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EDITOR'S NOTE

Subsequent to the completion of this article, the Securities and Exchange Commission adopted Rule 19c-4 under the Securities Exchange Act of 1934. The new Rule formalizes a unified standard among the exchanges regarding the listing of public companies that issue securities, or take other corporate action with the effect of disparately reducing the per share voting rights of its existing common stock. Therefore, readers should be aware that some of the recapitalization schemes analyzed in this article are now prohibited by Rule 19c-4.

THE EFFECT OF DUAL CAPITALIZATION ON THE SHAREHOLDER: VOTING RIGHTS COME FULL CIRCLE

Andrew D. Simons*

I. INTRODUCTION

The dramatic surge in hostile takeover activity in recent years has profoundly affected traditional notions of corporate governance.¹ In the wake of the raider-arbitrager blitz, directors have scurried to shield their corporations and respective positions by adopting one of the many anti-takeover devices available. Yet shark repellents and “lock up” provisions, the remedies that initially seemed so promising, have begun to backfire with disturbing frequency.² Directors

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1. For a general discussion of the increase in merger activity, see Matheson & Norberg, Hostile Share Acquisitions and Corporate Governance: A Framework For Evaluating Antitakeover Activities, 47 U. Pitt. L. Rev. 407, 411-15 (1986) (“Since 1975, there have been more than fifty billion-dollar mergers or acquisitions, with over one-half of these occurring since the beginning of 1984. In 1984 alone, there were nearly 3,000 mergers or acquisitions, the highest total in more than a decade.”). See also Sloan, Why is No One Safe?, FORBES, Mar. 11, 1985, at 134; 1985 Profile, Mergers & Acquisitions, May-June 1986, at 45.

2. See Siegel, Tender Offer Defensive Tactics: A Proposal For Reform, 36 Hastings L. J. 377 (1985). The term “shark repellants” refers to provisions that potential targets implement to deter hostile takeovers. The provisions take a variety of forms but seek the same result of rendering the company less vulnerable to takeover by amending the corporation’s bylaws or charter. Because they make a company less attractive as a target, they “repel” takeover
still lose the fight in the end to the more innovative and determined bidder,\(^8\) or face a shareholder derivative suit for mismanagement or squandering corporate assets.\(^4\) But the raider has definitely lost the element of surprise that made the early kills so easy.\(^6\) As a more seasoned corporate management armors itself in defensive shells that appear impenetrable, the momentum continues to shift. In fact, the newest vogue in defensive planning, dual class recapitalization,\(^6\) seems to offer directors the machinery they have been searching for to permanently neutralize the hostile bidder. By amending the corporation's certificate of incorporation, directors can recapitalize their equity structures to create dual classes of common stock with dispa-


Lock up options, actually a subcategory of the shark repellant heading, are also manifested in a variety of ways. The aim remains consistent, however, namely to discourage takeover attempts. *Id.* at 202. The poison pill defense generally involves a shareholders' rights plan that allocates "flip in" rights that are activated by a triggering event like a tender offer. Once activated, the right gives the holder the option to buy shares of the tender offeror or acquiring corporation. Again, the central idea is to deter hostile bidders by rendering the target a difficult acquisition to digest. See, e.g., Moran v. Household Int'l., 500 A.2d 1346, 1348-49 (Del. 1985) (target issued rights to its shareholders which allowed them to acquire shares of successful tender offeror at half price).

3. *See generally Tender Offers, supra* note 2.

4. MacAndrews & Forbes Holding v. Revlon, 506 A.2d 173 (Del. 1986) (Delaware Supreme Court held that the Revlon board's decision to grant a lock up option to a white knight during the pendency of a hostile bid was not protected by the business judgment rule). *But see* Unocal v. Mesa Petroleum, 493 A.2d 946 (Del. 1985) (business judgment rule vindicates defensive maneuvering by target's board). Crouse-Hinds Co. v. InterNorth, 634 F.2d 690 (2d Cir. 1980) (directors entering into merger agreement to prevent hostile takeover protected by business judgment rule). Notwithstanding management's ability to win these suits under the permissive business judgment rule, the litigation is a tedious process that often leaves permanent scars on the respective parties.

5. For an interesting perspective of the merger mania that brought enormous profits to several investors who pioneered the hostile tender offer process, see I. BOESKY, *MERGER MANIA* (1985). The Williams Act originally required a minimum of seven calendar days between the time a tender offer was publicly announced and its deadline or expiration (twenty days are presently required). Bidders could therefore drastically reduce management's ability to respond to a tender offer by announcing the offer on Saturday evening. The "Saturday Night Special" was tantamount to a surprise attack as targeted corporate managers frequently became aware of the bid only after reading about it in Monday's paper. *Id.* at 81.


Few takeover defenses are more likely to be successful than dual class capitalization. In a typical dual class capitalization, insiders receive common stock with multiple votes per share; public stockholders receive shares with one vote per share. Dual class capitalization thus permits the insiders to control a majority of votes of a corporation while owning a small minority of its stock. With a majority of votes in hand, their corporation will not be a takeover target.

*Id.* at 687.
rate voting rights. The procedure operates to consolidate voting control over the corporate entity in the hands of management, thereby discouraging a potential bidder's attack. The scheme obviously serves the target corporation very nicely; by undergoing a simple restructuring, management can effectively tighten its control and chill would-be aggressors without any additional expenditure. 7

Yet dual class capitalization is not without a downside. 8 Critics argue that the procedure expressly repudiates the inveterate principles of corporate democracy and shareholder participation that hold such an esteemed position in American corporate law. 9 In short, the practice of disenfranchising shareholders from their voting rights threatens corporate governance with a return to the fraud and deceit that ravaged the 1920's. At the very least, it insulates directors from all foreseeable shareholder pressure. Since the debate surrounding the tender offer remains active, the propitiousness of permitting infallible defensive mechanisms like the dual class capital structure can be forcefully argued both pro and con. Certainly, as directors continue to restructure their corporations, the procedure will come under increased scrutiny. 10 At issue, and of primary concern to the regulators 11 that must evaluate the scheme (Congress and the Securi-

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7. Dual class capitalization must be distinguished from initial capitalization or a “public offering” involving the issuance and sale of new shares. Although any shareholder vote runs up a significant bill for a corporation, the costs of recapitalization are minimal in comparison to expenses associated with greenmail and self tender options. See generally Tender Offers, supra note 2.

8. See infra note 108 and accompanying text.


10. Dual class capitalization has attracted considerable attention recently as the Securities and Exchange Commission (SEC) is currently considering the New York Stock Exchange's (NYSE) proposal and has hinted at the possibility of creating a listing standard that will apply to all exchanges. See also Securities and Exchange Commission, Form 196-4, Proposed Rules Changes by New York Stock Exchange, Inc. September 16, 1986; One Share, One Vote Controversy Comes to a Head in SEC Hearings, Wall St. J., Dec. 16, 1986, at 30, col. 5; See infra notes 102-04 and accompanying text.

11. Corporate capitalization structures have traditionally been regulated by state law which is restricted only to the extent that it might be preempted by federal law. The phrase “regulators,” refers to those entities that directly or indirectly effect changes in the law regarding corporate governance. An interesting example of Congress' indirect impact on this rule making process can be seen in the Exchanges' reaction to Senator D'Amato's proposed legislation on the one-share, one-vote issue which threatened to forever end the debate. The NYSE, the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD) quickly initiated discussions to resolve the problem themselves. Although they were
ties and Exchange Commission), are the rights of shareholders. A determination that corporations with dual class structures significantly violate permissible standards of corporate governance will undoubtedly undermine its legitimacy and quicken its demise. The one-share, one-vote model would thus become dispositive in terms of acceptable forms of corporate capitalization and governance. Conversely, a finding that the dual class system neither imperils the shareholders' position nor alters their participatory behavior will help to vindicate it as a reasonable practice. Ultimately, a middle ground may emerge as these polarized extremes collide in judicial interpretations that permit a modified form of dual class capitalization. Some shareholder plans that have recently surfaced appear to fit that role.

The debate over stock with unequal voting rights raises no substantive issues that have not already been addressed in the last 100 years of evolving corporate law. But the issues in the present dialogue acquire a new meaning when viewed against the backdrop of the recent hostile takeover whirlwind. While the central discussion in the past focused on the need to stem corporate deceit and misrepresentation, the emphasis of the current dilemma lies in balancing the interests of the parties engaged in the battle for corporate control. At present, the equation seems to be stacked against management. A multitude of creative financing and takeover plans such as the two-tier tender offer financed by "junk bonds" has substantially im-

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12. The NYSE has maintained a "one share, one vote" rule that prohibits the listing of any shares of a company that has outstanding more than one class of common stock or stock with restrictions on voting power since 1926. N.Y. STOCK EXCHANGE LISTED COMPANY MANUAL § 313.00 (1985). The proponents of the one-share, one-vote regime are led by T. Boone Pickens, Jr. See Pickens, Second-Class Stock Impairs Market, Wall St. J., Feb. 13, 1986, at 24, col. 4. See also Note, Dual Class Capitalization and Shareholder Voting Rights, 87 COLUM. L. REV. 106 (1987) (arguing that the business judgment rule operates to make the recapitalization process impermissible).


15. Loomis & Rubman, Corporate Governance In Historical Perspective, 8 HOFSTRA L. REV. 141, 149-58 (1979).

16. The two-tier tender offer or front loaded takeover begins when a bidder pays a high
proved the bidder's position. Every corporation comprised of liquid assets, coveted raw materials, or undervalued stock potentially becomes a target and can be acquired overnight by a carefully orchestrated takeover plan. Thus, successful implementation of an efficient and effective anti-takeover device seems to offer management its only chance for survival, regardless of its track record. Because the popularity of dual class capitalization stands to grow significantly in the years ahead, the dangers it harbors for the law of corporate governance must be resolved now.

This article examines the impact that dual class capitalization has upon shareholders' rights and the extent to which the process disrupts traditional modes of corporate governance. By documenting the nature of corporate suffrage before and after the arrival of the hostile bidder, it can be shown that dual class capitalization actually brings shareholder voting full circle. In other words, historically speaking, ownership in a corporation does not translate into a corresponding proportion of control. Instead, shareholders defer decision-making authority to management. But the hostile bidder has interrupted that dynamic by purchasing stock for its voting power. Dual class capitalization, it can be argued, merely returns shareholder voting to the symbolic status that it enjoyed prior to the boom in tender offer activity.

premium in a partial bid for fifty-one percent of the target's stock. The bidder then effectuates a merger or acquisition of the remaining shares at a price below what they sold for prior to the tender offer. See Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1166-73 (1984). A noteworthy example of two-tier takeover is U.S. Steel's successful offer for fifty-one percent of Marathon Oil in 1981 for a cash price of $125 per share. U.S. Steel later acquired the remaining forty-nine percent of Marathon in a subsidiary merger that cost approximately $86 per share. Thus the average price paid for each share was $105.50.

17. Junk bonds are high-yield subordinated debt that offer bidders quick capital in large amounts. Brokerage houses played a key role in the budding popularity of junk bonds frequently engineering takeovers through their ability to rally needed resources in a hurry. See H. BENJAMIN & M. GOLDBERG, LEVERAGED ACQUISITIONS AND BUYOUTS (1987); Two Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs—Advance Notice of Possible Commission Action, Exchange Act Release No. 21,079 [Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637 (June 21, 1984). Sometimes the junk bonds are issued by a corporation that will have no assets prior to acquiring the target. See Carney, Junk Bonds Don't Merit A Black-Hat Image, Wall. St. J., Apr. 29, 1985, at 24, col. 3.

18. While a primary justification for the tender offer lies in the purging effect it has upon inefficient management, recent commentary suggests that the hostile tender offer wave increasingly swallows efficient and lucrative management. Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 COLUM. L. REV. 249, 289-94 (1983). In addition, tax law, rather than the inefficiency of a particular board, often supplies the incentive for takeovers. Lowenstein, Management Buyouts, 85 COLUM. L. REV. 730, 759-64 (1985). For other incentives, see infra notes 74-75.
Yet the analysis cannot end without a more incisive investigation into the future of corporate America if dual class capitalization becomes a pervasive norm. Indeed, a distinction must be drawn between an uncast vote and no vote at all. If the dormant power that emanates from unused votes actually influences managerial decisions, then permanently neutralizing shareholder voting might be an overly-potent remedy.

Part I of this article traces the history of shareholder voting and participation to expose the ideal of corporate democracy as a fictional concept. Part II studies the metamorphosis experienced by corporate law as a result of the hostile tender offeror, arguing that voting shares have suddenly acquired meaning as bidders begin to vote their shares to oust management or consummate a merger. Part III evaluates corporate governance under the dual class capitalization structure, demonstrating that its practical effect engenders no significant change in the relationship shareholders have with their corporations. Part IV considers the deeper effects that the elimination of shareholder voting might have upon management’s perspective of its responsibility and duty to the corporate entity. It suggests that a modified form of recapitalization might be the more equitable way to balance this currently unbalanced situation.

II. THE FICTION OF CORPORATE DEMOCRACY

One primary stumbling block for the dual class capitalization scheme lies in the very profound impact it has upon shareholders’ voting rights. In no uncertain terms, the procedure severs the shareholder from the voting power naturally flowing from stock ownership. A controlling group within the corporation gains hold of voting shares from other owners who relinquish their right to influence the decision-making process or direct the company in exchange for dividend priority or freedom of transferability. The shift of control into the hands of a few seems to violate the principles of democracy that, in theory, underpin traditional corporate law and govern-

19. The forces that operate in the corporate democracy equation have been extensively treated by several authors. See M. Eisenberg, The Structure of the Corporation (1976); R. Larner, Management Control and the Large Corporation (1970); G. Means, The Corporate Revolutions in America (1962).


21. See generally Seligman, supra note 6.
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ance structures. Yet, as the corporate law scholars Bearle and Means have extensively documented, the ideal of corporate democracy has no foundation in reality.

Under the perfect model of corporate democracy, each corporation is ultimately governed by its shareholders who command authority in proportion to the size of their ownership interest. The corporation obtains its initial capital through the public offering, which generates the shares and distributes the right to control accordingly. Thus, the shareholders have rights to dividends and liquidation value (should that event occur), in addition to their voting powers. The model works well on a small scale, in a closely-held corporation, for example, where the majority shareholder is often the business’ founder and president and therefore exercises total control over the company’s direction and affairs. But the nature of the public corporation makes the same ideal unobtainable.

Traditionally, large corporations necessarily have found it difficult or impossible to function where every decision must be resolved by a multitude of owners literally scattered across the world. As enormous corporations began to take root in the economy, an entrusted management emerged that controlled day-to-day and long-term activities. In turn, shareholders assumed the characteristics of “investors,” unconcerned with their corporation’s management and direction, provided their initial purchase yielded a favorable return. As one author identified the problem in 1936,

[b]y their own practices, [shareholders] are more nearly lenders to the business than owners of it. They exhibit more interest in dividends than in policies. They do not attend meetings, nor do they exercise the privilege of voting by proxy, or, . . . the privi-

22. Hetherington, When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights, 8 Hofstra L. Rev. 183, 193-99 (1979-80); A. Berle & G. Means, The Modern Corporation and Private Property 123-30 (rev. ed. 1967). Early corporate charters required strict compliance with a rigid set of provisions, all designed to promote equality and fairness in the corporate structure. Proxy solicitations were prohibited ensuring full shareholder participation and directors could be voted out at the shareholders’ will. Furthermore, the unanimous consent of shareholders was required before the management could implement certain policies. As a result, the business could not undergo any significant change without full shareholder approval.


25. Because of the unique nature of the closely-held corporation, statutory and judicial exceptions have been adopted by several states. R. Hamilton, Corporations 385-407 (3d ed. 1986).

lege of executing a proxy. In consequence of this apathy and inertia on the part of small investors, annual meetings must sometimes be adjourned.

The divorce between stock ownership and corporate control never aroused the type of controversy or public outcry that might have provoked legislative regulations or change. Shareholders simply did not perceive their investment as a claim to corporate authority. Instead, the purchase of shares, especially in the secondary market, seemed to be governed by an assumed contract whereby the owners accepted existing management and its ability to operate the company with efficiency and expertise. The remedy always available to disgruntled shareholders was a sale of their holdings. Thus, as corporations rapidly expanded beyond the financial parameters of their initial capitalization, the shareholder became further and further removed from a position of managerial authority. The concomitant transformation of the shareholder into an investor sealed the disenfranchisement. In 1931, Berle described the then current norm of corporate governance as follows:

The stockholder has changed his position in American financial life so radically that the old rules no longer apply. Originally he was supposed to be a kind of modified partner in a small enterprise . . . able to take care of himself, and to take active part in the counsel of his corporation. During the past generation this

28. Professor William Z. Ripley of Harvard spearheaded the campaign against non-voting stock in the mid-1920's and his efforts were not in vain. His well-known message was published as a book entitled W. RIPLEY, MAIN STREET AND WALL STREET (1927) and generated debate and attention to problems concerning corporate abuse. See also R. SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK EXCHANGE 236 (1965). See supra note 14 and accompanying text.
29. See generally Loomis & Rubman, supra note 15; Hetherington, supra note 22, at 184-86.
30. Hetherington, supra note 22, at 184 ("[A fact] about shareholders and managers of publicly held companies on which commentators of all shades of opinion agree . . . is the existence of the separation of ownership and control . . . [I]t is generally agreed that . . . shareholders of publicly held companies play an entirely passive role in the election of directors.").

Our corporation statutes assume that shareholders own the corporation, that the powers and rights of shareholders flow from their providing "risk capital," that directors shall manage the business, and that officers are agents of the corporation under the direction and control of the board and with a duty to manage the corporation for the benefit of all the shareholders. None of these claims are true. Shareholders do not provide most of the "risk capital;" directors do not direct; and management has reversed the hierarchy of control.

situation has almost completely reversed itself. . . . An overwhelming majority [of American stockholders] . . . are "little people," that is, members of the investing public who . . . know little or nothing about corporate activities; whose advice is not sought in running the corporation and probably would be worth little if it were given. . . . [The stockholder] trusts implicitly to the corporate management; his function is merely to contribute.81

In the early 1900's, corporate directors wielded near absolute control over their business entities.82 Unfettered by external restraints such as active shareholder participation or supervisory regulatory agencies, directors managed with virtually no duty to account for their actions. Corporate corruption ran rampant as a result. Insider trading scams and fraudulent corporate reporting, designed to entice purchases of bogus stock, became commonplace.83 Finally, in the early twenties, companies began to experiment with what one critic terms "the crowning infamy of all," the issuance of non-voting shares.84 The corporation could easily deny the shareholder the right to vote and thereby solidify its authority by issuing non-voting shares. Several dramatically inequitable transactions occurred as a result. For example, in 1925, Dillon Read and Company was able to gain control of the $130 million Dodge Company through a well-

31. Berle, Stockholders: Their Rights and Duties, Handbook of Business Administration 394, 374-75 (1931); see also A. Berle & G. Means, The Modern Corporation and Private Property 281 (1932) [hereinafter A. Berle & G. Means (1932)].

32. See Loomis & Rubman, supra note 15, at 149.

33. The thrust of the problem clearly lay in the virtual nonexistence of disclosure regulations thereby enabling management to overvalue assets or portray corporate activity in any way they desired. There are also several cases of excessive remuneration being paid to officers and directors. One of the most egregious examples cited by commentators involved the Bethlehem Steel Corporation which paid corporate officers over $31 million in bonuses between 1917 and 1928 compared to less than $41 million received by shareholders for the same period. In addition, several corporations enacted provisions in their corporate charters that waived or released insiders from liability to the company for willful or negligent misconduct.

34. W. Ripley, supra note 28, at 72.
crafted plan that involved an investment of only $2.25 million. The vast majority of the shareholders found themselves handcuffed in opposing the transaction since their shares had no voting rights.

Meanwhile, overvalued stock saturated the market and director self-dealing raged on out of control. While state law regarding fiduciary duty outlawed much of this practice, the legal apparatus needed to tame the situation simply did not exist. Finally, in 1926, the New York Stock Exchange and the New York Curb condemned the practice of disenfranchising the shareholder with non-voting shares and refused to list companies that engaged in the practice. The event marks the codification of the one-share, one-vote rule and the beginning of the effort to regulate corporate abuse through shareholder oversight. Unfortunately, the shareholder had long since become an investor guided almost exclusively by profit potential. Thus, the real origins of the arguments championing corporate democracy stem from a perception of the shareholder as an eager, interested party. That shareholders have little or no interest in overseeing and disciplining their corporation's management explains why then, as now, the theory ultimately fails.

Significantly, the impetus to eradicate non-voting stock was ignited by the furor and outrage of corporate directors' flagrant abuse. Reformers simply compelled management to change by outlawing nonvoting stock. However, management quickly found other conceptually similar arrangements to accomplish the same objective of concentrated power. Soon, voting trusts emerged that enabled management to consolidate a majority of the voting shares under the guard of a single trustee. The momentum behind the reform effort

35. A. Berle & G. Means (1932), supra note 31, at 75-76; Seligman, supra note 6, at 694.
37. For a general discussion of state securities law prior to the federal regulations enacted in 1933 and 1934, see Berlack, Federal Incorporation and Securities Regulation, 49 Harv. L. Rev. 396 (1936); Mulvy, Blue Sky Law, 36 Can. L. Times 37 (1916).
38. A. Berle & G. Means (1932), supra note 31, at 76.
39. Loomis & Rubman, supra note 15, at 153 ("The demise of nonvoting common resulted from outside pressure and outrage, not from a reformed consciousness on the part of certain corporate managers.").
40. Voting trusts involve the creation of a group of trustees empowered with the authority to vote all stock placed in a specific trust. The stock's owners therefore do not vote their shares but still receive disbursements according to normal procedure. Voting trusts are considered to be the most powerful devices available for separating control from the stock ownership. Although often regulated by state law, such regulation has focused on limiting the duration of trusts rather than prohibiting them altogether. See A. Berle & G. Means (1967), supra note 22, at 73.
quickly fizzled as shareholders, both private and institutional investors, remained indifferent to the activity of their respective boards.

After the ruins of the Depression, the thirties ushered in a period of reform that would forever change corporate governance. The widespread corruption of the twenties had played a key role in the market’s collapse, demanding that full disclosure requirements and strict regulations be applied vigorously to any future transactions involving a public entity’s stock. The Securities Act of 1933 and the Securities Exchange Act of 1934 followed this period of corruption, and the Securities Exchange Commission was subsequently created to write and interpret the panoply of rules authorized by the Acts. In turn, the responsibility for policing corporate management gradually shifted into the hands of federal and state commissions which, armed with a code of rules, assumed the role of overseer jettisoned by shareholders. The judicial system facilitated the effort by fashioning and enforcing doctrines such as the duty of care, duty of loyalty and the business judgment rule to sabotage undesirable board practices.

Significantly, those that masterminded the changes opted not to rely on shareholder participation to curb managerial abuse, clearly suggesting a recognition that shareholders lack both the capacity and interest to assume the duty. Rule 14(a) of the 1934 Act stands as the sole provision that attempts to bring shareholders into the governance fold. However, its limitations in terms of creating meaningful access to the proxy system reveal its true colors as a largely symbolic rule. Thus, the transformation was complete; the regulation of corporate management would be a governmental function.

41. Much of the blame for the Depression fell on the shoulders of corporate management who seemed to be a likely scapegoat. See S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933) ("[W]e cannot but believe that many recent disastrous events in the investment world would not have taken place if those whose names have appeared as directors had known themselves to be under a legal, as well as a moral, responsibility to the investing public.").

42. For a general overview of registration and disclosure requirements mandated by the Acts, see L. Loss, SECURITIES REGULATION (1980). The birth of the SEC, it has been suggested, was “an accident.” The Federal Trade Commission appeared to be the likely candidate for the role of enforcing securities regulations; however, Senator Carter Glass and opponents of the Exchange Act feared that agency was overly saturated with aggressive New Deal reformers. Thus, the push for the agency was inspired by the hope that it would be less effective. This has not proved to be the case. J. Seligman, THE TRANSFORMATION OF WALL STREET—A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 91-99 (1982).

A. The Shareholder of Today

Perhaps the most unfortunate repercussion of the securities laws and regulations lies in the way they validate shareholder passivity. The complex web of government regulation that ensnares public corporations fosters a sense of security within shareholders that allows them to remain oblivious to their corporate board's behavior. They can afford to be indifferent because there are regulations that protect their interests. As a result, from the 1930's to the 1980's, the pattern of shareholder participation has varied little and never threatened to significantly impact management.44

In addition, like the stock buyer of the twenties, today's shareholder purchases stock for investment purposes: profitability or secure, long-term gain.45 The authority to vote the purchased shares in a meaningful way does not seem to weigh in the decision. Arguably, holders of common stock have made a deliberate choice over other investment products such as a company's preferred stock or a bond. But the vote attached to a security is not necessarily its most alluring feature in terms of attracting purchasers. Dividends paid to common stock are not fixed, nor must its holder wait for a maturity date. Shareholders are the residual claimants of the firm's assets and, therefore, face no limitations on the amount they can receive if the company's profits skyrocket. Thus, the present day shareholder generally purchases stock for investment purposes and anticipated return, not for the chance to voice a controlling interest.

Strong arguments have been put forth extolling the value of the shareholder vote. Certainly, it serves an essential function in the governance process by creating a tangible constituency empowered to act when a corporation fails to meet its contractual obligations. Yet, that

44. For a discussion of the exceptions to this premise, see infra notes 55-59 and accompanying text.
45. Some commentators argue that the vast majority of shareholders "do not even deserve the right" to vote since their stock purchase, in the secondary market, does not contribute "risk capital" to the corporate entity. Flynn, supra note 30, at 98. Today's stockholder does not hold shares as an owner or entrepreneur. "Instead, they are investors in a huge crap game, betting upon the ability of the holder of the die (management) to accumulate and expand their holdings." Flynn, supra note 30, at 98.

In 1981, AMAX, Inc. attempted to give meaning to the term ownership by letting its shareholders know exactly what each share was worth in terms of corporate assets. For each share of common stock, the bulletin read, "you own" reserves of 53.6 tons of coal, 3.7 tons of copper ore, 0.1278 tons of silver ore and so on through natural gas, potash, and tungsten. Advertisement, Wall St. J., July 29, 1981, at 43, col. 3. But, as Professor Lowenstein notes, "the shareholders of AMAX knew that no matter how valuable the real assets might be, they did not own anything but their shares. They had bought their AMAX shares solely for resale." Lowenstein, supra note 18, at 276.
type of authority has little value to anyone but a corporate insider or a creditor on the open market. Indeed, securities are never advertised through campaigns that highlight “residual value;” instead, profit potential captures the most attention. The shareholder receives a vote along with the stock purchase; however, undoubtedly the holder has less interest and perhaps less authority to actually control the corporation than a creditor who might have contracted with the corporation and thereby retained the power to veto risky business ventures.

This analysis applies with equal veracity to both small-private and large-institutional shareholders. The recent record-breaking activity in the mutual funds market bolsters this theory. Mutual funds signify the ultimate renouncement of any interest in corporate control as the purchaser of such shares allows a group of money managers to select and purchase stocks to achieve various pre-expressed investment goals. The mutual fund owns the shares on behalf of their investors and buys and sells according to anticipated fluctuations in the stock’s price. The voting power of the shares is rarely, if ever, exercised.

Other institutional investors do not vote their shares as meaningful owners because their concern lies in investment return. They subscribe to the “Wall Street Rule,” which calls upon the professional investor to sell rather than initiate change if dissatisfied with management’s performance. Often the funds comprising the holding represent institutional reserves, generally pension plans or insurance accounts. Those controlling the funds gravitate toward investments that offer security, profitability or some blend of the two, but not for the shares’ voting strength. In fact, the corporation's perceived ability to fulfill the investor’s objectives will often be the determinative factor upon which the decision to invest turns. As one commentator noted,

46. Statistics show the volume of mutual fund transactions has risen considerably in recent years. Apparently, the explanation lies in the luxury the funds offer investors in that the difficult decisions are made by an informed group. The investor seems to be attracted to investments that require little or no participation. See Small Investors Going to Mutual Funds, Wall St. J., Feb. 7, 1986, at 1, col. 6.
47. T. FRANKEL, THE REGULATION OF MONEY MANAGERS, Ch. XX, E § 19.1 (1980).
49. Id. at 605-55.
50. Ratner, The Government of Business Corporations: Critical Reflections on the Rule of “One Share, One Vote,” 56 CORNELL L. REV 1, 26 (1970) (“the institutional investors generally want shares only for the possibility of profit or return. They do not really want the votes . . ..”).
[there] are problems created by lodging the power and responsibility for the selection and legitimization of corporate management in the hands of [money managers] who have disclaimed any interest in the election decision. The standard line of the institutional manager is: ‘We vote with the management. If we don’t like the management, we sell the stock.’ . . . [T]his attitude creates a rather large vacuum in the corporate election process.  

Deliberate abstention, rather than pure apathy, sometimes explains the institutional investors’ reluctance to vote the shares it holds. During “campaign General Motors” in 1970, the General Motors Board solicited proxies from its majority shareholders so that management’s response might reflect its owners’ perspective of the socially pregnant issue.  

Yale University, holder of 25,000 votes, refused to vote on the proposal stating that “the Fellows of [Yale University] do not and should not have the power to take a corporate position in issues of a political or social nature which do not directly affect the university. . . .”  

Regarding Yale’s statement, one commentator poignantly remarked,  

[the] institutional investors that are amassing an increasing proportion of the voting shares of major industrial companies, do not want the votes that come with these shares if it requires them to do anything other than make a decision on how best to increase their investment return to meet their pressing financial needs.  

B. The Nature of Shareholder Participation  

While achieving corporate democracy through director-shareholder synergy remains a fantastical ideal, certain events suggest that shareholders do come forward when their interests are sufficiently piqued. However, an analysis of that movement, facilitated by the

52. Stoller, Saverin & Cunningham, supra note 51 at 28. See Proxy Statement of Campaign GM (Mar. 25, 1970). Campaign GM was initiated by the Project on Corporate Responsibility, a Nader-affiliated organization. It consisted of nine resolutions for inclusion in General Motors’ proxy statement which proposed that the company take a more active role in its own racial integration and generally be more responsive to progressive public policy.  
54. Rainer, supra note 50, at 29.
proxy contest, various state laws, and Rule 14a-8 of the 1934 Act, reveals the limits of its significance in terms of indicating a trend toward meaningful shareholder voting.

Rule 14a-8 encourages shareholder participation by sanctioning their use of the proxy system to change corporate policy at the corporation's expense. The rule permits a qualified security holder "to present a proposal for action at a forthcoming meeting of the issuer's security holders." Termed the shareholder proposal rule, the provision attempts to promote shareholder democracy by requiring corporations to include its shareholders' ideas in distributed proxy materials. Accordingly, several shareholders have ambitiously utilized Rule 14a-8 as an instrument for corporate change.

Yet, statutory limitations severely restrict the subject matter that shareholders are entitled to address in the proxies. Any proposal relating to the conduct of the corporations ordinary business operation or elections to the board can be rejected by management pursuant to Rule 14. Consequently, the rule attracts proxies primarily concerned with social issues and undesirable corporate activities. Such proxies were more frequently filed in the late 1960's and early 1970's when Americans grew impatient with unbridled bureaucratic abuse and directed their anger at big business. Dow Chemical Company faced a proxy from shareholders seeking to prohibit its chemical weapons division from producing armaments, and shareholders of General Motors launched a campaign to compel its directors to more actively pursue the company's racial integration. A large majority

55. Regulation 14A of the 1934 Act allows shareholders that meet a certain set of qualifications to have their proposal included within the corporation's proxy. It states, "[i]f any security holder of an issuer notifies the issuer of his intention to present a proposal for action at a forthcoming meeting of the issuer's security holders, the issuer shall set forth the proposal in its proxy statement. . . ." 17 C.F.R. 240.14a-8 (1986). Rule 14 of the 1934 Act also contains the rules and regulations regarding proxies. See Loss, The SEC Proxy Rules and State Law, 73 Harv. L. Rev. 1249 (1960).


57. Rauchman v. Mobil Corp., 739 F.2d 205, 207 (6th Cir. 1984) (The court noted the oddity of the rule in comparison with the other rules of the Act, stating that "Rule 14a-8 seems unrelated to prohibiting the inclusion of misleading or dishonest information in proxy statements, which is the primary object of the statute.").

58. See H. Bloomental, Securities and Federal Corporate Law ¶ 13.35 (1987). (Rule 14a-8(c)(8) provides for exclusion of a proposal which "relates to an election to office.")


of shareholder proposals are voted down, and many are judicially voided in their infancy. Others, like the General Motors campaign, may have a long-term impact or at least result in highlighting the issue for future debate.

Opposing management's slate of directors, electing a different set of directors, or otherwise probing into the corporation's by-laws or operations requires a proxy filing under Rule 14d. The procedure necessarily burdens the shareholder with a significant expense in terms of both time and money. Disclosure requirements vary according to state law and the particular focus of the proxy, but full compliance often involves a substantial effort. Nonetheless, the proxy offers the shareholder a vehicle for accessing corporate decisionmaking and represents the most sound principle of corporate democracy available in the federal statutes to date.

Several state laws permit shareholder involvement in addition to that allowed by Rule 14. Delaware statutes, for example, authorize shareholders to choose managers directly or through an elected board of directors. Directors and managers serve full terms at the shareholders' discretion and can be removed at any time for any reason. Clearly, the legal machinery surrounding corporations permits shareholders, irrespective of the difficulties involved, to voice concerns or attempt to implement some structural changes.

Whether or not the shareholder proposal, the proxy contest or the various state statutes actually offer the shareholder a sufficient instrument for participation remains an unresolved issue. The significance of these elements lies in the way they have not been used. Although the cost and effort may or may not be the reason why only the largest or wealthiest stockholders can consider the proxy alternative, the fact remains that corporate boards are not routinely faced with challenges from shareholders. The analysis shows that share-

61. Shareholder proposals must relate in some capacity to the business' conduct or operations. Management can reject shareholder proposals that seek only to highlight political issues that bear no relationship to the corporation. See generally Libeler, supra note 59.

62. Forbes, Apr. 15, 1976, at 40, 42 ("[W]inning the vote is not the main point. There is also the publicity.").

63. H. Bloomenthal, supra note 58, at ¶¶ 13.10-13.34. For some exemptions, see Rule 14a-2.


66. Id. § 141(k).

67. Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 346, 402 (1983). Shareholders do not have the incentives to become informed to vote intelligently be-
holders do not attempt to make use of the proxy machinery available to them. When they do, it is almost always a corporate raider engaged in a proxy contest for personal gain, rather than for the betterment of the corporation, or a shareholder proposal concerned about a social issue.

Clearly these rules and regulations have neither galvanized the interest of shareholders in voting their shares nor abated their apathy in supervising management. In short, the ideal of the corporate democracy exists only in theory, as reflected in the behavior of both shareholders and management alike.

III. THE NEW CORPORATE DEMOCRACY: THE HOSTILE TENDER OFFER

A legion of factors concerning the circumstances and market conditions of the 1970's accounts for the outbreak of the hostile tender offer flurry. Cash tender offers had taken form in the 1960's, but since stock prices remained well above earnings, few companies could afford the premium needed for a successful bid. By 1974, the sluggish market had pulled the aggregate price of many stocks down to within five or six times that of their earnings. As interest rates and construction costs soared, astute managers began to acquire and merge rather than build. When the investment firm of Morgan Stanley broke the long-standing "hands off" tradition re-

68. The development of the cash tender offer had a particularly sharp impact on the manner in which bidders approached takeovers. The growth of large pools of capital made purchase-type takeovers of publicly-held corporations feasible. This practice began to attract attention in the 1960's; however, mergers and acquisitions of that period predominantly occurred as a result of negotiated transactions. Statistics indicate that over two-thirds of the contested bids for corporate control in the 1960's were defeated. See Hayes & Taussig, Tactics of Cash Takeover Bids, HARV. BUS. REV., Mar.-Apr. 1967, at 137. It is generally agreed that low stock prices and chronic inflation spurred the rapid spread of the hostile tender offer in the 1970's. Cash became the most overvalued asset on the market and thus depressed shares were readily snapped up. Hostile mergers became common. Total merger activity broke all-time records for volume rising from about $12 billion in 1971 to $44 billion in 1979, and $82 billion in 1981 to more than $100 billion in 1984. See J. Boesky, supra note 5, at 22.

69. See P. Hoffman, The Dealmakers 143 (1984) ("Tender-offer raids themselves were a symptom of the sagging market. During the go-go years of the 1960's, when stocks sold for fifteen to twenty times earnings, few companies had the resources to offer thirty to forty for another's shares.").

70. P. Hoffman, supra note 69, at 142. Whenever economic factors such as the oil embargo of 1973 stall production, stock prices will drop and a corporation's liquidation value may reach or even exceed it aggregate worth as reflected by its stock. Such corporations are "ripe" for takeover. See J. Boesky, supra note 5, at 80.

71. P. Hoffman, supra note 69, at 143.
Regarding tender offers embraced by most law firms and brokerage houses, the wildfire began.\(^{72}\)

The hostile takeover mania that continues to stir the financial community has completely transformed traditional corporate methods and operations.\(^{78}\) Corporate raiders work quickly, identifying undervalued companies and then purchasing its stock by offering a premium above market value. Before management can rally a defense, the raider owns a controlling interest and votes the board out.\(^{74}\) Herein lies the significance of the hostile tender offer in terms of corporate democracy. Although the corporation issued voting stock for years without fanfare or response from shareholders, suddenly these raiders, the new holders of the corporation’s stock, are exercising the attached voting right and ousting management.\(^{75}\) In a technical sense, since the shares are voted and their holder is possessed of an interest in manipulating the business’ disposition, corporate democracy is at work. Of course, corporate democracy ideally envisions shareholders participating for the betterment of the corporate entity. The hostile bidder’s motivation usually involves self profit at the expense, or even demise, of the company. Clearly, it is not corporate democracy in its fullest glory. Nonetheless, the transactions involve the owners of stock exercising their right to influence and even change management. That democratic process, even if it is a distortion in the given circumstances, has never really occurred before. So, as raiders continue to hunt for corporations, management shudders at the new meaning of shareholder voting.

The Williams Act set out a package of guidelines to regulate

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\(^{72}\) P. HOFFMAN, supra note 69, at 142. (The blue-chip law firms and investment banks maintained the “old school’s gentlemanly hands off policy” toward advising raiders on hostile bids until Robert F. Greenhill took over Morgan Stanley’s mergers-and-acquisitions department. In 1974, Greenhill helped International Nickel of Canada takeover EBS Inc., a Philadelphia battery maker and the “stampede started.”).

\(^{73}\) The threat of hostile takeover and the use of anti-takeover provisions has caused significant problems for the judicial system as well. The judicial system must grapple with the difficult task of evaluating management decision-making and has encountered several problems in articulating a clear set of guidelines. See Matheson & Norberg, supra note 1, at 415.

\(^{74}\) See E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL (1977). Takeovers are motivated by a variety of factors. Sometimes ego or machoism allowance is sufficient. See generally Coffee, supra note 16 and accompanying text.

\(^{75}\) There are basically two types of bidders executing a hostile tender offer. One, the individual raider, usually seeks to acquire the corporation for its liquidation value. The other, the corporate entity, seeks a merger to strengthen its position or increase its size. In both cases, existing management must be removed. See generally Lowenstein, supra note 18 and accompanying text.
the tender offer practice.\textsuperscript{76} However, determined bidders with creative schemes quickly devised new and innovative approaches to succeed in the spree for corporate control.\textsuperscript{77} Invariably, their plans envisioned the restructuring of the target’s corporate management by voting the shares that wield that control. One of the more devastating techniques employed by raiders involves a “two-tier” or front-loaded offer whereby an offer for 51 percent of the target’s voting stock is extended to shareholders. Once the raider acquires the 51 percent threshold, the offer expires. The raider then uses the controlling votes to force either a merger, commonly known as a “bear hug,” or management out—through a much less expensive exchange of stock.\textsuperscript{78} The technique gives a substantial advantage to the raider since it minimizes the needed initial cash outlay and achieves more quickly the goal of takeover.

The problem acquires a more troubling dimension for corporate management as creative mechanisms for financing these transactions flood the market. “Junk bonds,” high-risk subordinated debt, enable a wise raider bolstered by an aggressive investment banker to wrest control of a multi-million dollar corporation from the hands of its management.\textsuperscript{79} Clearly, the hostile battle for corporate control seems to be stacked against management.\textsuperscript{80}

While the Williams Act has been amended to restrict the two-tier tender offer, the nature of the corporate structure continues to fuel the raider’s success.\textsuperscript{81} The raider in possession of a large block of a corporation’s stock has discovered the spectacular power that inures to him through the possession of voting rights. For the first time, shareholder democracy has found a basis in that the shareholder has exercised his right to vote. Unfortunately for management, that process has worked an abrupt and violent change on traditional modes of merger and acquisitions dealmaking, almost completely removing them from the negotiations equation.

Frequently, a target’s shareholders welcome the hostile bidder

\textsuperscript{77} Cash was the primary instrument used to complete deals in the 1970’s. But exchange deals are now much more common whereby the aggressor offers a package of securities or an equity interest in itself or its subsidiaries in lieu of cash for the target’s stock. R. HAMILTON, supra note 60, at 787.
\textsuperscript{78} See supra note 16 and accompanying text.
\textsuperscript{79} See Carney, Junk Bonds, supra note 17, at 18, col. 3.
\textsuperscript{80} See generally Lowenstein, supra note 18; Coffee, supra note 16.
because the price of the stock invariably rises. The shareholder, it
will be recalled, generally prefers the quick return of profit to the
intangible security and benefits that come from having a solid group
of managers at the corporation’s helm. Shareholders stand to gain
even more if management engages in a bidding war or attracts other
equally eager third parties into the fray. Meanwhile, the corporate
entity necessarily suffers since management invariably bogs down in
defensive posturing and becomes distracted from the main task of
managing. Shareholders who tender at the inappropriate time or not
at all may also suffer. But the process of the hostile takeover has
emphatically changed both the meaning and significance of the
shareholders’ right to vote.

One illustration of this change can be more closely examined by
analyzing the recent restructuring events of Union Carbide. The
price of that corporation’s stock hit rock bottom after a chemical spill
at its Bhopal, India facility immersed the company in a jungle of
major lawsuits. Three different arbitragers moved in, quickly buy-
ing up shares of Union Carbide stock at bargain rates. The
company and its stock price subsequently rebounded, but thirty percent
of its shares remained in unfriendly hands. Since the new sharehold-
ers were “out to make money fast,” management was distracted and
could not remain focused on the corporation’s business. As a result,
management initiated an elaborate restructuring and repurchasing
plan designed to bring that stock back into the fold of friendly con-
trol. The restructuring will be felt by Union Carbide for years to
come since it “shrinks the company, raises dust and changes Car-
bide’s overall strategy.” Nonetheless, the disposition of the com-

82. See Easterbrook & Fischel, The Proper Rule of a Target’s Management in Re-
sponding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981).
83. See supra notes 30-31 and accompanying text.
84. Comment, Greenmail: Can the Abuses Be Stopped?, 80 Nw. U. L. Rev. 1271, 1275
(1986).
85. See Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate
Takeovers, 98 Harv. L. Rev. 1698, 1720-23 (1985) (shareholders often face a prisoner’s
dilemma-type choice).
86. Union Carbide’s Destiny Shaped by the Changing Nature of its Holders, Wall St.
87. Id.
88. Id.
89. Id. at 18, col. 2. (The paragraph continues: “But those aren’t [the arbitragers’] con-
cerns. Within a month or two he expects to be out of Union Carbide and looking for new
takeover stocks.” Id. The sentence underscores the poignancy of the problem management
confronts when voting rights designed for shareholders concerned with the corporation’s best
interest fall into the hands of those motivated solely by personal gain. The shareholder concept
came about to help corporations run more lucratively, not the other way around.)
pany's shareholders mandated the move. Management recognized that its new shareholders wanted quick profits and responded by issuing them accordingly. The alternative would have been devastating: the arbitragers would sell to a hostile bidder who would liquidate a majority of Carbide's holdings and otherwise create traumatic change. Thus, the shareholders' threat to vote forced management to radically alter its corporate strategy.

Whether the tender offer benefits corporate America, shareholders and society as a whole is uncertain. However, the practical effect of the raider's presence has clearly precipitated some fundamental changes in traditional corporate structure. The erstwhile meaningless vote attached to an issued share has acquired tremendous potency in the hands of the bidder or arbitrageur. For the first time in history, the ideal of shareholder participation, of corporate democracy, has become a reality. Unfortunately, it is not a democracy imbued with endearing notions of equity and shared-effort. Instead, it more closely resembles a crafty manipulation of a system that was never intended to be used in that manner.

IV. MANAGEMENT FIGHTS BACK: DEFENSIVE TACTICS

In response to the tender offer crunch, management seized upon whatever takeover defense it could find to rebuff the raider. Over a decade has passed since that process began, and corporate counsel, now thoroughly skilled in the practice, has saturated the market with various anti-takeover devices. The early "shark repellents" and "poison pills" often reflected a rudimentary approach to solving the problem. Invariably the plans envisioned some deliberate harm to the corporation, thereby rendering it a less attractive target for a raider to ingest. Corporations would take on substantial debt or acquire

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90. For a thorough analysis of the arguments for tender offers, see Bebchuk, Facilitating, supra note 9; Easterbrook & Fischel, supra note 9; Gilson, Structural Approach, supra note 9; Gilson, The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concepts, 34 STAN. L. REV. 775 (1982). For a critical view of takeovers, see Liman, Has the Tender Movement Gone Too Far?, 23 N.Y.L. SCH. L. REV. 687 (1978); Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 BUS. LAW. 1017 (1981).

91. See generally Coffee, supra note 16.

92. SHARK REPELLANTS AND GOLDEN PARACHUTES: A HANDBOOK FOR PRACTITIONERS §§ 395-422 (1986) (R. Winter, M. Stumpf & G. Hawkins eds.) (While anti-takeover provisions were occasionally found in corporate charters prior to the advent of the hostile tender, their use became widespread only after that phenomenon began.).

93. Id.

94. Gilson, Shark Repellant, supra note 90, at 776.
new entities to trigger antitrust problems for the bidding corporation.\textsuperscript{95} Other techniques involve selling off the target’s prime asset or incorporating “flip in” provisions that permit target holders to automatically acquire a controlling interest in the merging corporation.\textsuperscript{96} However, all these tactics seem to suffer conceptually as a true defense to potential raiders, since they are virtually inapplicable until the takeover begins. Like an enjailed secret agent who chooses cyanide over a tortuous interrogation by his enemy (ergo the term “poison pill”), the plans lack deterrent value.\textsuperscript{97} In that alone, these formulas are flawed. In addition, when successful they frequently cause sizable harm to the corporation from which it often takes years to recover.

The inherent conflict of interest faced by management in fighting any takeover attempt raises other significant questions. Management’s concentrated effort on a strong defense necessarily distracts it from the more important task of proper management.\textsuperscript{98} Moreover, the battle will no doubt be costly for the corporation, especially if greenmail or self tender becomes an option.\textsuperscript{99}

Management must tread carefully in this area, always aware of their duty to account for their actions. Courts have entertained shareholders’ derivative suits brought against managers who squandered corporate assets to retain control.\textsuperscript{100} Accordingly, some commentators have argued that the proper function for managers con-

\textsuperscript{95} See Siegel, supra note 2, at 379. Section 7 of the Clayton Act, 15 U.S.C. § 18 (1982), generally prohibits stock acquisitions “where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” Id. See, e.g., Babcock & Wilcox Co. v. United Tech., Corp., 435 F. Supp. 1249, 1255-56 (N.D. Ohio 1977).

\textsuperscript{96} See supra note 2 and accompanying text. “Poison Pill” rights plans are fully described in SHARK REPELLANTS, supra note 92, at 4.

\textsuperscript{97} See Gilson, supra note 90, at 775-79 (arguing that only those shark repellants which actually amend the corporation’s by-laws have actual deterrent effect; other anti-takeover provisions are either detrimental or inexpedient).

\textsuperscript{98} See generally Lipton, supra note 90.

\textsuperscript{99} Greenmail refers to the target’s repurchase of shares held by a hostile bidder at an above average price. Self tender involves management’s buy back or bidding for its own shares. Both transactions are costly in terms of corporate expenditures. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950 (Del. 1985) (discretionary self tender requires the target to incur enormous debt).

\textsuperscript{100} Such actions are brought on a breach of duty theory. Courts have applied the business judgment rule which requires the director to prove the defensive actions were fair and reasonable to the corporation. It has not been difficult for directors to avoid liability under this standard. See supra note 4 and accompanying text. Treadway Companies v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Revlon, Inc. v. MacAndrews & Forbes, 506 A.2d 173 (Del. 1986); see also D. DeMott, SHAREHOLDER DERIVATIVE ACTIONS L. & PRAC. § 4.03 (1986).
fronted with hostile bidders is total passivity. Even though the business judgment rule will vindicate all but the most flagrant defensive tactics, the war for corporate control remains ugly.101

In turn, management has begun to rethink defensive strategy. The rapid spread of "golden parachutes," whereby top management receives lucrative severance pay guarantees in the event of their displacement, marks the first signs of the new defense tactic.102 This more logical approach addresses the mechanics of the tender offer and specifically converges on that aspect which allows the takeover to occur—namely, a raider's acquisition of enough stock to vote management out. Poison pills have made headway in that respect; but a more potent formula might yield better results. In concentrating on the dynamics of voting share consolidation, dual class capitalization has emerged, engrossing management because of its piercing focus on the source of their problem.103

It is important to note that the practice of dual class capitalization is, at best, currently on probation. The New York Stock Exchange refuses to list firms with dual class common stocks, preferring instead the one-share, one-vote rule discussed below.104 But the Exchange has recently reconsidered its position.105 Recognizing that "[m]any of the Exchange's requirements were designed in a time when unnegotiated offers for securities of an issuer were virtually unknown," the Exchange has discontinued the practice of delisting firms that implement dual capitalization schemes.106 This change has been partially fueled by competition the Exchange feels from both the American Stock Exchange and the National Association of Securities dealers who trade on the NASDAQ, both of which reject the one-share, one-vote listing requirement.107 Thus, dual class capitali-

102. SHARK REPELLANTS, supra note 92, at § 425; N.Y. STOCK EXCHANGE LISTED COMPANY MANUAL § 313.00 (1985); compare AMERICAN STOCK EXCHANGE COMPANY GUIDE 122 (1985).
103. See supra notes 6, 10 and accompanying text.
104. N.Y. STOCK EXCHANGE, INITIAL REPORT OF THE SUBCOMMITTEE ON SHAREHOLDER PARTICIPATION AND QUALITATIVE LISTING STANDARDS, DUAL CLASS CAPITALIZATION 2, 3 (1987) ("The onset of tender offers has caused a wide-ranging re-examination of many accepted legal doctrines when shareholders are provided with extensive and meticulously regulated information . . . and then vote for such recapitalizations, the Exchange should penalize them . . . by denying them the benefits of an Exchange listing.") [hereinafter INITIAL REPORT].
106. See INITIAL REPORT, supra note 104, at 2-3.
zation appears to be headed for a busy future.

A. Dual Class Capitalization

The prototype dual class recapitalization involves the reclassification of the corporation's outstanding shares into two classes that have disproportionate rights in voting.\(^{108}\) The recapitalization creates a new class, commonly known as class B common, which is allocated ten or more votes per share. The outstanding common, now-termed class A common, retains its one vote per share. The class A shares can be freely transferred and their holders retain a normal dividend preference. Conversely, the class B common shares cannot be publicly traded and carry an inferior right to dividends. After the reclassification, but for a limited period, the holders of class A are permitted to exchange for shares of class B. Since the process involves an amendment to the corporation's certificate of incorporation, shareholder approval must be obtained.\(^{109}\)

The concentration of voting power occurs over time. Generally, management and select white knights will exchange all their holdings for class B while other investors retain their class A for its dividend and transferability features. The class B may always be tendered for class A on a share-for-share basis so that shareholders who initially exchanged will not be locked into the restricted shares. Any other transfer of class B will be prohibited or will automatically convert that stock into class A. Thus, as the system operates, class B shares gradually flow into the hands of management while outside investors amass the class A shares. In turn, management stymies the corporate raider by accumulating the stock empowered with superior voting rights that ensures continued control. Meanwhile, the holders of class A continue to receive dividends and remain free to trade their shares.\(^{110}\)

Recapitalization can be implemented in any variety of ways, but the ultimate objective remains constant: concentration of voting control.\(^{111}\) The result secures management's position without visiting

\(^{108}\) For a general overview of the mechanics of dual class capitalization, see J. Seligman, The One Share, One Vote Controversy 11-13 (1986).

\(^{109}\) Statistical data compiled and analyzed by De Angelo & Rice indicates that shareholders routinely approve such amendments in spite of the detrimental implications for them as a whole. They assert that even "informed" investors find little value in opposing a management anti-takeover plan. DeAngelo & Rice, Antitakeover Charter Amendments, 11 J. of Financial Econ. 329, 334 (1983).

\(^{110}\) J. Seligman, supra note 108, at 12.

\(^{111}\) J. Seligman, supra note 108, at 12.
any significant hardship upon the corporation's reserves or shareholders. The Wang Laboratories recapitalization in 1976 illustrates the mechanics of a typical plan.

Wang issued a dividend of one share of class B common for every four of its outstanding shares. The class B paid a higher dividend per share and entitled its holders to elect twenty-five percent of the company's board. The remaining directors were elected by the holders of the common, or class A stock. On all other matters outside of the election of management, both groups of holders vote together, with class B having one-tenth of one vote per share and class A one full vote. The plan neither restricted the transferability of either class nor imposed an automatic conversion requirement.

Subsequently, Wang amended the plan to require that any merger or consolidation must be approved by two-thirds of the class A and class B shares voting together as well as each class of stock voting separately. In effect, the amendment precludes a merger or consolidation unless such a proposal receives three separate approvals. Since Wang's family owned 73.8 percent of the class A common, it had final veto power over any change in management even though the class B stock represents 95 percent of the company's value.

The Dow Jones and Company's recapitalization in 1984 provides another enlightening example. That transaction involved the dividend issuance of one share of newly-created class B stock for every two outstanding shares of common, or class A. Both shares have equal rights to dividends and other distributions, but each class B share has the power of ten votes. Class B stock, however, cannot be transferred to any outsiders, although it can be used to redeem unrestricted common class A shares at a rate of one to one. Therefore, as shareholders begin to trade their holdings, they will convert their class B shares for class A shares. Eventually, management will hold all the potent class B shares and control the election of the board, in spite of the fact that its holding represents a fraction of the company's initial capitalization.

114. Id.
115. Id.
B. **Shareholder Voting Comes Full Circle**

These various manifestations of dual class capitalization design-
edly share the common objective of neutralizing the shareholders’ voting power. An issuance of stock no longer endows its holder with a permissive right to participate in the corporation’s politics. Instead, the instruments of control shift into the hands of management, and the masquerade of corporate democracy is forever castaway as a desired goal. In causing that effect, dual class capitalization furnishes management with its much-needed elixir. However, such a coup cannot be won without a fight, and opponents of restricted voting shares are prepared for battle.120

Such an emphatic transfer of corporate control raises obvious concerns regarding the protection of shareholders’ interests and the supervision of management. By far the most troubling scenario pictures management exploiting its freedom to govern without a constituency and thereby tumbling the corporation into bankruptcy or out of existence. Shareholders would be powerless to vote management out or influence their decision-making unless some evidence of fraud or gross negligence was apparent.121 As the price of the stock plummeted, shareholders’ only recourse would be to sell their shares on the open market. Yet, as gruesome as it sounds, that remedy does not appear to be entirely inadequate. In fact, any group of shareholders from a traditionally capitalized corporation would probably respond in the same fashion. In other words, even those shareholders possessed with the right to vote out slothful or unwanted management will not do so given the choice between that and liquidating the interest in the market. Indeed, the shareholder is an investor who, as the above analysis has demonstrated, shirks the duty of monitoring management.122

Herein lies the roots of the full circle analysis. Although dual class recapitalization actually sifts the voting power out of stock, that voting power has a history of not being used by its holder, thus suggesting that its disappearance will not be noticed, or at least not excessively mourned. The practical effect of this recapitalization procedure engenders no significant change in the way most shareholders

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120. T. Boone Pickens, a noted player in the market for corporate control has vociferously criticized the dual class capitalization procedure and is generally considered the spokesperson for the campaign against it. See Pickens, *Second Class Stock Impairs Market*, Wall St. J. Feb. 13, 1986, at 30, col. 3.

121. See H. Bloomenthal, *supra* note 58, at ¶¶ 11.02-11.25 for a discussion of the fraudulent sections that give shareholders a cause of action against directors.

122. *See supra* notes 44-54 and accompanying text.
will behave. Of course, the hostile bidders will suffer, because they did purchase the stock for its voting power. But the hostile bidder represents the new force that subverts the traditional meaning and nature of shareholder voting in the first place. Since the bidder's intent is generally to profit at the expense and detriment of the company, his interests are perceived as not warranting protection as a typical shareholder.

C. Shareholder Protection

Disenfranchising shareholders from their votes is not without its problems. The above analysis shows that dual class capitalization inhibits voting behavior only to the extent that it involves ousting management in a takeover scheme. Yet, even if identifying the dynamics of the process helps to justify or encourage its use, there are other strong shareholder considerations militating against it that must be addressed.

It may be recalled that those who champion the ideal of the corporate democracy, aside from the raiders, do so for two primary reasons: (1) shareholder participation compels directors to manage profitably and honestly; and (2) it allows shareholders, the ostensible, true owners, to voice concerns about the nature and type of business in which the corporation engages.123 While these internal restraints on management seem to evaporate under the dual class scheme, they are somewhat supplanted by other external pressures that operate to accomplish the same objectives, at least in terms of deterring fraud.

The more formidable external restraints, at least for overseeing management, are the SEC, state and federal anti-fraud statutes, and the requirements of the stock exchanges themselves.124 The conjunctive efforts of these bodies, although not always coordinated, successfully minimize the incidence of managerial abuse, fraud and misrepresentation. In fact, as discussed earlier, these agencies have taken the responsibility upon themselves recognizing shareholders' inability to perform the same task adequately. Finally, corporate law provides even non-voting shareholders with ammunition to attack a destructive board. The business judgment rule, various duties of care, and

123. See supra note 19 and accompanying text. See also Ratner, supra note 50.
124. For an indepth examination of the SEC's enforcement techniques and operation, see M. Steinberg, Corporate Internal Affairs 13-31 (1983). Of the three Exchanges, the NYSE maintains the most comprehensive set of requirements and listing prerequisites. N.Y. Stock Exchange Company Manual (1985).
the shareholder derivative suit are examples of doctrines that protect non-voting shareholders from a corrupt management. Thus, the external pressures that engulf corporate management provide an adequate, perhaps more efficient, substitute for the check otherwise inherent in the shareholder vote.

D. Passive Shareholder Pressure

In terms of holding management accountable for the corporation's profitability and efficiency, the problems are more genuine and not easily dismissed. Most companies employ independent directors who govern from a "disinterested" perspective. Ostensibly they help to ensure a certain quality of managerial performance. Independent audit committees are also routinely used to prepare and review the company's financial records. These devices, however, appear to be very limited in their ability to motivate or compel directors to manage efficiently. Of course, most management compensation structures tie salary to performance. Moreover, the manager associated with a failed effort or a bankrupt company will undoubtedly suffer tremendously in terms of damaged reputation. Nonetheless, the external pressures rooted in corporate law that are calculated to ensure managerial efficiency do not necessarily replace the naturally occurring pressure or power housed in the shareholders' vote.

According to the full circle analysis, rendering the shareholder impotent should not affect governance since the votes they hold are rarely exercised. However, the intangible passive pressure that emanates from thousands of uncast or outstanding votes impacts management in a way that is difficult to quantify. Some have argued that every action or decision made by a corporate board anticipates the shareholders' likely response. If shareholders remain passive and continually accede to management's proposals, that represents a sign of approval of a job correctly done. Conversely, if management's direction goes askew and the corporation suffers, shareholders will ac-


126. Most outside directors, however, are selected by internal managers. See Fama & Jensen, Separation of Ownership and Control, 26 J.L. & ECON. 301, 318 (1983).

127. Id.


129. See Fama & Jensen, supra note 126, at 303-07.
ivate their voting rights and implement changes. That this does not happen frequently, if at all, is testimony to the performance of corporate America's boards of directors.

Certainly the passive pressure that management faces from dormant votes plays some role in their decision-making process. It is significant to the full circle analysis in that it highlights a critical difference between the nature of shareholder voting before the hostile bidder impacted the meaning of voting and that supposed nature after the implementation of dual class capitalization. In the latter situation, the shareholder is completely disenfranchised. Therefore, while dual class capitalization may return shareholder voting to its old status, a perhaps crucial component, the dormant power of the vote, is removed from the equation.

E. Shareholder Plans

The primary objective of dual capitalization lies in keeping voting control over management away from raiders. The effect the plan levies upon the corporate structure and the extent to which shareholders will be disadvantaged obviously must be weighed in fashioning its contours. Thus, shareholder rights plans have recently surged in popularity because they avoid any structural changes in the corporation's infrastructure until a certain specific threat develops. In essence, they accomplish the same objective as dual class capitalization without disenfranchising the shareholder.

One such type of plan places a "threshold limitation" on the number of shares any one entity can own for purposes of mandating large transactions such as a merger or consolidation. MCI employs such a plan. Once any owner acquires ten percent or more of the corporation's stock, each additional share in his possession carries

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130. Dual class capitalization has been used for other purposes than defense in recent years. General Motors, for example, has twice in the past two years issued "alphabet" stock representing interests in non-automatic subsidiaries acquired by the company. The new classes have dividend preferences but unequal voting rights and are distributed to employees and management of subsidiaries. Thus, the recapitalization is not a defense but a form of incentive compensation program, or profit sharing scheme, that inspires employees to boost their companies' profits. J. Seligman, supra note 108, at 12-13.

131. These shareholder plans must be distinguished from the basic poison pill provisions discussed previously. While poison pills operate in a similar fashion, they activate target shareholders' rights in or to the acquiring entity, not voting rights. Poison pills aim at making the takeover an unattractive option for the bidder while these plans specifically empower the shareholders to prevent it. These plans are not dual class recapitalizations in the true sense since they do not create a second class of stock. Nonetheless, the plans cap the voting power of large shareholders and thus fall into the recapitalization analysis.

only 1/100th of a vote. Shareholders enjoy participatory rights consonant with traditional governance models, provided they are not bent on monopolizing the corporation's voting stock. Thus, the plan harmonizes the ideal of protecting shareholder access with the competing goal of preventing hostile takeovers.

Another more frequently used plan involves issuing each existing shareholder a "preferred stock purchase right." The right, as in the plan used by the Tyler Corporation, enables the holder to buy 1/100th of a preferred share for $50.00. A preferred share is equivalent to 100 common shares in voting rights, value and dividends. Accordingly, the rights will be exercisable only in the event that one shareholder or entity acquires twenty percent or more of the company's common stock or makes a tender offer for thirty percent or more. Reaching those thresholds triggers the stock's supervoting power and effectively precludes the hostile bidder from acquiring the voting strength to compel a restructuring.

The recurrent theme that can be extrapolated from these various plans is management's need to insulate its outstanding voting shares from stalking hostile bidders. Significantly, these plans are not ploys to forever engrave management's philosophy and form of governance on the corporation. Instead, they represent a deliberate effort to redress the enormous problems that have materialized as a result of the hostile bidder's exercising the right to vote. The aim of the plans focus on limiting the share's voting power with respect to mergers, consolidation and the election of the board. Clearly, the purpose lies in obviating management's need to entertain costly defensive strategies every time a raider hones in.

But, at whose expense are these plans being erected? It appears that those shareholders disadvantaged by these related plans are a much smaller group than those potentially harmed by a full blown dual class recapitalization—namely, those holding the shares to specifically vote out management to secure control or, more specifically,

135. Id.
136. Id.
137. The "managerial entrenchment hypothesis" holds that antitakeover amendments, like dual class recapitalization, primarily operate to increase incumbent management's job protection and decision-making prerogatives at the expense of shareholders. It is often used to substantiate arguments against tender offer regulation. See supra note 104 and accompanying text.
138. See supra notes 108-25 and accompanying text.
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the corporate raiders and hostile bidders. Other stockholders, it will be recalled, are investors that do not purchase shares for voting rights and consistently abstain or accede to management in all matters relating to governance. Yet, they nonetheless retain their voting rights and are encouraged to participate under this type of plan. Of course, it can be persuasively argued that raiders spark drastic jumps in the price of stock and thereby benefit shareholders as a whole. While such arguments may have merit, the focus of this analysis is upon the shareholders of the corporation and the extent to which the flourishing of recapitalization schemes impact them. That analysis reveals that shareholder plans do not seriously jeopardize shareholders' rights since they do not foreclose shareholders from voting or otherwise participating in corporate affairs. In turn, the plans' restrictions on voting rights do not practically affect shareholders or their interests as a group. Only the corporate raider who actually uses the vote to dislodge management is truly disadvantaged by the restructuring. Therefore, whether or not dual class capitalization presents corporate America with a favorable change depends on one's cost benefit analysis of tender offers as a whole. This analysis, however, has demonstrated that the new defensive tactic, by neutralizing the bidder, merely returns shareholder voting to the symbolic status it enjoyed prior to the hostile tender offer deluge without significantly endangering shareholder rights in the process.

Due to the growing awareness of this analysis, critics of these defensive plans are finding their counter arguments increasingly narrowed. Indeed, the most recent shareholder plans that leave the corporate structure completely unmarred until a bidder activates the supervoting defense have almost totally refuted the assertion that the adopted plans trammel shareholders' rights. Instead, the reality is exposed: corporate raiders lose their ability to orchestrate takeovers. Subsequent debate should be focused accordingly.

139. See supra note 75 and accompanying text.

140. See generally supra note 9. Again, these are the leading arguments of those that advocate a restriction-free market for corporate control.

141. The analysis of this article deliberately avoids the pro/con analysis of dual capitalization and does not seek to express an opinion in that regard. For an article that does undertake such a theme, see Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. CHI. L. REV. 119 (1987). See also J. SELIGMAN, supra note 6 and accompanying text.

142. See supra notes 120-25 and accompanying text.
V. Conclusion

Targeted boards seem to embattle hostile raiders on every front in the current war for corporate control. Even the most prolific managers fear overthrow from bidders who deal in mergers, acquisitions, or worse, the assets of a dismantled company. So dual class recapitalization has surfaced as a powerful defensive weapon. The process immunizes corporate boards from foraging raiders by sterilizing the voting power of the company’s outstanding common stock. The resulting structure of the company precludes the possibility of takeover.

As a remedy, however, dual class capitalization seems to go too far since all shareholders are completely shut out of the participation process. Its critics are up in arms over this shifting of control and portend a return to the helter skelter of the twenties if it is permitted to continue. However, the dual class capitalization schemes that have recently captured so much attention can be distinguished from the scams that flourished years ago. The backdrop of today’s recapitalizations looks entirely different in comparison to the corrupt market of decades past. External regulatory checks are woven into the system and perform the management monitoring task, at least in terms of inhibiting fraud, adequately.

In addition, the separation of corporate ownership from control has long ago matured into an accepted and basic principle of corporate law in America. While dual class capitalization might properly be described as the coup de grace to that enduring tug of war, the rift between the two has drifted far past the point of mending. The disenfranchised shareholder, or at least the passive investor, stands more readily as a portrait of the corporate owner than the fictional participant of the corporate democracy. Therefore, the practical effect of dual class capitalization, depriving shareholders of their right to vote, will cause little consternation since shareholder voting has always been meaningless, with the exception of the hostile bidder’s brief tango.

On the other hand, proponents of dual class capitalization cannot reasonably win their case on the full circle analysis alone. That the shareholder traditionally does not exercise the right to vote does not necessarily justify its elimination. Indeed, imagine the outcry if a state attempted to eradicate public elections merely because voter turnout was repeatedly very low. The pressure that uncast votes passively impress upon delegates is difficult to qualify, but it does ex-
Since directors shape corporate policy with the shareholder in mind to some extent, removing that dormant force as a factor for them to consider is tantamount to sanctioning their unfettered control.

What corporate governance needs lies somewhere between the strict one-share, one-vote model and the dual class capitalization scheme. A more balanced approach preserves the constituency ingredient that is so attractive in the shareholder voting formula while simultaneously erecting a barrier to the hostile advances of a raider. The shareholder plans seem to capture both of these ideals. Under such a plan, management maintains a traditional governance model until a triggering event, such as a hostile bidder’s attack, activates the shield. Only then are voting rights diluted and often only those of the bidder. Corporate democracy and passive shareholder pressure survive under these plans, yet they also deter the raider. In that respect, they represent the ideal balance or compromise.
