some shareholders failed to tender, but enough of the other shareholders tendered so that Pickens garnered his 51%, those who had not tendered would be stuck with the "back end" junk bonds. Accordingly, the offer threatened the shareholders' welfare, and the directors' response to thwart Pickens was reasonable. If the court had stopped there, even an honest raider would applaud — but it did not. In dicta, the court said that shareholder interests were not "controlling" and directors could prevent an offer if they believed it might adversely 'impact on constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally).[9] The court also held that when a board cited a valid threat and responded in a reasonable manner, the business judgment rule would shield their actions unless the plaintiff could prove by a preponderance of the evidence that the directors acted to perpetuate themselves in office.[10]

In *Moran v. Household International,*[11] the court applied the *Unocal* analysis to the target board's adoption of a "poison pill" that gave its shareholders the right to purchase shares of an acquiror's company at half price, unless management approved the acquiror's offer. This tactic would tend to stop potential acquirors from making offers without the board's approval[12] and preclude shareholders from having the opportunity to decide if they wanted to sell. Unlike *Unocal,* however, there was no raider, nor any immediate threat at all. The court accepted a statement in the board's minutes dictated by the directors' attorney, Martin Lipton, which said the board adopted the poison pill because the directors were concerned about "the increasing frequency of 'bust-up' take-

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9. *Id.* at 955.

10. *Id.* at 953-59.

11. 500 A.2d 1346 (Del. 1985).

12. Mounting a takeover effort requires substantial expenditures, including legal fees and commitment fees for financing. If management can throw up enough roadblocks so that consummation is unlikely, fewer takeover attempts will be launched.

overs, . . . and the possible adverse effect this type of activity could have on employees and others . . . ."[13]

The court's acceptance of this "threat" was a declaration of open season. In practice, with competent counsel, a board could cite a theoretical threat to a non-shareholder constituency, thereby allowing management to take control of the company's fate. The court continued to pay lip service to the "omnipresent specter" that management was acting to protect itself. However, once a valid threat was cited and the response was deemed reasonable, the burden shifted. The plaintiffs had to prove by a preponderance of the evidence that the directors were really thinking about their jobs, perks and prestige, and not about the workers whose welfare they claimed to be protecting. The plaintiff's burden was almost insurmountable absent a stool pigeon in the boardroom who would stand up in court. It is hard to believe that Household International's board was thinking about workers and "others," and not about themselves.[14]

B. *A Temporary Setback: Sometimes Management Must Maximize Shareholder Value*

A shift in judicial treatment of anti-takeover actions occurred in *Revlon v. MacAndrews & Forbes.*[15] The board of Revlon reacted to Ronald Perelman's tender offer by agreeing to sell the company to Forstmann, Little & Company. Forstmann, Little had announced that it would sell off the contact lens and pharmaceutical divisions, two divisions which Perelman also intended to sell. The *Revlon* court followed precedent, and latched onto the specific threat validated in *Moran* — the "bust-up" — and held that when a "bust-up" and sale were "inevitable," the "duty of the board . . . changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the shareholders' benefit."[16]

The court followed precedent without analysis and reached a dubious conclusion. Neither *Moran* nor *Revlon* analyzed the impact of a "bust-up." In fact, the sale of the pharmaceutical and contact

13. 500 A.2d at 1349. Lipton's reference to employees, one of the enumerated "constituencies," may have been guided by the recent decision in *Unocal.*

14. *See id.* at 350-57.

15. 506 A.2d 173 (Del. 1986).

16. *Id.* at 182.

lens businesses did not end the existence of Revlon as a corporate entity. After shedding some of its non-cosmetic businesses, Revlon added new core divisions. Revlon remains a corporation with billions of dollars in annual sales. However, the court equated a "bust-up" with the end of corporate existence and held that once a "bust-up" was inevitable, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[17] In other words, only in such limited situations must the directors look out for the shareholders and not employees, the general community, "others" or themselves.

Revlon was an effort to respond to the *Unocal* and *Moran* decisions that paved the way for actions which favored management over the owners in the name of ill-defined "constituencies." Such favoritism contravenes one of the basic principles of corporate law — directors are fiduciaries of the shareholders. In *Dodge v. Ford Motor Co.*,[18] one of the classic cases in corporate law from the height of the entrepreneurial era, the court held that a corporation exists to make a profit for its shareholders, and not for the benefit of employees or the welfare of society. The problem with *Revlon* is that by blindly following the precedent of *Moran*, which decided that a "bust-up" is a "valid" threat; and then holding that if a "bust-up" is inevitable the directors have a duty to work for the shareholders (and not for other constituencies), the court finessed the real question: in general, who decides whether a business may be sold — the individuals who own it or those who manage it?

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17. *Id.*

18. 170 N.W. 668 (Mich. 1919). Henry Ford owned 58% of Ford Motors, and decided the time had come to benefit society rather than accumulating yet more personal wealth. Instead of paying dividends, Ford plowed the money back into building new smelting plants on the Rouge River. Ford declared, "My ambition is to employ still more men; to spread the benefits of this industrial system to the greatest possible member, to help them build up their lives and their homes." Although this was a case where the majority shareholder wanted to benefit employees and the community (rather than a self-serving assertion by entrenched management), the Michigan Supreme Court ordered the company to pay dividends and held that,

> A business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end . . . It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of the shareholders and for the primary purpose of benefitting others.

Id. at 684.

C. *The Establishment Triumphant*

Four years after *Revlon*, the court tackled the issue of who decides whether a company is to be sold. By this time, however, George Bush was in the White House, and the Reagan era was history. In tandem with the re-emergence of the political establishment, the corporate elite once again carried the day. In *Paramount Communications v. Time, Inc.*,[19] the court upheld the Time board's decision to merge with Warner Communications, which, as a practical matter, prevented Time's shareholders from considering Paramount's offer to purchase Time for $200 per share, a 60% premium over market value. The court limited *Revlon* to the rare case where a board acted to make a "bust-up" inevitable. In all other situations, a board may preclude the owners from receiving an offer by responding to a "valid" threat. What threats did the *Paramount* court cite? First, a threat to Time's culture.[20] Second, a threat to all the non-shareholder constituencies listed in *Unocal.* Third, and most incredible, the threat that the target company's shareholders might want to accept the offer in the "mistaken" belief that holding their stock and relying on management's business strategy was not as good a bet as the offer.[21]

The *Paramount* court stated that since Delaware's corporation statute grants the power to "[manage] the business and affairs of the corporation"[22] to the directors, it is a misunderstanding of basic principles of corporate governance to suppose that anyone but management can decide whether, when and to whom to sell the company.

Unfortunately, the principle is not so clear. It is unclear (even doubtful) that the decision to sell a business comes within the statutory mandate to "manage."[23] The *Paramount* court based its decision not on logic, precedent or a clear reading of the statutory

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19. 571 A.2d 1140 (Del. 1990).

20. Time, Inc. is the publisher of, inter alia, *People Magazine, Sports Illustrated* and *Tales of the Unknown.*

21. *Paramount Communications*, 571 A.2d at 1150-55. The court noted that "[C]ertain Time directors expressed their concern that Time shareholders would not comprehend the long term benefits of the Warner merger. . . . The board feared that . . . Paramount's cash premium would be a tempting protect to these investors . . . who might elect to tender into Paramount's cash offer in ignorance." *Id.* at 1148-53.

22. DEL. CODE ANN. titl. 8 § 141(a) (1991 Repl. Vol.)).

23. Under principles of agency law, authority to manage a business does not include authority to sell the business. RESTATEMENT (SECOND) OF AGENCY § 73 cmt. b (1958). According to the American Law Institute,

language, but on unarticulated values stemming from the establishment vision of corporate America.[24]

IV. THE PENDULUM SWINGS

As a postscript, I should point out that Paramount offered $200 a share for Time, an offer which the court and the board felt the shareholders might have "mistakenly" accepted. Now, two years later, the stock is valued at $100. Perhaps courts should let the free market decide, even when corporate control is at issue. That conservatives who pay lip service to free markets would applaud the decision in *Paramount* is a testimonial to the influence of the establishment vision.

By 1990, the pre-*Paramount* war on the corporate bastion was part of history, as CEOs again basked in their perquisites. The rise of the entrepreneurial ideal in political discourse had given way to the re-emergence of establishment values, personified by George Bush. In the social sphere, the enthusiastic celebration of yuppie excess receded in the face of stability, tradition and frugality. In the contest over corporate control waged in the Delaware courts, the establishment emerged completely victorious as the challenge to managements' power was crushed. In addition to several "generations" of specific anti-takeover statutes, twenty-eight states have enacted statutes authorizing directors to consider the interests of various "constituencies," in some cases even when the long-term

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> Shareholders normally have the right to sell their shares, free of any restrictions, to any person who wishes to purchase their stock. An action taken by the board that interferes with that right, as by blocking a tender offer, goes well beyond the usual board function of conducting the Corporation's business, and needs special justification.

Moreover, directors may not block an unsolicited tender offer if that action would materially disfavor the long-term interests of the shareholders. § 6.02 PRINCIPLES OF CORPORATE GOVERNANCE (Tenth Draft, 1990).

24. For an alternative approach, supplanted by *Revlon*, see Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988), in which Chancellor Allen held that, "every instance in which an incumbent board seeks to thwart a shareholder majority . . . involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation." *Id.* at 660. The Chancellor felt that

> the only justification that can . . . be offered for the action taken is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant . . . The theory of our corporation law confers power upon directors as agents of the shareholders; it does not create Platonic masters.

interests of shareholders would be harmed.[25] If one carefully examines the recent legislation, the fact that management is the true beneficiary becomes clear. The vast majority of these statutes permit directors to take actions that entrench management for the supposed good of various "constituencies" but do not grant standing to the constituents to challenge management's actions.

We are currently in an era of diminished liquidity, when the sources of credit that financed the raiders have run dry. Looking back on the 1980's through establishment lenses, many blame our current economic state (which resembles a hangover after a tremendous party) on the junk bond raiders, without noting the general over-heating of real estate, art and other markets that have collapsed. Nevertheless, the entrepreneurial ideal remains firmly embedded in American culture. There is already some grumbling about excessive executive compensation. Some day the perquisites of the establishment will once again seem too lavish. A new period of optimism and liquidity will arise, and a new generation of insurgents will ride to battle against the forces of the corporate elite.

25. *See* IOWA CODE § 490.1108(1) (1989); MO. ANN. STAT. 351.347(1) (Vernon 1991); 1990 PA. LAWS 36; NEB. DEV. STAT. § 21-2035 (Cum. Supp. 1990).