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# ASYMMETRIC INFORMATION IN MERGERS AND THE PROFITS OF DECEIT

*E.C. Lashbrooke, Jr.\**

## I. INTRODUCTION

Managerial motivation to pursue mergers and acquisitions may vary widely—from empire building to diversification of risk. One such motivation is to allow shareholders of an undervalued corporation to realize the true value of their stock. Stock may be undervalued because of asymmetric information; managers may have inside information of which neither the market nor the shareholders are aware. A slack<sup>1</sup>-poor corporation may have investment opportunities in unfinanced positive net present value projects that it cannot finance without issuing new equity and thereby depressing the market value of the stock—to the detriment of the existing shareholders.<sup>2</sup> A slack-rich corporation may have no such internal investment opportunities. A merger or acquisition of one of these corporations by the other would benefit both shareholder groups.

Managers with knowledge of corporate opportunities who do not maximize the value of the corporation by investing in all positive net present value projects may find themselves takeover targets. New management presumably will invest in the previously foregone opportunities, thereby increasing the value of the subsidiary or combined entity.

Without disclosure of the inside information or the ability to signal a potential suitor, the merger will not take place. This Article examines mergers and tender offers in the context of asymmetric

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1. Slack is the amount of cash and equity securities on hand.

2. Empirical studies show that stock prices are depressed when a corporation announces an equity issue. See Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61 (1986); Richard Kolodny & Diane Rizzuto Suhler, *Changes in Capital Structure, New Equity Issues, and Scale Effects*, 8 J. FIN. RES. 127 (1985); Ronald W. Masulis & Ashok N. Korwar, *Seasoned Equity Offerings: An Empirical Investigation*, 15 J. FIN. ECON. 91 (1986); Wayne H. Mikkelson & M. Megan Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31 (1986).

information and the restrictions that securities laws place on the flow of information and its accuracy.

First, the existing finance literature on mergers is examined. Next, a merger or tender offer between a slack-rich and a slack-poor corporation with unfinanced positive net present value projects is analyzed in the context of federal and state securities laws. Strategies of disclosure and deceit are examined together with their attendant benefits and costs. The Article concludes that the managerial decision to disclose, remain silent, or deceive depends on the managers' subjective evaluation of the risk of being caught.

## II. BACKGROUND

Finance merger literature can be divided into two groups, the older empirical studies on conglomerate mergers and the more modern studies. Gershon Mandelker found that over most of the period prior to merger, the target firms in his sample earned significantly lower rates of return on equity than other firms.<sup>3</sup> Mandelker further discovered a significant and steady increase in cumulative residuals for the target corporation over the seven-month period preceding the merger.<sup>4</sup> Other studies confirm that there is a positive relationship between merger activity and strong economic growth—that is, periods of economic and market advances.<sup>5</sup> Mergers do not seem to have generated increases in the value of the acquiring corporation,<sup>6</sup> but this phenomenon may be explained by Richard Roll's *hubris hypothesis*.<sup>7</sup> Roll's hypothesis is that managers are overly optimistic in evaluating target corporations as takeover candidates and thus pay more for the target corporation than they should.<sup>8</sup> This phenomenon may be a function of asymmetric information.

This asymmetric information problem is quite different than that posed in other finance literature dealing with mergers and tender of-

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3. Gershon Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303, 314, 319-20 (1974).

4. *Id.* at 314.

5. RALPH L. NELSON, *MERGER MOVEMENTS IN AMERICAN INDUSTRY 1895-1956* (1959); SAMUEL R. REID, *MERGERS, MANAGERS AND THE ECONOMY* (1968).

6. Dennis C. Mueller, *The Effects of Conglomerate Mergers*, 1 J. BANKING & FIN. 315, 332-33 (1977).

7. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

8. *Id.* at 212.

fers. In the literature it is usually the bidder who has the information advantage rather than the target management.<sup>9</sup>

Ronald Giammarino and Robert Heinkel modelled takeover behavior in 1986.<sup>10</sup> They model an informed bidder and an uninformed bidder in addition to the target corporation—all of which are risk neutral.<sup>11</sup> The informed bidder has an information advantage over both the uninformed bidder and the target corporation.<sup>12</sup> The model is highly structured and the uninformed bidder is given a tactical advantage in the way in which the bidding is organized.<sup>13</sup> Under the Bayesian-Nash equilibrium, all actions are optimal and each bidder and the target manager correctly anticipate the strategies of the other participants.<sup>14</sup> The model generates two distinctive equilibria resulting from different assumptions about the uninformed bidder's behavior. The first assumption is that the uninformed bidder will not present a counteroffer when expected payoffs from bidding and not bidding are equal.<sup>15</sup> This is the passive competition case. In this case the informed bidder may acquire the target corporation for less than its synergistic value.<sup>16</sup> In the second case, the "white knight" scenario, the uninformed bidder is assumed always to counterbid. A counterbid gives the target corporation a higher price at the expense of the informed bidder.<sup>17</sup>

The Giammarino and Heinkel model gives the target corporation's management a rational basis for rejecting the informed bidder's offer in the hope of getting a higher counterbid from the uninformed bidder.<sup>18</sup> The model also accounts for overbidding by the uninformed bidder and loss of the offer if the informed bidder's offer is rejected and a counterbid is not forthcoming.<sup>19</sup> Both result from asymmetric information.

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9. See, e.g., *infra* note 10.

10. Ronald M. Giammarino & Robert L. Heinkel, *A Model of Dynamic Takeover Behavior*, 41 J. FIN. 465 (1986).

11. *Id.* at 467.

12. *Id.*

13. *Id.*

14. *Id.* at 470.

15. *Id.* at 472.

16. *Id.* at 473.

17. *Id.*

18. *Id.*

19. *Id.* at 471.

David Hirshleifer and Ivan Png formulated a model with two bidders competing for the target corporation.<sup>20</sup> In contrast to earlier models that assume that bidding is costless,<sup>21</sup> this model assumes that bidding is costly. The objective of the target management is to maximize the value of the shareholders' stock; this implies that target managers will accept the bid if it exceeds the value of the target corporation's cash flows without the merger.<sup>22</sup> The first bidder investigates and formulates a value for the target corporation. The second bidder is alerted by the first bidder's offer. The second bidder must then decide whether to investigate, and based on any investigation, whether or not to bid.<sup>23</sup> The second bidder investigates only if its expected return from investigation is strictly positive.<sup>24</sup> Bidding is structured in two different ways. The first model is a single-bid model; each bidder may bid only once.<sup>25</sup> Alternatively, the second model allows a competing bid to be revised.<sup>26</sup>

Contrary to assumptions that competitive bidding for a target corporation always resulted in higher prices than a single bid,<sup>27</sup> Hirshleifer and Png demonstrated that if bidding is costly, competitive bidding may result in a lower price than that obtainable from a single deterring bid.<sup>28</sup> Under the Hirshleifer and Png model, the Delaware Supreme Court's requirement for an auction in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>29</sup> may actually be detrimental to the target corporation's shareholders.

The target corporation's management may affect the outcome by the degree to which it is willing to disclose information to either or both bidders and thereby reduce investigation costs.<sup>30</sup> This has the

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20. David Hirshleifer & Ivan P.L. Png, *Facilitation of Competing Bids and the Price of a Takeover Target*, 2 REV. FIN. STUD. 587 (1989).

21. See, e.g., Michael J. Fishman, *A Theory of Preemptive Takeover Bidding*, 19 RAND J. ECON. 88 (1988); Andrei Shleifer & Robert W. Vishny, *Greenmail, White Knights, and Shareholder's Interests*, 17 RAND J. ECON. 293 (1986).

22. Hirshleifer & Png, *supra* note 20, at 591.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* at 595.

27. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).

28. Hirshleifer & Png, *supra* note 20, at 600.

29. 506 A.2d 173 (Del. 1986).

30. Hirshleifer & Png, *supra* note 20, at 600.

unfortunate effect of lowering the expected price for the target corporation and decreasing social welfare.<sup>31</sup>

Andrei Shleifer and Robert Vishny examined the role of a large shareholder in corporate control.<sup>32</sup> If the shareholders are atomistic, it may not benefit any one of them to monitor the performance of the target corporation's management. However, it may be beneficial for a large shareholder to assume a monitoring role.<sup>33</sup> Shleifer and Vishny assume that management is inefficient, to the detriment of its shareholders.<sup>34</sup> If the large shareholder discovers inefficiency and can improve the value of the corporation, the large shareholder's return on the shares makes up for costs incurred in monitoring and takeover.<sup>35</sup> The bid made by the large shareholder is a function of the number of shares held. The larger the holding, the smaller the bid premium—but the larger the increase in the value of the firm.<sup>36</sup> If the large shareholder can buy anonymously before the takeover bid, he or she can deprive minority shareholders of any gain from the takeover.<sup>37</sup> This has ramifications for disclosure under section 13(d) of the Securities Exchange Act of 1934,<sup>38</sup> which restricts the ability of a large shareholder to buy anonymously.

The motives for conglomerate merger are still largely unknown, but one hypothesis is that diversification reduces product line or industry risk.<sup>39</sup> The merged firms have a reduced risk of default; this is referred to as the "co-insurance effect."<sup>40</sup> The implication is that a reduction in risk should increase the value of the bonds at the expense of the stockholders. Of course, in a perfect capital market, diversifica-

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31. Social welfare is the expected valuation of the acquiring bidder minus the second bidder's cost of investigation minus the bidding costs of both bidders. *Id.* at 601. Social welfare varies directly with the cost of investigation. *Id.* Hirshleifer and Png show that the expected price of the target corporation and social welfare increase with the cost of investigation. *Id.* at 601-04. Conversely, they show that the effect of reducing the cost of investigation is a reduction in the expected price of the target and a reduction in social welfare. *Id.* at 603-04.

32. Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

33. *Id.* at 461-62.

34. *Id.* at 463.

35. *Id.*

36. *Id.* at 464.

37. *Id.* at 475.

38. 15 U.S.C. § 78m(d) (1988).

39. Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605, 605 (1981); E. Han Kim & John J. McConnell, *Corporate Mergers and the Co-insurance of Corporate Debt*, 32 J. FIN. 349, 349 (1977).

40. See John C. Coffee, Jr., *Unstable Conditions: Corporate Governance as a Multi-player Game*, 78 GEO. L.J. 1495, 1501 (1990).

tion through conglomerate merger is unnecessary because shareholders can achieve their own degree of risk through portfolio diversification.

J. Fred Weston, Keith V. Smith, and Ronald E. Shrieves rejected diversification as a risk-reducing mechanism because they found betas<sup>41</sup> of the merged firms to be nearly twice as high as those of comparable mutual funds.<sup>42</sup> They concluded that conglomerate mergers may reduce product line risk but increase general economic risk.<sup>43</sup> Han Kim and John J. McConnell, on the other hand, concluded that there was a co-insurance effect, but it was offset by increased use of debt financing.<sup>44</sup> Their findings are consistent with the assumption that managers act in the best interests of the shareholders—at least where there is a conflict between shareholders and bondholders. Yakov Amihud and Baruch Lev hypothesize that managers engage in conglomerate mergers to diversify their employment risk since human capital is not divisible.<sup>45</sup> The implication is that managers are acting not in the best interests of the shareholders or the corporation, but in their own. This type of activity is more likely to occur in manager-controlled firms than owner-controlled firms.

Michael C. Jensen's free cash flow theory is relevant here because one of the empirical implications of the hypothesis is that acquiring corporations should have free cash flow or excess debt capacity.<sup>46</sup> Jensen asserts that managers have incentives to cause their firms to expand beyond their optimal sizes.<sup>47</sup> Such firms generate large amounts of free cash flow.<sup>48</sup> Rather than pay out the free cash flow to shareholders, managers seek other alternatives, including merger or takeover. Jensen argues that his free cash flow theory predicts that such mergers and takeovers are more likely to destroy, rather than

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41. "Beta" is a term of art used to designate financial risk. Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 761 (1985).

42. J. Fred Weston et al., *Conglomerate Performance Using the Capital Asset Pricing Model*, 54 REV. ECON. & STAT. 357, 360 (1972).

43. *Id.* at 362.

44. Kim & McConnell, *supra* note 39, at 349.

45. Amihud & Lev, *supra* note 39, at 606.

46. See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AEA PAPERS & PROC. 323, 328 (1986).

47. *Id.* at 323.

48. Free cash flow is cash flow in excess of that needed to fund all positive net present value projects. LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* ch. 6, § D.1 (1993).

create, value because managers will undertake low- or negative-benefit mergers or takeovers just to expend free cash flow.<sup>49</sup>

This Article examines the problem created when target managers do not fund available positive net present value projects and thereby avoid maximizing the value of the corporation. Under these circumstances a merger or tender offer should create value rather than destroy it.

### III. ANALYSIS

#### A. *Financial Aspects*

A corporation that does not maximize its value by investing in positive net present value projects may become a takeover target or seek out slack-rich corporations as suitors to finance projects without issuing equity securities. A merger or tender offer by a slack-rich corporation is assumed to be an all-cash transaction; thus, evaluation of its securities is not an issue. Further, the slack-poor corporation has not announced any issue-invest decision regarding the project.

The analysis in this Article utilizes the Myers and Majluf model.<sup>50</sup> Stewart Myers and Nicholas Majluf created a single-period model showing that under certain conditions firms may pass up positive net present value projects if they must issue equity to finance them.<sup>51</sup> Consider a firm that has a single asset in place and an investment opportunity that must be financed in whole or in part by issuing equity. The firm does not have sufficient cash or other marketable securities on hand to finance the project. Further, there are no taxes, transaction costs, or other market imperfections, and investors are rational. Myers and Majluf assume asymmetric information, and that managers act in the best interest of old shareholders who are assumed to be passive—that is, shareholders who will not rebalance their portfolios in response to the firm's actions.

The Myers and Majluf model is a three-date model.<sup>52</sup> At  $t = -1$ , both the market and managers have the same information. At  $t = 0$ , managers receive information concerning the value of the asset in place and the project that is unknown to the market. At  $t = +1$ , the market receives the information that managers received at  $t = 0$ . The

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49. Jensen, *supra* note 46, at 328.

50. See Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

51. *Id.* at 188.

52. *Id.* at 190.



value of the asset in place at  $t = -1$  is the expected future value,  $\bar{A} = E(\tilde{A})$ , where the distribution of  $\tilde{A}$  is the possible values of the asset in place at  $t = 0$ . Management information received at  $t = 0$  is the updated estimate 'a,' which is the realization of  $\tilde{A}$ . Similarly, the net present value (NPV) of the project at  $t = -1$  is  $\bar{B} = E(\tilde{B})$ , where  $\tilde{B}$  represents the possible NPVs of the project at  $t = 0$ . Management receives the updated estimate 'b' at  $t = 0$ . Both 'a' and 'b' are assumed to be nonnegative.  $S$ , the amount of slack—cash and equity securities—on hand, is known by both the market and managers. Equity is issued if  $0 \leq S \leq I$ , where  $I$  is the amount of investment needed to finance the project.<sup>53</sup>

Myers and Majluf show that managers will issue equity and invest only if  $S + a \leq [P / (P + E)](E + S + a + b)$ , where  $P$  is the "old shares" market value if stock is issued and  $E = I - S$ .<sup>54</sup> The old shareholders' share of the firm with investment must be greater than or equal to the value of the firm without investment in the project.<sup>55</sup> If this condition does not obtain, managers will pass up the positive net present value project and not maximize the value of the firm.<sup>56</sup>

In this model it is assumed that target shareholders are atomistic; however, for purposes of target management acting in the best interest of its shareholders, the existence of a large shareholder does not alter the result. In a contest for corporate control where the large shareholder is a bidder, there may be an effect if the large shareholder has an information advantage. It is further assumed that no shareholder has an information advantage over any other. Instead, the asymmetry of information is between target management, which has the information advantage, and its shareholders and the market.

First, consider an aggressive, slack-rich corporation seeking takeover targets. The assumption of asymmetric information is maintained in that managers of the target, slack-poor corporation have inside information about their corporation that the slack-rich, acquiring corporation managers do not have. This is the opposite information asymmetry utilized by Giammarino and Heinkel in their 1986 paper and Hirshleifer and Png in their 1989 paper.<sup>57</sup> They assume that an informed bidder has an information advantage over both an

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53. See *id.* at 189-94.

54. *Id.* at 190.

55. *Id.* at 192.

56. *Id.* at 188.

57. See Giammarino & Heinkel, *supra* note 10, at 466-67; Hirshleifer & Png, *supra* note 20, at 596.

uninformed bidder and the target corporation's management.<sup>58</sup> Here, both sets of managers, acquiring and target, know the distributions of  $\bar{A}$  and  $\bar{B}$ . Only the slack-poor, target corporation managers know the updated estimates of 'a' and 'b.'

The slack-rich, acquiring corporation could acquire the slack-poor, target corporation and either sell off its component parts or continue its operations by financing the positive net present value project. Under *Revlon*, if the cash-poor target corporation is to be put on the auction block and its assets sold, the target management is under an obligation to maximize its shareholders' value.<sup>59</sup> Managers know the updated estimate 'a'; hence, they must get at least  $S + a$  in the transaction to fulfill their fiduciary duty to the shareholders. The acquiring corporation will only be willing to offer  $S + \bar{A}$  in the absence of inside information. A holdout or opposition by the target corporation's managers could be interpreted as a signal that the updated estimated value of 'a' exceeds  $\bar{A}$ . It would be in the best interests of the shareholders of the target corporation, however, for management to hold out for a higher value, thereby sending a false signal concerning the true values of 'a.' If the acquiring corporation believed the false signal and paid an amount greater than  $S + a$  for the target corporation, the shareholders of the slack-poor, target corporation would benefit at the expense of the shareholders of the slack-rich, acquiring corporation.

Second, a slack-rich corporation—one with slack in excess of its needs or opportunities—can acquire one or more slack-poor corporations with unfinanced positive net present value projects. Assuming sufficient slack to internally finance the projects, such an acquisition would create value and support the notion that the merged corporations have a synergistic value greater than the sum of the parts.<sup>60</sup>

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58. Giammarino & Heinkel, *supra* note 10, at 467; see Hirshleifer & Png, *supra* note 20, at 591.

59. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

60. This would be true if the managers of the acquiring corporation accurately assessed the value of the target corporation. The empirical studies attempting to measure synergy produce mixed results. See, for example, Peter Dodd & Richard Ruback, *Tender Offers and Stock Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351 (1977) and Paul J. Halpern, *Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers*, 46 J. BUS. 554 (1973), for articles supporting the synergy theory. On the other hand, Jensen's free cash flow theory predicates that mergers and takeovers are likely to destroy rather than create value. Jensen, *supra* note 46, at 328. Jensen's theory asserts that managers spend cash on value-destroying mergers rather than distributing that cash to shareholders. *Id.* However, this is not the case here. The target corporation has untapped value in the positive net present value project. A more troublesome problem is presented by Roll's

Maintaining the assumption of asymmetric information requires that the acquiring corporation know the distributions of  $\bar{A}$  and  $\bar{B}$ , but not the updated estimated values 'a' and 'b.' The offer for the target, cash-poor corporation would be less than or equal to  $S + \bar{A} + \bar{B}$  but greater than the market value of the stock. Such an offer would, *ex ante*, make the shareholders of both corporations better off. The target corporation's shareholders are better off because the market value of their stock is discounted to less than  $S + \bar{A} + \bar{B}$  because of the unfinanced positive net present value project and incomplete information. Moreover, the target corporation's shareholders are also better off if the offer exceeds  $S + a$ . In the absence of the merger, the value of the target corporation is the sum of the slack plus the value of the asset in place,  $S + a$ , since the positive net present value project will be not be undertaken. Any aggregate offer in excess of  $S + a$  increases the value of the target shareholders' claim. The acquiring, slack-rich corporation's shareholders are better off because they get all or part of the unfinanced positive net present value project's unrealized value.

Target managers know the updated estimates 'a' and 'b'; hence, they must get at least  $S + a + b$  in the transaction to fulfill their fiduciary duty to the corporation. Rational managers of the acquiring corporation should be willing to offer only  $S + \bar{A} + \bar{B}$  in the absence of inside information.<sup>61</sup> A holdout or opposition by the target corporation's managers could be interpreted as a signal that the updated estimated values of 'a' and 'b' exceed  $A$  and  $B$ . It would be in the best interests of the shareholders of the target corporation, however, for management to hold out for a higher value, thereby sending a false signal concerning the true values of 'a' and 'b.' If the acquiring corporation's managers believed the false signal and paid an amount greater than  $S + a + b$  for the target corporation, the shareholders of the slack-poor, target corporation would benefit at the expense of the shareholders of the slack-rich, acquiring corporation. Indeed, Robert Jennings and Michael Mazzeo found that target management resist-

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hubris hypothesis. Roll asserts that managers are overly optimistic in evaluating target corporations and overpay. Roll, *supra* note 7, at 198, 212. For an empirical study showing no synergistic value, see Terence C. Langetieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger*, 6 J. FIN. ECON. 365 (1978).

61. Jennings and Mazzeo show, however, that bidders revise offers in favor of the target even in the face of adverse market reaction to the announcement. Robert H. Jennings & Michael A. Mazzeo, *Stock Price Movements Around Acquisition Announcements and Management's Response*, 64 J. Bus. 139, 160 (1991).

ance increased the likelihood that the acquiring corporation would revise its offer to the benefit of the target.<sup>62</sup>

It may be that the updated estimates of ' $a$ ' and ' $b$ ' are less than  $\bar{A}$  and  $\bar{B}$ . In this case, in a nonnegotiated merger, the target corporation's managers need not oppose the merger to fulfill their fiduciary duty. However, if the acquiring corporation's managers observe that the target corporation's managers are not opposing the merger, they may take that action as a signal that they overbid for the target corporation and back out if possible.<sup>63</sup> Therefore, even if  $a < \bar{A}$  and  $b < \bar{B}$ , the target corporation's managers should hold out or oppose the merger in the best interests of the slack-poor, target corporation's shareholders.

The best strategy for the managers of a target corporation is always to hold out or oppose the merger.<sup>64</sup> Easterbrook and Fischel argued that managers of target corporations should be bound by a "rule of managerial passivity" that would prohibit target managers from soliciting a competing bid or opposing a takeover.<sup>65</sup> The law, however, is to the contrary—a fact the two researchers recognized by calling for the repeal of the Williams Act.<sup>66</sup> Developments in state corporation law have encouraged target opposition to takeover bids.<sup>67</sup> State takeover statutes tend to be paternalistic by protecting local businesses.<sup>68</sup> State legislatures assume that the interests of local incumbent managers are identical to the state's public policy.<sup>69</sup> This introduces an element of agency costs associated with managers seeking to preserve their own positions. Consequently, their action cannot be used as a signal to the acquiring corporation's managers as to the true value of the target corporation,  $S + a + b$ . The target corporation's shareholders are not harmed since their stock is discounted in the

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62. *Id.* at 154.

63. Proposed acquisitions may fail for a host of reasons such as a lack of response, resistance by the target, or the occurrence of a condition precedent which terminates the proposal. Jennings and Mazzeo studied 472 proposed acquisitions between June 1, 1979, and December 31, 1987. *Id.* at 161. A total of 121, or approximately one-quarter, of these proposed acquisitions were canceled. *Id.* Forty-seven were canceled by the acquiring corporation alone. *Id.*

64. See Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980) (concluding that effect of federal and state regulation is to raise price bid for target corporation).

65. Easterbrook & Fischel, *supra* note 27, at 1164.

66. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

67. See *infra* notes 259-63 and accompanying text.

68. See, e.g., MO. ANN. STAT. § 409.511-.546 (Vernon 1990); N.Y. BUS. CORP. LAW §§ 1602, 1612 (McKinney 1986).

69. See, e.g., *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985).

market, due to the asymmetric information and unfinanced positive net present value project, to less than  $S + \bar{A} + \bar{B}$ —the maximum offer the acquiring corporation should make without inside information. Any merger offer amount between the discounted market value of the target corporation stock and  $S + \bar{A} + \bar{B}$  inures to the benefit of the target corporation's shareholders. Further, any offer greater than  $S + a$ , the value of the firm without investment in the project, increases the value of the target shareholders' claim and should be accepted.

A slack-poor corporation may aggressively seek a merger with a slack-rich corporation. This action may be interpreted as a signal that the slack-poor corporation has an unfinanced, positive net present value project and is seeking outside financing for that project through a merger. Without the investment the true value of the slack-poor corporation is  $S + a$ ; however, the market value of the slack-poor corporation is less than or equal to  $S + \bar{A} + \bar{B}$ . By seeking the merger, the slack-poor corporation could be signalling that  $S + a + b > S + \bar{A} + \bar{B}$ . The problem, however, is that the managers of the slack-poor corporation have an incentive to lie.

Assume that  $S + a + b < S + \bar{A} + \bar{B}$  and that only the managers of the slack-poor corporation know the updated estimates of 'a' and 'b.' The slack-poor corporation's managers would seek a merger in which they would be willing to accept any amount between  $S + a$  and  $S + \bar{A} + \bar{B}$ , where  $S + a < S + a + b < S + \bar{A} + \bar{B}$ . The medium of exchange has an effect. Jensen's free cash flow theory predicts that takeovers financed with cash and debt create greater benefits than those financed through the exchange of stock.<sup>70</sup> Similarly, empirical evidence shows that the market reacts more favorably to cash offers than to stock exchanges.<sup>71</sup> In an exchange of stock, target shareholders are at risk on the downside if the acquiring corporation's managers overbid; however, if there is synergy from the merger, target shareholders will benefit at the expense of acquiring shareholders. The shareholders of the slack-poor corporation would benefit at the expense of the shareholders of the slack-rich corporation for any cash offer greater than  $S + a + b$ . Indeed, it may be assumed that the more aggressive the managers of the slack-poor corporation are in seeking a merger, the less

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70. Jensen, *supra* note 46, at 329.

71. See Paul Asquith et al., *Gains to Bidding Firms From Merger*, 11 J. FIN. ECON. 121 (1983); Yen-Sheng Huang & Ralph A. Walkling, *Target Abnormal Returns Associated with Acquisition Announcements: Payment, Acquisition Form and Managerial Resistance*, 19 J. FIN. ECON. 329 (1987); Nickolaos G. Travlos, *Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns*, 42 J. FIN. 943 (1987).

the true value,  $S + a + b$ , will be. Because no meaningful or useful signal is given by the slack-poor corporation's managers' actions in seeking a merger, without inside information the slack-rich corporation's managers should never offer more than  $S + \bar{A} + \bar{B}$  cash in a merger. Nonetheless,  $S + \bar{A} + \bar{B}$  may be an overbid if the value of the stock is overpriced, as in the case where  $S + a + b < S + \bar{A} + \bar{B}$ . Given the tendency of acquiring corporations' managers to overbid, a stock exchange benefits their shareholders.

The minimum acceptable offer from the viewpoint of the slack-poor corporation's shareholders is  $S + a$ . Rational shareholders of the slack-poor corporation should therefore reject any offer for less. A merger offer is only acceptable to the slack-rich corporation if the offer price is between the market price of the slack-poor corporation's stock and  $S + \bar{A} + \bar{B}$ , and if the stock is undervalued, that is,  $S + a + b > \text{market price}$ . A merger is acceptable to both parties only if (1)  $S + a + b \geq S + \bar{A} + \bar{B} > \text{offer price} \geq S + a \geq \text{market price}$ ; or (2)  $S + \bar{A} + \bar{B} \geq S + a + b \geq \text{offer price} \geq S + a \geq \text{market price}$ ; or (3)  $S + a + b \geq S + \bar{A} + \bar{B} \geq \text{offer price} \geq \text{market price} \geq S + a$ ; or (4)  $S + \bar{A} + \bar{B} \geq S + a + b \geq \text{offer price} \geq \text{market price} \geq S + a$ . The proposed merger should fail in all other cases. Since the updated estimates 'a' and 'b' are known only to the slack-poor corporation's managers, the only conclusion the slack-rich corporation's managers can reach from the slack-poor corporation's acceptance of the offer is that the offer price is greater than  $S + a$ . They know  $S + \bar{A} + \bar{B}$  but not  $S + a + b$ . The relative position of the offer price vis-a-vis  $S + a + b$  is unknown to the managers of the slack-rich corporation. Certainly, the merger is unacceptable to them if the offer price exceeds  $S + a + b$ . Cautious management of a slack-rich corporation would not enter into any particular merger with a slack-poor corporation, although on average it would be beneficial.

Where, in a merger situation, the slack-rich corporation offers an amount less than or equal to  $S + \bar{A} + \bar{B}$ , Myers and Majluf show that the slack-poor corporation is better off issuing equity and investing in the positive net present value project itself.<sup>72</sup> However, the slack-poor corporation will not do so if the value of the corporation without

72. Myers & Majluf, *supra* note 50, at 202. The proof is as follows: Define  $a^*(N')$  as the breakeven value of  $a$ , the value at which the slack-poor firm is just indifferent to being acquired at the equilibrium price  $Q'$ . Note that  $Q' = a^*(N') + S$ . Recall that the requirement for a corporation to issue stock is  $(E/P)(S + a) \geq E + b$ . If  $P$  were equal to  $Q'$ , the corporation would issue and invest in  $a^*(N')$  for any  $b > 0$ . That is, since  $P = Q' = S + a^*(N')$ ,  $(E/P)(S + a) = [E / (S + a^*(N'))](S + a^*(N')) = E < E + b$ . Thus  $a^*(M')$ , the breakeven value of  $a$  at which the firm is just willing to issue stock, exceeds  $a^*(N')$  for any  $b > 0$ . Thus,  $\bar{A}(M') + \bar{B}(M') > \bar{A}(N') + \bar{B}(N')$  and  $P > Q'$ .

investment is greater than the old shareholders' aliquot share of the corporation with investment. The slack-poor corporation will only accept the merger terms if the offer price exceeds  $S + \bar{A} + \bar{B}$ , but without inside information the slack-rich corporation should never offer more than  $S + \bar{A} + \bar{B}$ . Under these conditions no merger would take place.

Mergers, however, do take place. Ironically, one of the key take-over indicators making a corporation particularly vulnerable to a take-over is the type of management-stockholder structure that Myers and Majluf described in their 1984 paper.<sup>73</sup> Slack-rich acquiring corporations obtain inside information from the slack-poor corporation's managers and  $S + a + b > S + \bar{A} + \bar{B}$ , or they foolishly offer more than  $S + \bar{A} + \bar{B}$ —which is not acceptable if managers are rational. Alternatively, the slack-poor corporation's managers accept terms less than  $S + \bar{A} + \bar{B}$ , particularly if  $S + a + b < S + \bar{A} + \bar{B}$ —which is not necessarily acting exclusively in the best interest of their shareholders.

A cash tender offer to the slack-poor corporation's shareholders may circumvent this problem. Typically, the value of the consideration offered to the target shareholders includes a premium to obtain control and thus exceeds the market value of the stock. In this model the consideration represents an amount between the market price and  $S + \bar{A} + \bar{B}$ . This strategy may succeed because neither party has inside information. A cash tender offer for the slack-poor corporation's stock would not convey any bad news to the market or the slack-poor corporation's shareholders since the offer would not be based on inside information concerning the updated estimated values of 'a' and 'b,' which are known only by the slack-poor, target corporation's management.

Target shareholders wishing to "tender" their shares do so by forwarding their stock to the tender offeror's agent, usually a depository bank.<sup>74</sup> The tender offer is usually left open for a fixed period of time which may be extended.<sup>75</sup> Commonly, the tender offer is conditioned on the occurrence of certain events, such as tender of all or a stated

73. Raymond S. Trough, *Characteristics of Target Companies*, 32 BUS. LAW. 1301, 1301 (1977).

74. See HANDBOOK OF MERGERS, ACQUISITIONS AND BUYOUTS 473 (Steven James Lee & Robert Douglas Colman eds., 1981); THE MERGERS AND ACQUISITIONS HANDBOOK 423 (Milton L. Rock ed., 1987).

75. The minimum period that a tender offer must remain open is 20 business days. Hirshleifer & Png, *supra* note 20, at 587 (citing 17 C.F.R. § 240.14e-1 (1994)). However, the length of time may be affected by the type of offer. Cash tender offers require only a 15-day minimum. 15 U.S.C. § 18a(b)(1). Also, the Federal Trade Commission (FTC) or the Attorney General have discretion to extend the open period. *Id.* § 18a(e)(2).

part or percentage of the target shares, a favorable antitrust ruling, or the tender offeror's ability to obtain financing.<sup>76</sup>

The advantages of a tender offer are that (1) as a nonnegotiated takeover, it is generally cheaper than a proxy fight; (2) if it is not successful, the tender offeror still has its investment in the acquired target stock and may be able to dispose of it at a profit;<sup>77</sup> (3) a tender offer is faster; and (4) secrecy is easier to maintain. Tender offers are frequently followed by mergers unless prohibited by state takeover statutes that impose postacquisition restrictions on business combinations.<sup>78</sup>

Tender offers may be used to circumvent target management in a hostile takeover situation. David Hirshleifer and Sheridan Titman construct a model for hostile takeovers.<sup>79</sup> In their model, unlike the model employed here, there is one potential acquirer—a minority shareholder of the target corporation.<sup>80</sup> All other shareholders are atomistic.<sup>81</sup> The potential acquirer has only one opportunity to bid, and if the offer is rejected, that person loses the synergistic value.<sup>82</sup> Hirshleifer and Titman show that the optimal bid is a strictly increasing function of the improvement in value resulting from the takeover; this is rational because the greater the potential gain, the more the potential acquirer is willing to bid.<sup>83</sup> This results in a separating outcome in that the bidders reveal the level of improvement through their bids.<sup>84</sup> Low improvement value results in a low bid while high improvement value results in a high bid.<sup>85</sup>

What the potential bidder does not know is the price at which the atomistic shareholders will tender as a result of personal costs and benefits of tendering not known to the bidder.<sup>86</sup> The asymmetry of information is between the large shareholder and atomistic sharehold-

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76. See HANDBOOK OF MERGERS, ACQUISITIONS AND BUYOUTS, *supra* note 74, at 475.

77. There is evidence that positive, cumulative abnormal returns persist for approximately two years after a failed takeover bid, thus providing the basis for a gain. Michael Bradley et al., *The Rationale Behind Interfirm Tender Offers: Information or Synergy?* 11 J. FIN. ECON. 183, 185-86 (1983).

78. See *infra* notes 276-77 and accompanying text.

79. David Hirshleifer & Sheridan Titman, *Share Tendering Strategies and the Success of Hostile Takeover Bids*, 98 J. POL. ECON. 295 (1990).

80. *Id.* at 298.

81. *Id.*

82. *Id.* at 298-99.

83. *Id.* at 300.

84. *Id.*

85. *Id.* at 302.

86. *Id.* at 297.



ers of the same target corporation. Hirshleifer and Titman imply that a reduction in the degree of asymmetry of information between the large shareholder and the others increases the probability of success.<sup>87</sup> Such is not the case in the model used in this Article because there is no difference in the degree of asymmetry of information. Both parties are ignorant of the true or updated estimated values of 'a' and 'b.' The Hirshleifer and Titman results only obtain if the potential acquirer, the large shareholder, has superior information. That model also shows that for a tender offer to be profitable, dilution of the minority holdings is not necessary, as Sanford Grossman and Oliver Hart modelled.<sup>88</sup>

Rejection of a bid is costly to the bidder, who loses both the improvement value and costs incurred in investigation and bidding. Rejection also allows target management time to react and organize to oppose the hostile takeover. Hirshleifer and Titman examine defensive actions of management, including "poison pill," "sale of the crown jewels," and litigation.<sup>89</sup> In such cases, the likelihood of failure increases.<sup>90</sup>

A major problem for a potential acquirer who holds a minority of the shares and attempts a hostile takeover is a control-share statute such as that enacted in Indiana.<sup>91</sup> Indiana's control-share statute withstood scrutiny by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*.<sup>92</sup> More than one-half of the states have enacted some form of control-share statute modelled after the Indiana statute.<sup>93</sup> The purpose of a control-share statute is to keep the acquirer from exercising the voting power of the acquired stock, thereby rendering the acquirer powerless to make the changes necessary to reap improvement value.<sup>94</sup> Whenever an entity acquires control at a level defined in the statute—twenty percent, thirty-three and one-third percent, or more than fifty percent—it is not necessarily entitled to vote those control shares.<sup>95</sup> The control shares cannot be voted unless a resolution is passed by a majority of disinterested shares of

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87. *Id.* at 304-05.

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

89. Hirshleifer & Titman, *supra* note 79, at 308-15.

90. See *id.* at 308.

91. See IND. CODE ANN. § 23-1-42-1 (West 1989).

92. 481 U.S. 69 (1987).

93. See Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783 (1994).

94. See IND. CODE ANN. § 23-1-42-9.

95. *Id.* § 23-1-42-1.

each class entitled to vote on the resolution.<sup>96</sup> Disinterested shareholders are those other than the acquirer or officers and inside directors of the acquired corporation.<sup>97</sup> The effect is to condition control of the corporation on the approval of a majority of the old, disinterested shareholders of the target corporation.<sup>98</sup>

In the model used in this Article, the managers of the slack-poor corporation may oppose the cash tender offer and advise their shareholders to reject the offer and hold out for a higher amount, possibly greater than  $S + \bar{A} + \bar{B}$ . Without inside information concerning the updated estimated values of 'a' and 'b,' the slack-rich firm should never offer more than  $S + \bar{A} + \bar{B}$ . *Ex ante*, both the slack-poor corporation's shareholders and the slack-rich corporation would be better off if an offer between the market price and  $S + \bar{A} + \bar{B}$  were accepted. However, the shareholders of the slack-poor corporation may be misled by their managers as to the true value of the corporation and refuse to tender. Ultimately, the shareholders must make their own decision regarding the sufficiency of the offer. Management that breaches its duty by intentionally inflating the value of the slack-poor corporation and misleading its shareholders may be guilty of violating section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934,<sup>99</sup> and section 3 of the Williams Act.<sup>100</sup>

## B. Legal Aspects

### 1. General antifraud provisions

The antifraud provisions of the federal securities laws apply to securities whether or not they are exempt from registration and whether or not they are transactionally exempt.<sup>101</sup> Consequently, the antifraud provisions apply to the model under consideration in all circumstances. The primary antifraud provisions are section 17 of the Securities Act of 1933,<sup>102</sup> section 10(b) of the Securities Exchange Act of 1934,<sup>103</sup> and section 206 of the Investment Advisers Act of 1940.<sup>104</sup>

Section 10 is the catch-all provision of the Securities Exchange Act of 1934. Its purpose is to provide relief from abuses not otherwise

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96. *Id.* § 23-1-42-9(b).

97. *See id.* § 23-1-42-3.

98. *See CTS Corp.*, 481 U.S. at 74.

99. 15 U.S.C. §§ 78a-78u (1988 & Supp. V 1993).

100. 15 U.S.C. § 78n(e) (1988).

101. *See id.* §§ 77c, 77q(c).

102. *Id.* § 77q.

103. *Id.* § 78j(b).

104. *Id.* § 80b-6.

addressed in the Act.<sup>105</sup> However, section 10 is not a self-executing provision. It is only effective through rules and regulations promulgated by the Securities Exchange Commission (SEC) pursuant to the authority granted by section 10 to make such rules as are "necessary or appropriate in the public interest or for the protection of investors."<sup>106</sup> In 1948 the SEC issued rule 10b-5.<sup>107</sup> Interestingly, rule 10b-5 is merely modified language of section 17(a) of the Securities Act of 1933; the primary difference is that section 17(a) applies only to sale of securities whereas section 10 applies to both purchase and sale.<sup>108</sup>

Rule 10b-5 provides that

[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>109</sup>

Section 10 and rule 10b-5 are stated as prohibitions and give rise to administrative proceedings,<sup>110</sup> suits for injunction by the SEC,<sup>111</sup> and criminal actions referred to the Justice Department for prosecution.<sup>112</sup> However, it was established as early as 1946 that there was an implied civil cause of action for damages on behalf of the defrauded victim.<sup>113</sup>

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105. *See id.* § 78j(b).

106. *Id.*

107. *In re Western Pub. Serv. Co.*, Exchange Act Release No. 3230, 13 Fed. Reg. 8183 (Dec. 22, 1948) (codified at 17 C.F.R. § 240.10b-5 (1994)).

108. Compare 17 C.F.R. § 240.10b-5 (1994) (making unlawful any act of fraud or deceit "in connection with the purchase or sale of any security") with 15 U.S.C. § 77q (making unlawful any act of "fraud or deceit upon the purchaser").

109. 17 C.F.R. § 240.10b-5.

110. 15 U.S.C. §§ 78u(a)(1), 78u-1(a)(1).

111. *Id.* § 78u(d).

112. *Id.* § 78ff(a).

113. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

The elements of a cause of action under rule 10b-5 are (1) use of the mails, an instrumentality of interstate commerce, or any facility of a national securities exchange; (2) a purchase or sale of a security; (3) fraud or deceit or a misstatement or omission of a material fact; (4) scienter; (5) causation; (6) reliance; and (7) damages in a civil action.<sup>114</sup> A private cause of action must be brought by a purchaser or seller;<sup>115</sup> this requirement is strictly applied.<sup>116</sup> A merger entails a purchase and sale of a security.<sup>117</sup>

Two of the three clauses of rule 10b-5 deal with fraud or deceit.<sup>118</sup> Fraud does not include overreaching by a controlling shareholder unless it is accompanied by actual deception.<sup>119</sup> A cause of action for fraud under rule 10b-5 is similar to common-law fraud in that there must be a relationship between the parties that gives rise to a duty that is violated.<sup>120</sup> In insider trading cases, the insider, by virtue of his or her position, gains access to information intended for corporate purposes and not personal benefit.<sup>121</sup> The corresponding duty is to abstain from the marketplace until the information is made public.<sup>122</sup> The insider must not take unfair advantage of information unknown to persons with whom the insider is dealing. In many instances the courts are not clear as to which clause of rule 10b-5 applies, particularly in insider trading cases.<sup>123</sup>

Clause (b) of rule 10b-5 deals with misstatements and omissions of material facts.<sup>124</sup> A fact is material if it is the kind of information that a reasonable investor would consider important in making an investment decision.<sup>125</sup> In the context of an untrue statement of a material fact, the intentional misstatement is akin to common-law fraud.<sup>126</sup>

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114. See 17 C.F.R. § 240.10b-5; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976); *Shores v. Sklar*, 647 F.2d 462, 468-69, 471 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983).

115. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

116. See *id.*

117. *SEC v. National Sec.*, 393 U.S. 453, 467 (1969).

118. 17 C.F.R. § 240.10b-5.

119. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

120. *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933).

121. *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

122. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974); *In re Investors Management Co.*, 44 S.E.C. 633, 640 (1971).

123. See, e.g., *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (mentioning all three clauses of rule 10b-5, but not stating which clause applies).

124. 17 C.F.R. § 240.10b-5.

125. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

126. See *Ernst & Ernst*, 425 U.S. at 201.

In the case of an omission of a material fact where there is a duty to disclose, an element of conjecture is introduced. The test of materiality then becomes whether the reasonable investor would have acted differently had he or she known of the undisclosed fact.<sup>127</sup>

Since the United States Supreme Court's decision in *Ernst & Ernst v. Hockfelder*,<sup>128</sup> scienter is a requirement of a cause of action under section 10(b) and rule 10b-5.<sup>129</sup> Scienter requires an intent to deceive, manipulate, or defraud.<sup>130</sup> Negligence will not support a cause of action under section 10(b) and rule 10b-5.<sup>131</sup> However, the Supreme Court reserved the issue of whether recklessness is equivalent to intentional conduct.<sup>132</sup> Breach of fiduciary duty without an allegation of deception or misrepresentation is not actionable under rule 10b-5.<sup>133</sup>

Causation is a necessary element of a cause of action under section 10(b) and rule 10b-5—the misrepresentation or fraud must be the proximate cause of plaintiff's loss.<sup>134</sup> If the misrepresentation is of a material fact on which plaintiff relied, but is not the reasonable direct cause of the pecuniary loss, no recovery is allowed.<sup>135</sup>

In fraud cases and cases involving affirmative misstatements of material facts, plaintiffs must show actual reliance.<sup>136</sup> However, if the misleading statement constitutes a fraud on the market, plaintiff need not show reliance but only that the security was bought or sold at a price that was affected by the misleading statement.<sup>137</sup> The fraud-on-the-market theory rests on the notion that the price of a security is based on all available material information concerning the business.<sup>138</sup> Misleading statements, therefore, affect market price.<sup>139</sup>

Nondisclosure or complete omission cases present another problem. Plaintiffs must show that they would have relied on the facts if they had been made known; in effect, this means that the omitted facts

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127. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

128. 425 U.S. 185 (1976).

129. *Id.* at 193.

130. *Id.*

131. *Id.* at 201.

132. *Id.* at 194 n.12.

133. *Santa Fe Indus.*, 430 U.S. at 474-76.

134. *Affiliated Ute*, 406 U.S. at 154.

135. *Id.* at 153-54.

136. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

137. *Basic, Inc. v. Levinson*, 485 U.S. 224, 248-49 (1988).

138. *Id.* at 241.

139. *Id.* at 241-42.

were material.<sup>140</sup> In a nondisclosure case, if the plaintiff proves materiality, reliance is established.<sup>141</sup>

The measure of damages in most cases is the "out-of-pocket" rule.<sup>142</sup> The award is based on the difference between the value of what the plaintiff gave up and the value of what was received in the transaction.<sup>143</sup> In the model used in this Article, the penalty for lying is the difference between the misrepresented value and  $S + a + b$ . In addition to damages awarded to a private plaintiff, the SEC may assess a civil penalty up to three times the actual damage.<sup>144</sup> No punitive damages are assessed in an antifraud case.<sup>145</sup> The potential for liability is great, especially in insider trading cases, because liability extends to all persons who traded in the market during the time that the inside information was undisclosed.<sup>146</sup> However, some courts attempt to limit the defendant's liability. For example, the Sixth Circuit requires "trading causation" between plaintiff's losses and defendant's trading on the basis of the undisclosed information.<sup>147</sup>

Knowing the amount of damages that can be assessed for violation of section 10(b), rule 10b-5, and section 14(e),<sup>148</sup> the cost of lying can be calculated. Court costs, attorneys' fees, and other costs are not considered. If the managers of the slack-poor firm lie and inflate the value of the firm, the gain from lying is the difference between the inflated value,  $V_i$ , and the actual or true value,  $V_t$ . Based on the inside knowledge of the updated estimates of 'a' and 'b,' the actual or true value of the firm,  $V_t$  equals  $S + a + b$ . The cost of lying is the difference between the product of the probability of being caught,  $p$ , times the gain and the product of the probability of not being caught,  $(1 - p)$ , times the gain. Thus,  $\text{cost of lying} = p(V_i - V_t) - (1 - p)(V_i - V_t)$ . Rearranged,  $\text{cost of lying} = (2p - 1)(V_i - V_t)$ . It pays to lie if the cost of lying is negative, that is,  $(2p - 1)(V_i - V_t) < 0$ . Since  $(V_i - V_t) > 0$ —

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140. *Affiliated Ute*, 406 U.S. at 153-54.

141. *Id.*

142. See 15 U.S.C. § 78t-1(b)(1); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1344-46 (9th Cir. 1976) (Sneed, J., concurring).

143. *Green*, 541 F.2d at 1344.

144. 15 U.S.C. § 78u-1(a)(2).

145. *Id.* § 78u-1(a)(3); see *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir.), *cert. denied*, 395 U.S. 977 (1969).

146. See *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 105 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

147. *Fridrich v. Bradford*, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

148. Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e); see *infra* notes 193-222 and accompanying text.

otherwise, the lie is not beneficial—it pays to lie if  $(2p - 1) < 0$  or  $p < .5$ .

If the possibility of civil penalties,  $CP$ , under section 21A(a)(2) of the Securities Exchange Act of 1934<sup>149</sup> is added, *cost of lying* =  $p[(V_i - V_j) + CP] - (1 - p)(V_i - V_j)$ . Rearranged, *cost of lying* =  $(2p - 1)(V_i - V_j) + pCP < 0$ , which must be negative for lying to pay. Consequently,  $[CP / (V_i - V_j)] < [(1 - 2p) / p]$ . Assuming the maximum civil penalty, equal to three times  $(V_i - V_j)$ ,  $[(1 - 2p) / p] > 3$ . For lying to pay,  $p < .2$ . Managers must determine their subjective assessment of the probability of being caught. If they believe that the probability of being caught is less than twenty percent, they will lie.

Knowing the cost of lying, the value of the firm,  $V$ , may be calculated. The value of the firm is equal to the false inflated value of the firm,  $V_i$ , less the cost of lying:  $V = V_i - \text{cost of lying}$ . Therefore,  $V = V_i - p[(V_i - V_j) + CP] - (1 - p)(V_i - V_j)$ . Simplifying,  $V = V_i - pCP$ . Finally,  $V = S + a + b - pCP$ . Thus, the value of the firm is the actual or true value less the probability of being caught lying, times the civil penalty imposed if caught. Since  $p < .2$ , the true value of the firm is reduced by less than twenty percent of the maximum civil penalty.

Rule 10b-5 applies to preliminary merger negotiations when there is either nondisclosure of a material fact when a duty to disclose exists, or a misleading material misstatement or omission.<sup>150</sup> Both sides in a negotiated merger would probably prefer not to disclose any information concerning the negotiations. Premature disclosure could drive up the price of the stock, making the merger more expensive or even causing the negotiations to be abandoned. Disclosure, if made, could also be misleading and subject the parties to liability. On the other hand, failure to disclose information where a duty to disclose exists is actionable; but silence is not misleading absent a duty to disclose.<sup>151</sup> "No comment" is the equivalent of silence.<sup>152</sup>

In *Basic, Inc. v. Levinson*,<sup>153</sup> the United States Supreme Court adopted the *TSC Industries, Inc. v. Northway, Inc.*<sup>154</sup> standard for materiality in preliminary negotiation cases.<sup>155</sup> Additionally, the Court stated that materiality must be determined on a case-by-case basis,

149. 15 U.S.C. § 78u-1(a)(2).

150. *Basic*, 485 U.S. at 231-32, 238.

151. *Id.* at 231-32.

152. *In re Carnation Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 n.6 (July 8, 1985).

153. 485 U.S. 224 (1988).

154. 426 U.S. 438 (1976).

155. *Basic*, 485 U.S. at 249 (citing *TSC Indus.*, 426 U.S. at 449).

balancing the probability that the transaction will be consummated and its magnitude or significance to the issuer.<sup>156</sup> The Court rejected the Third Circuit's standard, set out in *Greenfield v. Heublein, Inc.*,<sup>157</sup> that merger discussions were not material until agreements with respect to price and structure of the transaction had been determined.<sup>158</sup>

Section 10(b) and rule 10b-5 apply in a negotiated merger situation.<sup>159</sup> Using the slack-rich-slack-poor model, if the slack-rich corporation seeks to negotiate a merger or the slack-poor corporation's managers actively seek out a slack-rich corporation; the preliminary negotiations may contain material facts that must be disclosed to the target corporation's shareholders. Information concerning price would be of the utmost importance to the slack-poor, target corporation's shareholders and, therefore, material. If the slack-poor corporation's managers distort or lie about the updated estimates of 'a' and 'b' in the negotiations, such action could constitute a misstatement of a material fact. This would subject the managers of the slack-poor, target corporation to liability for violation of section 10(b) and rule 10b-5. If the managers distort or lie about the value of the slack-poor corporation to their shareholders when disclosing the negotiations or recommending approval of the merger—that is, if a shareholder vote is required—they violate section 10(b) and rule 10b-5. Interestingly enough, if the directors of the slack-poor corporation and all of the old shareholders are involved in the fraud on the slack-rich corporation with respect to the true value of the slack-poor corporation, the slack-poor corporation could recover on the basis of a plan to defraud future shareholders.<sup>160</sup> Potential liability under section 10(b) and rule 10b-5 provides an incentive for managers to tell the truth about the value of the corporation if disclosure is required. The effectiveness of that incentive depends on the managers' perception of the possibility of being subjected to such liability. It has already been established that that probability is not high.

## 2. Tender offers and the Williams Act<sup>161</sup>

Mergers and sales of all of the assets require action by the board of directors of the target corporation.<sup>162</sup> A hostile board of directors

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156. *Id.* at 250.

157. 742 F.2d 751 (3d Cir.), *cert. denied*, 469 U.S. 1215 (1984).

158. *Basic*, 485 U.S. at 236.

159. *Id.* at 232.

160. *See* Bailes v. Colonial Press, Inc., 444 F.2d 1241, 1244 (5th Cir. 1971).

161. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f).

162. *See* Ordower v. Office of Thrift Supervision, 999 F.2d 1183, 1187 (7th Cir. 1993).



generally means instant doom to a merger or sale. A direct confrontation with a hostile board of directors may be avoided by dealing directly with the shareholders of the target corporation by offering to buy their stock for cash, property, or other stock in a tender offer.

At first blush the definition of a tender offer seems straightforward. The problem is whether the tender offer is subject to the Williams Act. The term "tender offer" is not defined in the statutes, and the SEC has refused to define it for fear that the definition would be too restrictive and provide lawyers with a weapon to avoid regulation.<sup>163</sup> The SEC has promulgated a list of eight factors to aid in the analysis, but at least one court has expressed concern as to whether the factors were "either a permissible or a desirable interpretation of the statute."<sup>164</sup> The SEC's position, although not adopted, is set out in Exchange Act Release No. 16,385 as Proposed Rule 14d-1(b)(1):

The term "tender offer" includes a "request or invitation for tenders" and means one or more offers to purchase or solicitations of offers to sell securities of a single class, whether or not all or any portion of the securities sought are purchased, which

(i) During any 45-day period are directed to more than 10 persons and seek the acquisition of more than 5% of the class of securities, except that offers by a broker (and its customer) or by a dealer made on a national securities exchange at the then current market or made in the over-the-counter market at the then current market shall be excluded if in connection with such offers neither the person making the offers nor such broker or dealer solicits or arranges for the solicitation of any order to sell such securities, and such broker or dealer performs only the customary functions of a broker or dealer and receives no more than the broker's usual and customary commission or the dealer's usual and customary mark-up; or

(ii) Are not otherwise a tender offer under paragraph (b)(1)(i) of this section, but which

(A) are disseminated in a widespread manner, (B) provide for a price which represents a premium in excess of the greater of 5% of or \$2 above the current market price and

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163. Proposed Amendments to Tender Offer Rules, Exchange Act Release Nos. 33-6159, 34-16,385, 44 Fed. Reg. 70,349, 70,349-50 (Dec. 6, 1979).

164. *Brascan, Ltd. v. Edper Equities, Ltd.*, 477 F. Supp. 773, 791 (S.D.N.Y. 1979).

(C) do not provide for a meaningful opportunity to negotiate the price and terms.<sup>165</sup>

Although tender offers have been the subject of many court cases,<sup>166</sup> the courts have yet to produce a clear, comprehensive definition of "tender offer." Congress understood the term to mean an offer to buy or sell securities, or a solicitation of an offer to sell a security through some sort of exchange of the securities for other consideration.<sup>167</sup> The courts have defined a conventional tender offer as having three elements: a bid, a premium price, and a conditional obligation to purchase all or a specified amount of the tendered shares.<sup>168</sup> However, courts recognize that an unconventional tender offer, such as an open-market or block purchase, is but an attempt to gain control of a corporation by purchasing shares without a formal tender offer.<sup>169</sup>

The United States Supreme Court's test was articulated in *SEC v. Ralston Purina Co.*<sup>170</sup> The test is whether, considering the totality of the circumstances, "the particular class of persons affected needs the protection of the [Securities Exchange Act of 1934]."<sup>171</sup> Courts have held that certain transactions are not tender offers; such transactions include a stock repurchase of a 9.9% voting block as "greenmail,"<sup>172</sup> open-market transactions at or below the market price without active solicitations,<sup>173</sup> the purchase of forty-two percent of a class of securities from only seven security holders,<sup>174</sup> and privately negotiated purchases from large or substantial shareholders.<sup>175</sup>

A tender offer for the stock of a publicly held corporation is subject to the Williams Act<sup>176</sup>—sections 13(d) and (e) and 14(d), (e), and

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165. Proposed Amendments to Tender Offer Rules, Exchange Act Release No. 16,385, 44 Fed. Reg. 70,349, 70,358 (Dec. 6, 1979).

166. See, e.g., *Brscan*, 477 F. Supp. at 791; *S-G Sec., Inc. v. Fuqua Inv. Co.*, 466 F. Supp. 1114, 1124 (D. Mass. 1978).

167. *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 17 (1967) (statement of Manuel F. Cohen, Chairman, SEC).

168. *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1206 (2d Cir. 1978).

169. *Id.* at 1208; see, e.g., *General Aircraft Corp. v. Lampert*, 556 F.2d 90 (1st Cir. 1977).

170. 346 U.S. 119 (1953).

171. *Id.* at 125.

172. *Pin v. Texaco, Inc.*, 793 F.2d 1448 (5th Cir. 1986).

173. *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985).

174. *Stromfeld v. Great Atl. & Pac. Tea Co.*, 484 F. Supp. 1264 (S.D.N.Y. 1980).

175. *Hanson Trust Pub. Co. v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).

176. 15 U.S.C. §§ 78m-78n.

(f) of the Securities Exchange Act of 1934.<sup>177</sup> Under section 13(d), any person or group of persons who becomes the owner of more than five percent of any class of securities registered under section 12 of the Securities Exchange Act of 1934<sup>178</sup> must file with the issuer of the securities and with the SEC a statement setting forth (1) the background of the person or persons, (2) the source of the funds to be used in the acquisition, (3) the purpose of the acquisition, (4) the number of shares actually owned, and (5) any relevant contracts, arrangements, or understandings concerning the ownership of the stock or its acquisition.<sup>179</sup> The statement must be filed within ten days of acquisition of the required percentage of stock.<sup>180</sup>

An accurate statement of the purpose of the acquisition is important since, under *Revlon*, managers' fiduciary duties shift from the corporation to the shareholders if the acquiring corporation intends to sell the assets rather than continue the target corporation's operations.<sup>181</sup> Managers of the target corporation may delay the tender offer by alleging that the tender offeror has filed a false or misleading Schedule 13D. A private right of action for injunctive relief under section 13(d) is recognized in many circuits,<sup>182</sup> although no private civil cause of action for damages is permitted.<sup>183</sup> A tender offeror's failure to disclose its intent—to gain control or sell the assets, for example—may result in injunctive relief granted to the target corporation's management.<sup>184</sup> The tender offeror's past activities in takeovers may or may not be used as evidence of intent depending on the circuit.<sup>185</sup>

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177. Securities Exchange Act of 1934, Pub. L. No. 90-439, §§ 13(d)-(e), 14(d)-(f), 82 Stat. 454, 454-57 (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f)).

178. 15 U.S.C. §§ 78a-78kk.

179. *Id.* § 78m(d)(1).

180. *Id.*

181. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

182. *See, e.g.*, *Portsmouth Square, Inc. v. Shareholders Protective Comm.*, 770 F.2d 866 (9th Cir. 1985); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984); *Indiana Nat'l Corp. v. Rich*, 712 F.2d 1180 (7th Cir. 1983).

183. *See, e.g.*, *Rubin v. Posner*, 701 F. Supp. 1041 (D. Del. 1988); *Sanders v. Thrall Car Mfg. Co.*, 582 F. Supp. 945 (S.D.N.Y.), *aff'd per curiam*, 730 F.2d 910 (2d Cir. 1984); *Schnell v. Schnell*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,927 (S.D.N.Y. Mar. 30, 1981).

184. *See Chromalloy Am. Corp. v. Sun Chem. Corp.*, 611 F.2d 240, 248 (8th Cir. 1979); *General Aircraft Corp.*, 556 F.2d at 96-97.

185. *See Dan River, Inc. v. Icahn*, 701 F.2d 278, 292 (4th Cir. 1983) (holding past performance not indicative of future performance). *But see Trane Co. v. O'Connor Sec.*, 561 F. Supp. 301, 308 (S.D.N.Y.) (finding past history persuasive), *appeal dismissed*, 718 F.2d 26 (2d Cir. 1983).

Under section 14(d) no person may make a tender offer that would result in his or her owning more than five percent of a class of securities required to be registered under section 12 of the Securities Exchange Act of 1934 unless the filing has been made with the SEC and a copy of the filing is furnished to each offeree.<sup>186</sup> The information to be contained in the statement is essentially the same information that is required under section 13(d).<sup>187</sup>

When managers of a target corporation solicit or recommend to their shareholders that they accept or reject a tender offer bid they must file a Schedule 14D-9 with the SEC.<sup>188</sup> The rationale for these disclosure requirements was aptly stated by the Second Circuit in *Chris-Craft Industries v. Piper Aircraft Corp.*:<sup>189</sup>

By reason of the special relationship between them, shareholders are likely to rely heavily upon the representations of corporate insiders when the shareholders find themselves in the midst of a battle for control. Corporate insiders therefore have a special responsibility to be meticulous and precise in their representations to shareholders.<sup>190</sup>

Management's position statement, as required by rule 14e-2, constitutes a solicitation or recommendation for purposes of rule 14d-9.<sup>191</sup> Item 4 requires disclosure of management's position regarding the offer, so if the price is stated to be inadequate, reasons must be given to support that position.<sup>192</sup> The shareholders of the target corporation receive the information in the Schedule 14D-9 because, in practice, the document is used without attachments as part of the initial communication to shareholders following the tender offer bid.

Section 14(e) makes it unlawful for any person to misstate or omit a material fact, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with a tender offer.<sup>193</sup> While there is no specific cause of action granted to shareholders of the target corporation under section 14(e), the United States Supreme Court has implied one in *Piper Aircraft Corp. v. Chris-Craft Indus-*

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186. 15 U.S.C. § 78n(d)(1).

187. Compare 17 C.F.R. § 240.14d-100 (1994) (stating disclosure requirements under section 14(d)) with *id.* § 240.13d-101 (stating disclosure requirements under section 13(d)).

188. 17 C.F.R. § 240.14d-9(a)(1).

189. 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

190. *Id.* at 364-65.

191. 17 C.F.R. § 240.14d-9(f).

192. *Id.* § 240.14d-9(4).

193. 15 U.S.C. § 78n(e).

tries.<sup>194</sup> Violation of section 14(e) is the most common claim asserted by the target corporation's managers and shareholders. As a result, judges are becoming skeptical and reluctant to entertain such claims.<sup>195</sup>

Standing is granted to the target corporation to bring suit for injunctive relief to prohibit the tender offer but not for damages;<sup>196</sup> likewise, the tender offeror does not have standing to sue the target corporation management for damages.<sup>197</sup> A tender offeror has standing to sue a competing tender offeror for injunctive relief<sup>198</sup> but not for damages.<sup>199</sup> Under section 14(e) a nontendering target corporation's shareholder has standing to sue since the statutory element is "in connection with" a tender offer rather than the "purchase or sale" of a security as under section 10(b) and rule 10b-5.<sup>200</sup>

The elements of a cause of action under 14(e) are similar to those required under section 10(b) and rule 10b-5. The test for materiality in tender offer cases<sup>201</sup> was actually set out in a proxy case under section 14(a): A fact is material if

there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.<sup>202</sup>

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194. 430 U.S. 1 (1977).

195. See, e.g., *Macfadden Holdings, Inc. v. JB Acquisition Corp.*, 802 F.2d 62 (2d Cir. 1986); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984); *Diamond v. Arend*, 649 F. Supp. 408 (S.D.N.Y. 1986).

196. See, e.g., *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513 (11th Cir. 1985); *E.H.I. of Florida, Inc. v. Insurance Co. of N. Am.*, 499 F. Supp. 1053 (E.D. Pa. 1980), *aff'd*, 652 F.2d 310 (3d Cir. 1981); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

197. *Piper Aircraft*, 430 U.S. at 42.

198. E.g., *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982); *Weeks Dredging & Contracting, Inc. v. American Dredging Co.*, 451 F. Supp. 468 (E.D. Pa. 1978); *Humana, Inc. v. American Medicorp, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,286 (S.D.N.Y. Jan. 5, 1978).

199. *Kalmanovitz v. G. Heileman Brewing Co.*, 769 F.2d 152, 159 (3d Cir. 1985).

200. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); *Wellman*, 475 F. Supp. at 817; *In re Commonwealth Oil/Tesoro Petroleum Corp. Sec. Litig.*, 467 F. Supp. 227, 242 (W.D. Tex. 1979); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1368 (N.D. Tex. 1979).

201. See *Piper Aircraft*, 430 U.S. at 50.

202. *TSC Indus.*, 426 U.S. at 449 (footnote omitted).

The courts have taken a relatively pragmatic approach to materiality rather than engaging in a "nit-picking" exercise.<sup>203</sup> This relaxation of the standard in takeovers occurs because both sides are represented by opposing forces, making it more likely that all material information will be disclosed by one or the other of the parties.<sup>204</sup> Moreover, in contested control situations, some courts consider the failure of one of the contestants to take remedial action with respect to an alleged misstatement or omission to be evidence that the alleged misstatement or omission is not material.<sup>205</sup> Any significant relationship between the tender offeror and the target managers is material to an evaluation of the target managers' recommendations to their shareholders.<sup>206</sup>

Scienter, which is required in a section 10(b) and rule 10b-5 case,<sup>207</sup> may or may not be required in a section 14(e) case. The language of section 14(e) that declares it unlawful to make an untrue statement or omit a material fact<sup>208</sup> can be read as not requiring scienter. Conversely, the language concerning fraudulent, deceptive, or manipulative acts or practices<sup>209</sup> can be read as requiring scienter. To date, the United States Supreme Court has not ruled on this question; however, several lower courts have held that scienter is a required element under section 14(e).<sup>210</sup>

Causation and reliance in a section 14(e) case are essential elements of a private civil cause of action.<sup>211</sup> Section 14(e) causation is often analyzed in the context of section 10(b) and rule 10b-5 materiality and reliance; causation and reliance are presumed in an omission case if materiality is proved.<sup>212</sup>

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203. See *Seaboard World Airlines, Inc. v. Tiger Int'l, Inc.*, 600 F.2d 355, 363 (2d Cir. 1979); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 267 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

204. See *Seaboard World Airlines*, 600 F.2d at 364; *Kennecott Copper*, 584 F.2d at 1200; *Ash v. LFE Corp.*, 525 F.2d 215, 219 (3d Cir. 1975).

205. *Kennecott Copper*, 584 F.2d at 1200 n.4; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

206. *Bell v. Cameron Meadows Land Co.*, 669 F.2d 1278, 1282 (9th Cir. 1982).

207. *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969), *aff'd and modified*, 478 F.2d 1281 (2d Cir. 1973).

208. 15 U.S.C. § 78n(e).

209. *Id.*

210. *E.g.*, *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 n.17 (2d Cir. 1973); *A & K Railroad Materials, Inc. v. Green Bay & W.R.R. Co.*, 437 F. Supp. 636, 642 (E.D. Wis. 1977).

211. *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310, 1323-24 (W.D. Mich. 1978); *Halle & Stieglitz, Filor, Bullard Inc. v. Empress Int'l, Ltd.*, 442 F. Supp. 217, 223 (D. Del. 1977).

212. *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766, 769 (9th Cir.), *cert. denied*, 459 U.S. 1035 (1982); *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980).

As in the case of an alleged section 13(d) violation, a tender offeror's failure to disclose its plans and purposes—an intent to obtain control or liquidate, for example—is actionable under section 14(e).<sup>213</sup> An accurate statement of the purpose of the acquisition is important because, under *Revlon*, managers' fiduciary duties shift from the corporation to the shareholders if the acquiring corporation intends to sell the assets rather than continue the target corporation's operations.<sup>214</sup>

In general the tender offeror may keep secret its own evaluations or appraisals of the target corporation made with publicly available information.<sup>215</sup> The tender offeror, however, must disclose confidential information used in making the evaluation.<sup>216</sup> In *In re Envirodyne Shareholders Litigation*, the target corporation had considered the possible sale of the corporation.<sup>217</sup> Its largest shareholder, ARTRA, had agreed to participate in the sale and consequently acquired confidential inside information.<sup>218</sup> The corporation received no offers and thus abandoned attempts to sell.<sup>219</sup> ARTRA's financial advisor, Solomon Brothers, was made privy to the inside information and subsequently pursued a takeover bid for Envirodyne using the inside information to formulate the offer price.<sup>220</sup> The court held that the inside information was material and must be disclosed to the target corporation shareholders.<sup>221</sup>

Likewise, other misuse of confidential, inside information constitutes a violation of section 14(e).<sup>222</sup> When the tender offeror receives confidential inside information under a confidentiality agreement, or from a former officer or director of the target corporation, the tender offeror cannot properly use such information without disclosing it to

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213. *Georgia-Pacific Corp. v. Great N. Nekoosa Corp.*, 795 F. Supp. 484, 486 (D. Me. 1990); *Koppers Co. v. American Express Co.*, 689 F. Supp. 1371, 1383-84 (W.D. Pa. 1988); *Pargas, Inc. v. Empire Gas Corp.*, 423 F. Supp. 199, 209 (D. Md.), *aff'd per curiam*, 546 F.2d 25 (4th Cir. 1976).

214. *See Revlon*, 506 A.2d at 179.

215. *Camelot Indus. Corp. v. Vista Resources, Inc.*, 535 F. Supp. 1174, 1182-83 (S.D.N.Y. 1982).

216. *In re Envirodyne Indus. Shareholders Litig.*, No. 10702, 1989 WL 40792, at \*7 (Del. Ch. Apr. 17, 1989).

217. *Id.* at \*3.

218. *Id.* at \*4.

219. *Id.*

220. *Id.* at \*5.

221. *Id.* at \*7.

222. *Camelot Indus.*, 535 F. Supp. at 1182-83.

the target corporation's shareholders.<sup>223</sup> However, disclosure may violate the agreement and may be actionable. Thus, the tender offeror is in an untenable position; in such cases the tender offer typically is not allowed to proceed.<sup>224</sup>

A tender offer may be initiated in two different ways: by "bear hug" or by a surprise announcement to the shareholders—directly bypassing the target corporation's board.

In the bear hug approach, the acquiring corporation makes an offer directly to the managers or board of directors of the target corporation to acquire the target corporation at a fixed price. This approach does several things. The offer can be in preliminary form and negotiable as a friendly takeover. Target directors are forced to disclose the offer to their shareholders, creating pressure on the directors to accept.<sup>225</sup> The preliminary negotiations may contain material facts that must be disclosed to the target corporation's shareholders. Information concerning price would be of the utmost importance to the slack-poor, target corporation's shareholders and, therefore, material.

Rule 14e-2 requires the target corporation's managers, within ten business days following an offer, to publish or send to their shareholders a statement that they (1) recommend acceptance or rejection of the offer, (2) express no opinion and are neutral toward the offer, or (3) are unable to take a position on the offer.<sup>226</sup> This statement must disclose the reasons why management either took the position or refuses to take a position.<sup>227</sup> In the ten-day interim, the target corporation may evaluate the offer and communicate with its shareholders provided, however, that the communication does no more than identify the bidder, state that the offer is being considered, state that the corporation will issue its opinion regarding the offer within the ten-day period, and request shareholders to wait until they are informed

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223. LFC No. 31 Corp. v. Ransburg Corp., No. IP 88-1277-C, 1988 U.S. Dist. LEXIS 17486 (S.D. Ind. Dec. 7, 1988); A. Copeland Enters., Inc. v. Guste, 1989-2 Trade Cas. (CCH) ¶ 68,713 (E.D. La. Nov. 28, 1988), *aff'd*, 865 F.2d 1264 (5th Cir. 1989); Murrar Ohio Mfg. Co. v. AB Electrolux, No. 1-88-0387, 1988 U.S. Dist. LEXIS 16819 (M.D. Tenn. Aug. 26, 1988).

224. Burlington Indus. v. Edelman, 666 F. Supp. 799 (M.D.N.C.), *aff'd*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,339 (4th Cir. June 22, 1987); General Portland, Inc. v. La Farge Coppee S.A., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,148 (N.D. Tex. Aug. 28, 1981).

225. 17 C.F.R. § 240.14d-9; *Basic*, 485 U.S. at 224.

226. 17 C.F.R. § 240.14e-2.

227. *Id.* § 240.14e-2(a)(3).



of the corporation's position.<sup>228</sup> All communications must be fair and in accordance with rule 10b-5 and section 14(e).<sup>229</sup>

The courts scrutinize management's statements to shareholders, particularly statements regarding the inadequacy of the price. A statement that the price is inadequate is misleading if the target managers are aware of nonpublic information that would dispute this conclusion.<sup>230</sup> Therefore, if the slack-poor corporation's managers lie to their own shareholders about the updated estimates of 'a' and 'b' in determining the adequacy of the tender offer, they may be liable under section 10(b) and rule 10b-5 as well as section 14(e). The incentive to tell the truth may solve the asymmetric information problem in bear hug tender offers. The offeror has inside information only if it is acquired from the target managers, and if so received, that information must be disclosed to the target shareholders.<sup>231</sup> The inside information concerning the updated estimates of 'a' and 'b' will also have to be disclosed if target managers make any representation concerning the adequacy of the tender offer.

A troublesome situation arising after the 1989 Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) releases<sup>232</sup> is the difference between the tests of *Basic, Inc. v. Levinson*<sup>233</sup> and Item 303 of Regulation S-K.<sup>234</sup> If the MD&A test for mandatory disclosure were applied to preliminary merger negotiations, the MD&A requirements would force disclosure in some cases that the *Basic* test would not. Under Item 303, forward-looking data is to be disclosed if (1) management cannot determine that the event is unlikely to occur and (2) it is otherwise of a material amount.<sup>235</sup> The Item 303 test effectively requires the probability of occurrence to be treated as if it were either 100% or zero percent.

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228. *Id.* § 240.14d-9.

229. *Id.* §§ 240.10b-5, 240.14e-2.

230. *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231, 1253 (N.D. Ill. 1980).

231. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 796 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

232. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release Nos. 33-6835, 34-26831, 54 Fed. Reg. 22,427 (May 24, 1989) [hereinafter MD&A Releases].

233. 485 U.S. at 249-50.

234. 17 C.F.R. § 229.303; RICHARD W. JENNINGS ET AL., *FEDERAL SECURITIES LAWS: SELECTED STATUTES, RULES AND FORMS* 232-35 (1994).

235. JENNINGS ET AL., *supra* note 234, at 233; *see* MD&A Releases, *supra* note 232, at 22,429.

In contrast, the *Basic* test allows for a continuous spectrum from zero to 100%.<sup>236</sup> Whether information could be withheld under the business purpose exemption in rule 10b-5 cases is an unanswered question.<sup>237</sup> Disclosure under Item 303 may be more extensive than under the antifraud provisions,<sup>238</sup> although the MD&A interpretive releases do provide that information need not be disclosed if it would jeopardize the negotiations.<sup>239</sup>

If the slack-poor corporation's managers distort or lie about the updated estimates of 'a' and 'b' in the negotiations, such action could constitute a misstatement of a material fact which might subject the managers of the target, slack-poor corporation to liability for violation of section 10(b), rule 10b-5, and sections 14(d) and (e). This potential liability provides an incentive for managers of the corporation to tell the truth about its value.

A hostile board of directors of the target corporation may engage in defensive maneuvers and frustrate the takeover attempt by stopping it or making it too expensive. A wide array of defensive maneuvers are available to thwart the takeover. These include a friendly merger with a more desirable corporation—or white knight, a counteroffer to buy by a friendly party, or a repurchase by the target corporation of its own stock. *Unocal Corp. v. Mesa Petroleum, Co.*,<sup>240</sup> *Revlon*,<sup>241</sup> and *Paramount Communications, Inc. v. Time, Inc.*<sup>242</sup> impose restrictions on the target corporation's board of directors' use of defensive measures. The modified or enhanced business judgment rule<sup>243</sup> is in effect in takeover situations. The purpose of the enhanced

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236. *Basic*, 485 U.S. at 250.

237. See, e.g., *Texas Gulf Sulphur Co.*, 401 F.2d at 849.

238. See *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 25 (1st Cir. 1987) ("The securities laws do not operate under the assumption that material information need not be disclosed if management has reason to suppress it.").

239. MD&A Releases, *supra* note 232, at 22,435 & nn.49-50.

240. 493 A.2d 946 (Del. 1985).

241. 506 A.2d at 173.

242. 571 A.2d 1140 (Del. 1989).

243. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), Delaware adopted a more stringent business judgment rule for takeover situations because of an "omnipresent specter" that the directors may be acting in their own best interests rather than the best interests of the corporation and shareholders. *Id.* at 954. The court imposed an "enhanced" duty calling for an initial judicial determination before the business judgment rule is applicable. *Id.* In Delaware "directors [in a takeover situation] must show that they had reasonable grounds [to believe there existed] a danger to corporate policy and effectiveness because of another person's stock ownership." *Id.* at 955. This enhanced duty is shown by good faith and reasonable investigation, particularly if done by a majority of independent outside directors. *Id.*

rule is to ensure that defensive measures are motivated by a good faith concern for the welfare of the corporation and its shareholders rather than to perpetuate management.<sup>244</sup> Under *Unocal* the board of directors must make a reasonable investigation before adopting a takeover defensive measure.<sup>245</sup> In order to facilitate an informed, dispassionate decision, the board investigation must provide material information and expert advice to the directors on such matters as inadequacy of consideration, nature and timing of the offer, legality, impact on stakeholders other than shareholders, and the risk of non-consummation.<sup>246</sup> Even if the transaction were approved by a majority of independent, outside directors, the board of directors still has the burden of showing its entire or intrinsic fairness.<sup>247</sup> Further, the defensive response must be reasonable in relation to the threat posed by the hostile bid.<sup>248</sup>

The Delaware Supreme Court in *Paramount* overruled the chancery court holdings in *City Capital Associates v. Interco, Inc.*<sup>249</sup> and *Grand Metropolitan Public Co. v. Pillsbury Co.*,<sup>250</sup> which indicated that a target corporation's board of directors could only oppose a hostile bid if it were a coercive, two-tier bid or constituted an all-cash bid at less than a fair price.<sup>251</sup> The Delaware court held that the board of directors of a target corporation may refuse to consider an all-cash, all-share offer made at an adequate price.<sup>252</sup> This is the "just say no" defense. This holding applies to the factual context of deciding between long-range and short-range plans.<sup>253</sup>

The fair price defensive tactic is used to defend against two-tier, front-end-loaded attacks to protect shareholders who may tender because they fear being squeezed out at a lower price.<sup>254</sup> To protect shareholders the consideration paid must be cash or the same type of consideration paid for the largest block of the stock acquired and must equal the greatest of: (1) the highest price paid by the offeror for any shares of the target acquired during the tender offer period; (2) an amount which bears the same or a greater percentage relationship to

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244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.*

249. 551 A.2d 787 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988).

250. 558 A.2d 1049 (Del. Ch. 1988).

251. *Paramount*, 571 A.2d at 1152-53.

252. *Id.*

253. *See Grand Metro.*, 558 A.2d at 1057-59.

254. *See, e.g., City Capital Assocs.*, 551 A.2d at 797.

the then market price of the target corporation's stock as the highest price paid by the tender offeror bears to the market price of the stock immediately preceding the commencement of the tender offer; or (3) an amount equal to the earnings per share of the corporation for the four, full, consecutive fiscal quarters immediately preceding the proposed business combination multiplied by the then price-earnings ratio of the offeror.<sup>255</sup> This provision ensures equal treatment of all shareholders during all stages of the tender offer.

An alternate defensive tactic with the same effect is the right of redemption privilege. Minority shareholders are granted the right in the articles of incorporation or bylaws to put their stock to the tender offeror at specified redemption prices.<sup>256</sup> The target corporation could adopt a right of redemption privilege that reflects the updated estimates of 'a' and 'b.' Such a signal could overcome the asymmetric information problem. Right of redemption privileges are not permitted in all states.<sup>257</sup>

### 3. State regulation of takeovers

More than forty states have enacted laws regulating takeovers of companies incorporated or doing business in their respective states.<sup>258</sup> These statutes tend to be more extensive than federal law, which is perceived by the states as having shortcomings, and tend to favor the incumbent management of the target corporation. Between 1968 and 1982, thirty-seven states adopted "first generation" takeover statutes.<sup>259</sup> These statutes required a bidder to disclose certain information concerning the offer.<sup>260</sup> One of the more debilitating aspects of these state statutes generally imposed a waiting period of ten to sixty days from the announcement to the commencement of the tender of-

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255. DEL. CODE ANN. tit. 8, § 262(2) (1993).

256. See *Nivrum Corp. v. Harcourt Brace Janovich, Inc.*, 840 F. Supp. 243 (S.D.N.Y. 1993).

257. The Delaware Court of Chancery upheld a fair value rights plan in *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. Ch.), *aff'd*, 505 A.2d 454 (Del. 1985). *Contra* *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987); *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985).

258. John C. Coates IV, Note, *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. REV. 806, 849 (1989).

259. Mark A. Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 690 n.7 (1981).

260. See, e.g., CONN. GEN. STAT. ANN. §§ 36-456 to -468 (West 1987); ME. REV. STAT. ANN. tit. 13, §§ 801-817 (West 1981).

fer.<sup>261</sup> This waiting period allowed hostile incumbent management of the target corporation to marshal its forces to ward off the tender offer and frustrate the takeover attempt. Most of these statutes empowered a state official to determine whether the disclosure was adequate and the offer was "fair";<sup>262</sup> the designated state official was empowered to conduct hearings to make these determinations.<sup>263</sup>

There have been inconsistent decisions in the federal courts as to whether or not these more extensive state statutes infringe upon the federal prerogative of regulating securities.<sup>264</sup> The United States Supreme Court's first decision regarding state takeover statutes resulted in six separate opinions in which a bare majority voted to overturn the Illinois statute on narrow Commerce Clause grounds.<sup>265</sup> Following the Supreme Court decision, state takeover statutes in Kentucky,<sup>266</sup> Maryland,<sup>267</sup> Michigan,<sup>268</sup> Minnesota,<sup>269</sup> Missouri,<sup>270</sup> Oklahoma,<sup>271</sup> and Virginia<sup>272</sup> were invalidated. The Massachusetts statute was upheld.<sup>273</sup> Five years after its decision in *MITE*, the United States Supreme Court upheld Indiana's takeover statute by a six-to-three vote.<sup>274</sup>

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261. See, e.g., DEL. CODE ANN. tit. 8, § 203(a)(1) (Supp. 1980); ME. REV. STAT. ANN. tit. 13, § 803(1).

262. See, e.g., ME. REV. STAT. ANN. tit. 13, § 804(i)(B).

263. See *id.* § 804(2).

264. *Brascan Ltd. v. Lassiter*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,247 (E.D. La. Apr. 30, 1979); *MITE Corp. v. Dixon*, No. 79-C-200, slip op. at 1-2 (N.D. Ill. Feb. 9, 1979), *aff'd*, 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom. Edgar v. MITE Corp.*, 457 U.S. 624 (1982); *Dart Indus. v. Conrad*, 462 F. Supp. 1 (S.D. Ind. 1978) (enjoining state laws). *Contra* *AMCA Int'l Corp. v. Krouse*, 482 F. Supp. 929 (S.D. Ohio 1979); *City Investing Co. v. Simcox*, 476 F. Supp. 112 (S.D. Ind. 1979), *aff'd*, 633 F.2d 56 (7th Cir. 1980); *UV Indus. v. Posner*, 466 F. Supp. 1251 (D. Me. 1979) (upholding state statutes).

265. *Edgar*, 457 U.S. at 643.

266. *Esmark, Inc. v. Strobe*, 639 S.W.2d 768, 770 (Ky. 1982).

267. *Bendix Corp. v. Martin-Marietta Corp.*, 547 F. Supp. 522, 532 (D. Md. 1982).

268. *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 568 (6th Cir. 1982).

269. *APL Ltd. Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1225 (D. Minn. 1985).

270. *National City Lines, Inc. v. LLC Corp.*, 524 F. Supp. 906, 913 (W.D. Mo. 1981), *aff'd*, 687 F.2d 1122 (8th Cir. 1982).

271. *Mesa Petroleum Co. v. Cities Serv. Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,049, at 99,064 (W.D. Okla. Dec. 21, 1982), *aff'd*, 715 F.2d 1425 (10th Cir. 1983).

272. *Telvest, Inc. v. Bradshaw*, 547 F. Supp. 791, 799 (E.D. Va. 1982), *aff'd*, 697 F.2d 576 (4th Cir. 1983).

273. *Agency Rent-A-Car, Inc. v. Connolly*, 686 F.2d 1029, 1040 (1st Cir. 1982).

274. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987).

As a result of these setbacks, states adopted "second generation" takeover statutes.<sup>275</sup> This second generation of takeover statutes uses several different approaches. One of the more common forms is the fair price takeover statute.<sup>276</sup> Under a fair price takeover statute, certain business combinations must be approved by a super-majority—usually eighty percent, unless a statutorily determined fair price is paid.<sup>277</sup> The fair price formulae are complicated and extensive.

Other states have adopted control share acquisition statutes that require shareholder approval before the corporation may acquire a specified percentage of stock.<sup>278</sup> The acquiring corporation may vote its control shares only to the extent approved by a majority of disinterested shareholders of that class of stock.<sup>279</sup> Business combination statutes are also common.<sup>280</sup> These statutes prohibit, for a specified period of time, business combinations with any person who acquires a certain percentage of stock.<sup>281</sup> Cash-out statutes and shareholders' rights plan validation statutes have also been enacted.<sup>282</sup> The cash-out statutes require an offeror who acquires a specified percentage of stock to buy out any shareholder who desires to tender at a price determined by the statute.<sup>283</sup> A shareholders' rights plan allows the target corporation to issue shareholders' rights or options to purchase a class of securities on conditions fixed by the board of directors.<sup>284</sup>

A "third generation" of takeover statutes is beginning to appear. Pennsylvania,<sup>285</sup> Indiana,<sup>286</sup> and New Jersey<sup>287</sup> have adopted far-

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275. Jonathan M. Karpoff & Paul Maltesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291, 291 (1989); Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 468 n.4; Jo Watson Hackl & Rosa Anna Testani, Comment, *Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study*, 97 YALE L.J. 1193, 1196-97 (1988).

276. See Karpoff & Maltesta, *supra* note 275, at 294-96.

277. Hackl & Testani, *supra* note 275, at 1205.

278. See *id.* at 1204.

279. Karpoff & Maltesta, *supra* note 275, at 294; see Hackl & Testani, *supra* note 275, at 1204.

280. See Karpoff & Maltesta, *supra* note 275, at 295-96.

281. *From the Hustings: The Role of States with Takeover Laws*, MERGERS & ACQUISITIONS, Sept. 1993, at 56, 56 ("Delaware's freeze-out law, for example, suspends a merger for three years unless the board approves the combination or the acquirer obtains at least 85% of the shares in its initial tender offer.").

282. See *id.*

283. *Id.* at 57.

284. *Id.*; Jonathan Shub, Comment, *Shareholder Rights Plans—Do They Render Shareholders Defenseless Against Their Own Management?*, 12 DEL. J. CORP. L. 1991 (1987).

285. PA. STAT. ANN. tit. 70, § 71-85 (1994).

286. IND. CODE ANN. § 23-2-3.1.05-11 (Burns Supp. 1994).

287. N.J. STAT. ANN. § 49:5.1-19 (West 1994).

reaching statutes in reaction to the enhanced business judgment rule applied by the Delaware court in *Unocal* and *Revlon*. Indiana rejects the *Unocal* rule and establishes a presumption that the board's action in taking defensive measures is "valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation."<sup>288</sup> This third generation of takeover statutes is broadening the corporate constituency statutes.

#### IV. CONCLUSION

In this Article the asymmetric information problems related to both negotiated—friendly—and hostile mergers and direct and bear hug tender offers were examined. Only in a direct tender offer, where managers of the target corporation remain neutral and silent, does the asymmetric information problem disappear.<sup>289</sup> In the direct tender offer, neither the offeror nor the target shareholders are in possession of inside information. Both sides benefit if the offered price is within the acceptable range between  $S + a$  and  $S + \bar{A} + \bar{B}$ .<sup>290</sup> In all other cases, asymmetric information is problematic. Moreover, managers of the target corporation have an incentive to lie about the updated estimates of 'a' and 'b'.<sup>291</sup>

Federal securities antifraud provisions provide some incentive to tell the truth.<sup>292</sup> In a negotiated merger or bear hug tender offer, the offeror may obtain inside information from the target corporation's managers. If so, disclosure may be required. Making a misstatement of a material fact or omitting a material fact may result in liability.<sup>293</sup> If the target corporation's managers mislead or fail to disclose material information to their own shareholders, they become liable. Defensive tactics may also be a source of liability under federal securities law.<sup>294</sup>

Under federal securities law, *cost of lying* =  $(2p - 1)(V_i - V_t) + pCP$ . It pays to lie if the probability of getting caught is less than twenty percent.<sup>295</sup> Thus, if managers perceive the probability of getting caught at less than twenty percent, they will lie about the true value of the corporation. The value of the corporation becomes  $V =$

288. IND. CODE ANN. § 23-1-35-1(g) (Burns 1989).

289. See *supra* notes 8-9 and accompanying text.

290. See *supra* p. 516.

291. See *supra* notes 59-62 and accompanying text.

292. See *supra* part III.B.1.

293. See *supra* notes 124-27 and accompanying text.

294. See *supra* notes 240-57 and accompanying text.

295. See *supra* p. 528.

$V_i - pCP$ , or  $V = S + a + b - pCP$ . The shareholders will have no confidence in the information received from their managers or the offeror if they perceive that the probability that the offending management will not be caught lying is greater than or equal to eighty percent.<sup>296</sup>

The asymmetric information problem also may be addressed through use of the fair price provisions of state takeover statutes.<sup>297</sup> The articles of incorporation or bylaws may be amended to provide that the target corporation's shareholders be able to put their stock to the corporation at a price that represents the updated estimates of 'a' and 'b.' The fair price provision signals the updated estimates.<sup>298</sup>

Managers in possession of inside information may disclose, remain silent, or deceive. Direct disclosure may not be possible; however, some signals of the true value of the corporation may be given through mechanisms such as the fair price statutes. Remaining silent, coupled with nonaction, leaves the corporation undervalued. Deceit, however, can be profitable.

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296. See *supra* pp. 527-28.

297. See *supra* notes 275-77 and accompanying text.

298. See *supra* notes 275-77 and accompanying text.



