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BRIAN A. KORMAN\*

## The Corporate Game of Thrones and the Market for Corporate Control

*The market for corporate control is critical to the achievement of highly efficient markets and provides a dire level of protection for non-controlling shareholders as the market reallocates bargaining power from the hands of executives into the hands of minority shareholders. This paper begins with a brief theoretical discussion regarding the financial and societal benefits brought about by the market for corporate control. Following this initial analysis, this manuscript will progress by providing a step-by-step user's guide for various players in the market for corporate control including practical advice for an acquirer in pursuit of a particular acquisition as well as methods for a corporation's managers and directors to fight off a hostile takeover attempt. In doing so, this text will begin with various ways for an acquirer to structure and consider a takeover attempt and will conclude with an overview of takeover defenses.*

### I. INTRODUCTION

The market for corporate control refers to a takeover market where underperforming or undervalued firms become attractive takeover targets by potential acquirers.<sup>1</sup> This market often comes into play when a corporation's performance declines due to a failure within the corporation's internal governance.<sup>2</sup> Such failure could be attributable to the board of directors, the management team, or both.<sup>3</sup> To put it simply, when a company's financial performance decreases over

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1. *Definition of Market for Corporate Control*, LEXICON FINANCIAL TIMES, <http://lexicon.ft.com/Term?term=market-for-corporate-control> (last visited Feb. 15, 2017); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

2. *Definition of Market for Corporate Control*, *supra* note 1.

3. Manne, *supra* note 1.

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time, it may reflect poor internal governance.<sup>4</sup> This, in turn, invites external governance players to infiltrate the corporate structure.<sup>5</sup>

*Firms whose share prices are lower than they could be if managed by more talented or highly motivated managers are attractive takeover targets. By buying up enough shares to vote in a new board of directors, a bidder can then replace an inefficient or ineffectual management team. The bidder profits when the new management team gets results, which come in the form of improved corporate performance, higher profits, and, ultimately, higher share prices.*<sup>6</sup>

One generally accepted goal of a takeover is to “revitali[z]e a poorly run company and achieve higher profitability after restructuring.”<sup>7</sup> This proposition, of course, runs tangential to the potential acquirer’s belief that it can manage the target firm more effectively than the existing management team.<sup>8</sup>

As an illustration, consider HBO’s hit TV series *Game of Thrones*.<sup>9</sup> The show depicts numerous Houses fighting to take over each other’s land in order to grow their own empire.<sup>10</sup> Consider each House its own corporation, and further consider the family members of each House serving as the corporation’s management team. For example, Cersei Lannister, Jaime Lannister and Tommen Baratheon are the executives of House Lannister, which controls King’s Landing, the most prized asset in Westeros. Also, think about Daenerys Targaryen operating as the CEO of House Targaryen. If Daenerys Targaryen believed House Lannister was not operating King’s Landing at its optimal level, she might vie to swoop in, take control and then overthrow the management team. While this endeavor could yield bountiful results, it may cost a bloody war.

Much debate has come to rise in the last half-decade regarding the market for corporate control and its effect on the relationship between a corporation’s shareholders and management team.<sup>11</sup> Not surprisingly, shareholders and managers have very different attitudes towards the market. The typical shareholder often wants a corporation to be highly susceptible to a takeover because it keeps the

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4. *Id.*

5. *Definition of Market for Corporate Control*, *supra* note 1.

6. Jonathan R. Macey, *Market for Corporate Control*, 2 LIBRARY OF ECONOMICS AND LIBERTY: THE CONCISE ENCYCLOPEDIA OF ECONOMICS (2008), <http://www.econlib.org/library/Enc/MarketforCorporateControl.html>.

7. *Definition of Market for Corporate Control*, *supra* note 1.

8. Manne, *supra* note 1, at 113.

9. *Game of Thrones* (HBO).

10. *Id.*

11. Manne, *supra* note 1, at 112, 117; see also Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698, 698 (1982) (discussing the differing views of managers and shareholders when considering changes in corporate control).

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managers disciplined and offers the shareholder a chance to receive a significant premium if a takeover occurs.<sup>12</sup> Conversely, managers are often far more resistant to takeover attempts because such an attempt could place their job security at risk and a post-takeover transition may cause a corporate executive to suffer significant career setbacks.<sup>13</sup> That said, since the late 1960's, society has viewed the market for corporate control as one that provides major benefits for the efficiency and productivity of all corporations in every industry.<sup>14</sup>

It has been said, "a robust, properly functioning market for corporate control is vital to the performance of a free-enterprise economy with public corporations."<sup>15</sup> The question however remains: why? What are the benefits of a market that allows outsiders to enter a corporation with the sole purpose of overthrowing its leaders? Sounds quite a bit like *Game of Thrones*, no? Henry G. Manne, American economist, scholar, and Dean Emeritus at the George Mason University School of Law,<sup>16</sup> aptly coined this concept the "Market for Corporate Control" in his highly acclaimed article *Mergers and the Market for Corporate Control*.<sup>17</sup> Prior to Manne's 1965 article, anti-trust laws dominated the market such that most large-scale mergers were blocked by federal regulation, particularly those between competitors.<sup>18</sup> Through his pioneering efforts, Manne established three reasons, which illustrate the importance of a properly functioning market for corporate control.

First, Manne set forth the now-widely acclaimed proposition that an acquirer might be motivated to effectuate a corporate merger for one of two reasons: (1) reduce competition or (2) increase corporate efficiency through improvements in management.<sup>19</sup> Prior to Manne's article, the former reason listed above was conventionally one of the most accepted motivations behind acquiring another company: to eliminate the competition in an effort to soak up market share.<sup>20</sup> This is why many mergers in the 1960's were often treated as per se illegal under Federal

12. Jordan M. Barry & John W. Hatfield, *Pill and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 640 (2012).

13. *Id.*

14. See Fred S. Mechesney, *Manne, Mergers, and the Market for Corporate Control*, 50 CASE W. RES. L. REV. 245, 247, 251 (1999) (discussing the advancements brought on by Manne and the correlation between managerial efficiency and market price).

15. Macey, *supra* note 6, at 1.

16. Henry G. Manne, '52, 1928-2015, THE UNIVERSITY OF CHICAGO: THE LAW SCHOOL (Jan. 20, 2015, 1:02 PM), <http://www.law.uchicago.edu/alumni/accoladesandachievements/henry-g-manne-52-1928-2015>.

17. See Manne, *supra* note 1.

18. See Macey, *supra* note 6, at 2, 6 (highlighting regulations such as The Williams Act, which effectively limited large-scale mergers between competitors).

19. Manne, *supra* note 1, at 112-13.

20. See *id.* at 112.

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anti-trust laws when challenged by the government.<sup>21</sup> However, Manne intuitively proposed an alternative motivation behind acquisition efforts, which is to purchase a poorly performing corporation, revitalize the company's operations, improve performance, and turn a profit.<sup>22</sup> Manne writes "[t]he lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently."<sup>23</sup> This proposition illustrates how the market for corporate control allows markets to operate at the highest level of efficiency. The market incentivizes managers to lead with their best foot forward otherwise players in the market will jump in and take control. This checks and balances-type of system keeps the efforts of management and directors honest.

Secondly, Manne suggested that the market for corporate control is critical to shareholder protection against poor business judgment by directors and managers.<sup>24</sup> The business judgment rule leaves non-controlling shareholders at the whim of corporate executive decision-making.<sup>25</sup> Manne writes:

*Apart from the stock market, we have no objective standard of managerial efficiency. Courts, as indicated by the business-judgment rule, are loath to second-guess business decisions or remove directors from office. Only the take-over scheme provides some assurance of competitive efficiency and thereby affords strong protection to the interests of . . . small, non-controlling shareholders.*<sup>26</sup>

The separation between ownership and control is one that can leave minority shareholders in a bargain-less position, but "the market for corporate control gives these shareholders both power and protection commensurate with their interest in corporate affairs."<sup>27</sup>

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21. See Macey, *supra* note 6, at 2 (discussing regulations aimed at limiting large-scale mergers).

22. Manne, *supra* note 1, at 113.

23. *Id.*

24. *Id.*

25. See Carol Seidler, *Assessing the Wisdom of the Business Judgment Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount?*, 23 LOY. L.A. L. REV. 919, 921 (1989) (discussing the business judgment rule and its protection of director decision-making); see also *Boland v. Boland*, 31 A.3d 529, 548 (2011) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)) (maintaining that courts will presume that business decisions by a board of directors are made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company).

26. Manne, *supra* note 1, at 113.

27. *Id.* at 112.

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Lastly, Manne's third contribution was his proposition that managerial efficiency should be objectively measured by only one factor: changes in share price.<sup>28</sup> In order for the first two propositions listed above to hold true, an objective measure of managerial efficiency must be universally accepted. Manne posits "[a] fundamental premise underlying the market for corporate control is the existence of a positive correlation between managerial efficiency and the market price of shares of that company."<sup>29</sup> If an existing company is being poorly managed—in the sense that shareholders are not receiving as great returns as they could under better management—the share price declines relative to industry competitors.<sup>30</sup> Understanding that managerial efficiency is best measured by share price provides unity among shareholders and managers by creating a common goal for all: high share prices. If the share price is high, shareholders are happy and managers continue to hold their jobs.<sup>31</sup> Conversely, if the share price is low, a takeover can unseat management while also providing shareholders a financial premium for their troubles.<sup>32</sup>

Because ownership of most public companies is so widely dispersed, shareholders and consumers depend on the market to provide an optimal level of efficiency.<sup>33</sup> Without an efficient market for corporate control, collective-action problems often hinder any changes in management personnel when a management team is underperforming. For example, a commonly known theory is the "free-rider" problem, which posits that a single shareholder often does not monitor management efficiency because the costs associated with doing so would be borne solely on that individual shareholder, yet the benefits of unearthing and replacing executives are reaped by all shareholders.<sup>34</sup> Shareholders of closely held businesses are lucky not to face this problem. "This free-rider problem leads to less than the optimal amount of monitoring and other corrective action [and] the market for corporate control is the only known antidote for . . . these collective action problems."<sup>35</sup> Thus, the market for corporate control aids to bridge the gap between the interests of shareholders and managers of any public corporation.

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28. *Id.* at 112–13.

29. *Id.* at 112.

30. *Id.*

31. See Kevin Haeberle, *Stock-Market Law and the Accuracy of Public Companies' Stock Prices*, 2015 COLUM. BUS. L. REV. 121, 134 (2015) (expressing that shareholders want the firm they own to maximize its value and that the responsibility of doing so falls strictly upon the corporate managers).

32. See Albert O. Saulsbury, IV, *The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies*, 37 DEL. J. CORP. L. 115, 146 (2012) (pointing to various empirical studies showing that premiums paid to shareholders in U.S. takeover deals generally exceed those paid in the U.K.).

33. See Macey, *supra* note 6, at 1.

34. *Id.*

35. *Id.* at 3.

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Therefore, the market for corporate control is critical to the achievement of highly efficient markets and furthermore provides a dire level of protection for non-controlling shareholders as the market reallocates bargaining power from the hands of executives into the hands of minority shareholders. Whether you are playing offense as an acquirer or you are playing defense to prevent a takeover, this manuscript will guide readers through a roadmap for students and young practitioners new to the market for corporate control who are eager to learn the market's basics. I begin with the offensive side of the market by discussing strategic best practices for identifying and executing a takeover opportunity. I will then switch to the defensive side of the market by providing an overview of takeover defenses for managers and directors to employ in an effort to ward off hostile takeover attempts.

## II. PLAYING OFFENSE: MAKING A TAKEOVER ATTEMPT

When an opportunity arises for an acquirer to make an acquisition, there are many ways for the acquirer to identify the takeover target. The process is common to purchasing a new car. The type of car a person buys will depend on factual distinctions unique to that consumer. For example, John might require a pickup truck because he needs to haul heavy equipment, while Paul might need a sedan to carry his family safely to each destination. The choices of each John and Paul are driven by their current needs and anticipated outcomes. Similarly, Season 6 of *Game of Thrones* concluded with Daenerys Targaryen having identified King's Landing as her next acquisition target.<sup>36</sup> Throughout the show, she has generated considerable value using the growth-by-acquisition model by taking Astapor, Yunkai and Meereen.<sup>37</sup> And, while she's been quite successful in her endeavors, she vies to expand her portfolio further by taking King's Landing because of what it has to offer.<sup>38</sup> King's Landing is cash rich, harbors the King's throne, and, most importantly, it is the city where her father ruled before the Baratheons rebelled and took the throne.<sup>39</sup> For these reasons, King's Landing offers something to Daenerys that no other target offers—the chance to be Queen.<sup>40</sup> Furthermore, the Lannisters—King's Landing's management—are as weak as they have ever been, making the timing for a takeover attempt particularly enticing.<sup>41</sup> Accordingly, the manner in which an acquirer might identify and ultimately effectuate a takeover opportunity will be dictated by firm-specific characteristics.

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36. *Game of Thrones: Winds of Winter* (HBO television broadcast June 26, 2016).

37. *Game of Thrones* (HBO).

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

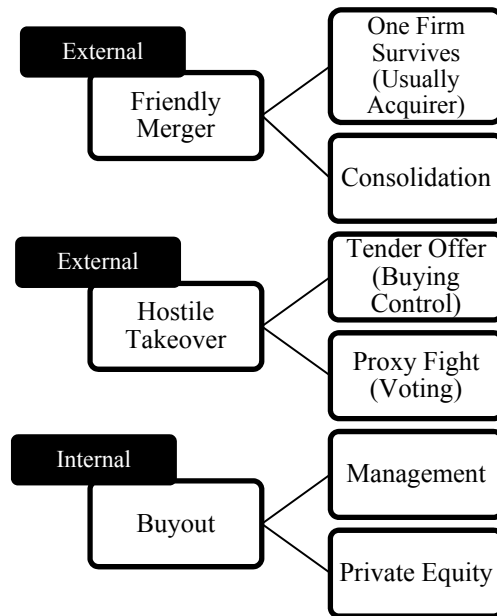
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This section will begin by categorizing the most common takeover methods. It will then move forward by setting forth guidelines for acquirers to implement in identifying, valuing, and paying for a target firm, as well as the final and most critical step in an acquisition: making the business work after the deal is complete.

#### A. Categorizing Acquisitions

Acquisitions in the market for corporate control can be broken down into three broad categories: (1) friendly mergers, (2) hostile takeovers, and (3) buyouts. The first two are considered external acquisitions because the acquirer is someone who comes from outside the firm. Conversely, a buyout should be considered an internal acquisition because the acquirer often comes from within the target firm. Each of these categories has two subparts, which will be discussed within each broader category. See Table 1 below for a summarization of the various categories.

Table 1: Acquisition Categories





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1. *Friendly Merger*

First, a friendly merger can be referred to hereinafter as a merger. In a merger, the boards of directors of two firms agree to join together.<sup>42</sup> Based on this definition, it is easy for one to understand why this can be categorized as a “friendly deal.” In a merger, shareholder approval will be required, which, in most cases, necessitates approval by more than 50% of the shareholders of both the target and the bidding firms.<sup>43</sup> The result of a merger will come in the form of either a survivor or a consolidation.<sup>44</sup> If one firm survives the merger, it is said that one firm will absorb the other firm.<sup>45</sup> Most commonly, the acquiring firm will survive the merger and the target firm will cease to exist, as it becomes part of the acquirer.<sup>46</sup> The inverse could also occur, in which case the target firm survives the merger and the acquirer would cease its existence.<sup>47</sup> While this is quite rare, a sound justification for surviving the target would be if the target held strong brand recognition in the marketplace. Conversely, in a consolidation, “a new firm is created after the merger, and both the acquiring firm and target firm shareholders receive stock in this firm.”<sup>48</sup> For example, Citigroup was created as a result of a consolidation between Citicorp and Travelers’ Insurance Group.<sup>49</sup>

2. *Hostile Takeover*

Alternative to a friendly deal is a hostile deal, which is the second acquisition category. Presumably, once an acquirer identifies a target, the managers or directors of the acquiring firm will approach those of the target to open discussions for a friendly merger. If the target’s board of directors are not interested in selling, then the acquiring firm can bypass the directors and managers and move in for a hostile takeover. A hostile takeover is an acquisition accomplished not by coming to an agreement with the target company’s management, but “by going directly to the

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42. ASWATH DAMODARAN, 2 CORPORATE FINANCE: THEORY AND PRACTICE 835 (2d ed. 2001).

43. *Id.*; see also Celia R. Taylor, “A Delicate Interplay”: Resolving the Contract and Corporate Law Tension in Mergers, 74 TUL. L. REV. 561, 574–77 (1999) (discussing the merger process and how shareholder approval is sought by individuals seeking corporate control).

44. See DAMODARAN, *supra* note 42.

45. 19 AM. JUR. 2D Corporations § 2151 (2015); *Ladjevardian v. Laidlaw-Coggeshall, Inc.*, 431 F. Supp. 834, 838 (S.D.N.Y. 1977) (“A merger contemplates the ‘absorption of one corporation by another which retains its name and corporate identity with the added capital, franchises and powers of a merged corporation.’”).

46. 19 AM. JUR. 2D Corporations § 2154 (2015).

47. See 26 U.S.C. § 368(a)(2)(e) (2006).

48. DAMODARAN, *supra* note 42; see also *Kirzhner v. Silverman*, 870 F. Supp. 2d 1145, 1149, 1155 (D. Colo. 2012) (discussing the consolidation following a merger and the transfer of stock in the acquired company to stock in the acquiring company); *Ladjevarian*, 431 F. Supp. at 838; 19 AM. JUR. 2D Corporations § 2154 (2015).

49. DAMODARAN, *supra* note 42.

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company's shareholders or fighting to replace management to get the acquisition approved.<sup>50</sup>

A hostile takeover can be accomplished through either a tender offer or a proxy fight.<sup>51</sup> In a tender offer, the acquiring firm offers to buy the outstanding stock of the target firm at a specific price, which usually includes a premium above the market price.<sup>52</sup> The goal here is for the acquiring firm to directly purchase the requisite number of shares to take control of the corporation (often 50.1%, depending on shareholder voting provisions in the target's corporate charter).<sup>53</sup> If a target's shareholder base is made up of large institutional investors, a tender offer could be an effective strategy for obtaining control because purchasing shares directly from those investors allows for secrecy and negotiation on price.<sup>54</sup> However, tender offers are most commonly used in hostile takeovers where "shares are widely held and there is a chance of a fast increase in market price if the news spreads that there is a heavy buyer in the market for the [target]'s shares."<sup>55</sup> Importantly, the tender offer will be executed only if a minimum percentage of shares are tendered at the offered price, so the decision to sell is left solely to the shareholders.<sup>56</sup> The tender offer will not succeed and the target firm will not be acquired so long as enough minority shareholders refuse to tender.<sup>57</sup> If the acquirer successfully tenders control of the target firm, the practical implication results in a merger.<sup>58</sup>

50. *Hostile Takeover*, INVESTOPEDIA, <http://www.investopedia.com/terms/h/hostiletakeover.asp> (last visited Feb. 15, 2017).

51. *Id.*

52. DAMODARAN, *supra* note 42. Case law has recognized seven elements, as deemed by the SEC, to be characteristic of a tender offer:

(1) active and widespread solicitation of public shareholders for the shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subjected to pressure to sell his stock.

*Wellman v. Dickinson*, 475 F. Supp. 783, 823–24 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982). A tender offer typically involves a public offering consisting of a general, publicized bid by an individual or a group to buy shares of a publicly owned company at a price substantially above the current market price. *See Telenor East Invest AS v. Altimio Holdings & Investment Ltd.*, 567 F. Supp. 2d 432, 442–43 (S.D.N.Y. 2008) (citing *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 54 (2d Cir. 1985)).

53. *Hostile Takeover*, NASDAQ, <http://www.nasdaq.com/investing/glossary/h/hostile-takeover> (last visited Feb. 5, 2017).

54. Manne, *supra* note 1, at 116.

55. *Id.*

56. *Tender Offer*, SEC, <https://www.sec.gov/answers/tender.htm> (last visited Feb. 15, 2017).

57. DAMODARAN, *supra* note 42; *see also* Taylor, *supra* note 43, at 583 (stating that shareholders hold the power to accept or reject tender offers, effectively holding the power in regards to approving a proposed merger).

58. DAMODARAN, *supra* note 42.

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Alternatively, an acquirer can win a hostile takeover by employing a proxy fight. In a proxy fight, “the acquirer will persuade existing shareholders to vote out company management so that the company will be easier to take over.”<sup>59</sup> The goal here is for the acquirer to persuade the existing target’s shareholders to join the acquirer in voting out incumbent managers or directors.<sup>60</sup> Also referred to as a proxy contest or a proxy battle, the acquirer is heavily relying on its lobbying ability to “whip” votes among existing shareholders.<sup>61</sup>

An interesting comparison can be drawn between how a proxy fight works and the way in which Daenerys Targaryen took control of Meereen.<sup>62</sup> When Daenerys arrived at Meereen, the kingdom was divided into two classes: masters and slaves.<sup>63</sup> The masters were controlling the kingdom while the citizens had been turned into slaves. In order to take control of the kingdom, Daenerys launched a “proxy fight” whereby she called on the citizens to choose their next ruler: her or the masters.<sup>64</sup> Upon the promise of being freed from slavery, the citizens “voted” Daenerys in and the masters were voted out.<sup>65</sup> From that point forward, Daenerys Targaryen became the ruler of Meereen.<sup>66</sup> This simplified example helps to illustrate the way in which a corporate raider might employ a proxy fight in order to gain influence on the target’s board of directors for the purpose of replacing incumbent management.

It has been said that a proxy fight is among the most expensive and uncertain of all takeover devices.<sup>67</sup> For this reason, it is not uncommon for an acquirer to combine a proxy contest with a tender offer.<sup>68</sup> In fact, Harvard Professors Lucian

59. *Proxy Fight*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/proxyfight.asp> (last visited Jan. 22, 2017); see also *Proxy Contest*, BLACK’S LAW DICTIONARY (10th ed. 2014) (defining proxy contest, which is also known as proxy fight, as “a struggle between two corporate factions to obtain the votes of uncommitted shareholders”).

60. *Wadman v. McBirney*, 443 A.2d 978, 979 (Md. Ct. Spec. App. 1982); *Spotlight on Proxy Matters – The Mechanics of Voting*, SEC, [https://www.sec.gov/spotlight/proxymatters/voting\\_mechanics.shtml#what\\_is\\_proxy](https://www.sec.gov/spotlight/proxymatters/voting_mechanics.shtml#what_is_proxy) (last visited Feb. 5, 2017).

61. Dealbook, *Revisiting the Proxy Contest*, N.Y. TIMES: THE DEALBOOK WITH FOUNDER ANDREW ROSS SORKIN (Mar. 2, 2009, 9:30 AM), [https://dealbook.nytimes.com/2009/03/02/revisiting-the-proxy-contest/?\\_r=0](https://dealbook.nytimes.com/2009/03/02/revisiting-the-proxy-contest/?_r=0); see *Spotlight on Proxy Matters – The Mechanics of Voting*, SEC, [https://www.sec.gov/spotlight/proxymatters/voting\\_mechanics.shtml#what\\_is\\_proxy](https://www.sec.gov/spotlight/proxymatters/voting_mechanics.shtml#what_is_proxy) (last visited Feb. 5, 2017).

62. *Game of Thrones: Breaker of Chains* (HBO television broadcast Apr. 20, 2014).

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. Arthur Fleischer, Jr. & Robert H. Mundheim, *Corporate Acquisitions by Tender Offer*, 115 U. PA. L. REV. 317, 320 (1967); Manne, *supra* note 1, at 114.

68. See Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, THE HARV. JOHN. M. OLIN DISCUSSION PAPER SERIES 1, 22–35 (2001), [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/336.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/336.pdf) (analyzing the effectiveness of takeover bids coupled with proxy battles).

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Bebchuk and Oliver Hart have made the case that combining proxy battles with acquisition offers is far superior to either takeover device used alone.<sup>69</sup>

### 3. Buyout

The third and final acquisition category is called a buyout. Generally speaking, a buyout is the purchase of a controlling interest in a company's shares.<sup>70</sup> However, a buyout does not fit within either of the first two categories above because the target's management team or a group of private equity investors (e.g., venture capital firm or angel investor) are serving as the acquirer.<sup>71</sup> For this reason, a buyout can be considered an internal acquisition, whereas mergers and hostile takeovers are considered external acquisitions. A buyout is often effectuated using a tender offer.<sup>72</sup> Buyouts of publicly traded companies are viewed as good investment opportunities because, after the transaction, the new majority owners can take the company private "so [they] can streamline operations and improve profitability away from the public eye, and then take [the company] public at a much higher valuation down the road."<sup>73</sup> These acquisitions are referred to as management buyouts ("MBO") if the firm's managers are involved, and leveraged buyouts ("LBO") if the financing is derived primarily from debt or if the buyers use company assets as collateral to obtain debt financing.<sup>74</sup>

69. *Id.*

70. *Buyout*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/buyout.asp> (last visited Jan. 26, 2017); see also *Buyout*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining buyout as "[t]he purchase of all or a controlling percentage of the assets or shares of a business; the acquisition of control of a company by buying all or most of its assets or shares").

71. DAMODARAN, *supra* note 42; see also *Leveraged Buyout*, BLACK'S LAW DICTIONARY (10th ed. 2014) (explaining that a public corporation's management or outside investors may purchase outstanding shares of stock using borrowed funds).

72. DAMODARAN, *supra* note 42. See *Glazer v. Formica Corp.*, 964 F.2d 149, 152–53 (2d Cir. 1992) for an example of a proposed tender offer financed by debt.

73. *Management Buyout*, INVESTOPEDIA, <http://www.investopedia.com/video/play/management-buyout/> (last visited Jan. 26, 2017); see also *Management Buyout*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining management buyout as "[a] buyout of a corporation by its own directors and officers"); DAMODARAN, *supra* note 42, at 835, 841 (explaining that an incentive for any type of acquisition including a management buyout may be to either remove incumbent management or change existing management policies or practices to increase the value of the firm); *The Case for Going Private*, THE ECONOMIST: CORPORATE OWNERSHIP (Jan. 23, 2003), <http://www.economist.com/node/1548664> (describing that managers of private firms have more control and face less scrutiny so they can make hard strategic decisions in the interest of improving the company's performance partly because of their ownership interest); Shayndi Raice, *The Art of the IPO*, WALL ST. J. (Nov. 12, 2012, 6:54 PM), <https://www.wsj.com/articles/SB10001424052970203922804578080763596406112> (explaining that the company's value is an important factor in determining the initial price offering for a company).

74. DAMODARAN, *supra* note 42. Compare *Management Buyout*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining management buyout as "[a] buyout of a corporation by its own directors and officers"), with *Leveraged Buyout*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining a leveraged buyout as "[t]he purchase of

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*B. Steps in an Acquisition*

As aforementioned, there are many methods for completing an acquisition. Whether the players are able to strike a friendly deal or choose to overthrow the company's king and his advisors through a hostile takeover, each acquirer must determine how and where to invest his money. Aswath Damodaran, a Professor at the New York University Stern School of Business, developed a step-by-step model for ensuring an acquisition is a sound investment.<sup>75</sup> Regardless of the acquirer's identity, position, or goals, he will have to think critically about these four basic steps before making the acquisition.

Step 1 is to identify the motive for the purchase. In Step 2, the acquirer must choose a target firm based on that motive and then value the anticipated benefit from the acquisition. Step 3 requires the acquirer to develop a plan to finance the purchase price. Finally, Step 4 looks into ways for turning that anticipated benefit into actual profits by considering best practices for making the acquisition work after the transaction.

*1. Step 1 – Identify Your Motive*

"The first [step in any acquisition] is the development of a rationale and a strategy for doing [the acquisition]."<sup>76</sup> The acquirer must ask himself, why am I doing this? Dr. Stephen Covey famously said "Begin with the end in mind" in his book *The 7 Habits of Highly Effective People*.<sup>77</sup> Before we can develop the best strategy for making an acquisition, we must first decide what is motivating the acquisition in the first place. Damodaran has identified five reasons a firm might make an acquisition:

1. Create operating or financial synergy;
2. Take over poorly managed firms and change management;
3. Diversify to reduce risk;
4. Acquire undervalued firms;
5. Managerial self-interest.<sup>78</sup>

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a publicly held corporation's stock by its management or outside investors, financed mainly with funds borrowed from investment bankers or brokers").

75. DAMODARAN, *supra* note 42, at 838–39.

76. *Id.* at 838; see also Jirsy Motis, *Mergers and Acquisitions Motives* 8–22 (Toulouse School of Economics and University of Crete, 2007) (summarizing various motives for mergers and acquisitions).

77. STEPHEN R. COVEY, *THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE: POWERFUL LESSONS IN PERSONAL CHANGE* 104–05 (25th Anniversary ed. 2013).

78. See DAMODARAN, *supra* note 42, at 839–43.

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*i. Create Operating or Financial Synergy*

Damodaran explains, “[s]ynergy [is] the potential additional value from combining two firms.”<sup>79</sup> The synergy motive relies on the economic premise that the value of the combined firm is greater than the sum of the values of the bidding and the target firms, operating independently.<sup>80</sup> Likely the most common rationale for acquisition activity, an acquirer might seek synergy in two different forms: operating synergy or financial synergy.<sup>81</sup>

“Operating synergies are those synergies that allow firms to increase their operating income, increase growth or both.”<sup>82</sup> There are three ways an acquisition can create operating synergy: (1) Economies of scale (streamlining operations to reduce costs and thereby increase profitability); (2) Increase pricing power (reducing competition to obtain higher market share thereby increasing profit margins); or (3) Purchasing functional strengths (e.g., a firm with strong marketing skills acquires a firm with a good product line).<sup>83</sup>

Financial synergies work to increase cash flow or reduce the cost of capital.<sup>84</sup> In the context of mergers and acquisitions (“M&A”), three kinds of financial synergy often motivate an acquisition depending on a particular acquirer’s situation: (1) cash slack – when a firm that has a number of cash extensive projects acquires a firm which is cash-rich, the new combined firm can enjoy profits from investing the cash of one firm into the projects of the other; (2) increase in debt capacity – combining two firms can create more stable cash flows, which allows the combined company to borrow more (carry more debt);<sup>85</sup> (3) tax benefits – a profitable firm can acquire unprofitable firms with unused net operating losses to offset profits thereby reducing its tax burden.<sup>86</sup> These deleveraging efforts should reduce the cost of capital for the combined firm.

79. *Id.* at 840; see also Lennart Horst Michael Junge, *Operating Synergy Types and Their Impact on Post-Merger Performance* 10 (School of Economics and Management, Tilburg University, ANR (791051), 2014) (defining synergy as “the additional value created by combining two companies”).

80. Mitchell B. Arden & Joseph Nappi, *Post-Acquisition, Post-Merger: Driving Value Through Synergy*, AM. BANKR. INST., Jan. 2013, at 42.

81. *See id.* at 42–43.

82. DAMODARAN, *supra* note 42, at 840.

83. *See id.* (identifying four types of operating synergy). Although Damodaran identified four types of operating synergy, the fourth type can be tied in with the third type.

84. *Id.*

85. *Id.* at 840–41.

86. *Id.*; Charles L. Barnard, *Acquisitions for Tax Benefit*, 34 CAL. L. REV. 36, 37 (1946); Motis, *supra* note 76, at 12.

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*ii. Taking Control of a Poorly Managed Firm and Replacing the Managers*

If synergy is the motive, a friendly deal is likely to result.<sup>87</sup> Conversely, if the goal of a takeover is to replace management and implement new policies, the acquirer is likely to face pushback from the target's existing managers.<sup>88</sup> Cue the hostile takeover. "Acquiring poorly managed firms and removing incumbent management . . . should make these firms more valuable, allowing the acquirer to claim the increase in value."<sup>89</sup> This increase in value is commonly referred to as the "value of control" and corporate control has been increasingly cited as a reason for hostile acquisitions.<sup>90</sup> Damodaran describes three characteristics shared by a typical target firm in a hostile takeover:

1. It has underperformed other stocks in its industry and the overall market, in terms of returns to its stockholders in the years preceding the takeover;
2. It has been less profitable than firms in its industry in the years preceding the takeover;
3. It has a much lower stock holding by insiders than do firms in its peer groups.<sup>91</sup>

In theory, once the acquirer takes control, it can replace the incumbent managers with a team that will make more efficient use of corporate assets. This should increase profitability and the acquirer will begin to realize his gain.

*iii. Diversify to Reduce Risk*

A reduction in risk exposure provides another common motive for acquisition activity. Diversification reduces an investor's exposure to firm- or industry-specific risk.<sup>92</sup> "By buying firms in other businesses and diversifying, the managers of acquiring firms believe they can reduce earnings volatility and risk, while increasing potential value."<sup>93</sup> This motive is most common for family-owned businesses and

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87. See DAMODARAN, *supra* note 42, at 842.

88. *Id.*

89. *Id.* at 841; see also Manne, *supra* note 1, at 113; Motis, *supra* note 76, at 17.

90. DAMODARAN, *supra* note 42, at 841.

91. *Id.* at 841–42.

92. *Beginner's Guide to Asset Allocation, Diversification, and Rebalancing*, SEC, <https://www.sec.gov/investor/pubs/assetallocation.htm> (last visited Feb. 15, 2017).

93. DAMODARAN, *supra* note 42, at 839; see also Malcolm S. Salter & Wolf A. Weinhold, *Diversification via Acquisition: Creating Value*, HARV. BUS. REV., July 1978, <https://hbr.org/1978/07/diversification-via-acquisition-creating-value>; Motis, *supra* note 76, at 13, 19.

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closely held firms where the managers have invested the bulk of their wealth in the firm.<sup>94</sup>

*iv. Acquire Undervalued Firms*

If a publicly traded company's stock price is trading at a value that the acquirer knows is below its true value, there is profit to be gained. "Firms that are undervalued by financial markets can be targeted for acquisition by those who recognize this mispricing."<sup>95</sup> For this to work, the acquirer must be privy to information unknown by other market participants and thus requires a great deal of intuitive appeal. As such, this motive is a risky acquisition driver if the target is traded on a large public stock exchange or other efficient markets. "The odds are better in less efficient markets or when acquiring private businesses."<sup>96</sup>

*v. Managerial Self-interest*

When an acquisition opportunity arises, the acquirer's managers make the final call regarding what to buy and how to buy it.<sup>97</sup> Therefore, a motive behind some acquisitions lies in the self-interest of those decision makers rather than the wealth maximization of a firm's shareholders.<sup>98</sup> Aptly coined "machismo" by Professor Damodaran,<sup>99</sup> a manager's ego may be the sole motivation for pursuing a particular deal, whether the manager is internally motivated by having the largest, most dominant firm in the market or is driven by his own competitive nature once a bidding war ensues.<sup>100</sup> Acquirers should be warned however that if "machismo" is solely motivating the deal, it is quite likely that the bidder will overpay rendering the deal a poor investment.<sup>101</sup>

*2. Step 2 – Choose and Value Your Target*

Once a firm has identified its acquisition motive, its managers must identify a potential target that best satisfies its investment goals given the motive. Additionally, the acquirer must determine how much it is willing to pay for the target to ensure its managers don't overpay. Part 1 of Step 2 is to choose a target

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94. See DAMODARAN, *supra* note 42, at 840.

95. *Id.* at 839; see also Motis, *supra* note 76, at 17 (explaining the potential value of acquiring a firm that is undervalued due to poor management).

96. DAMODARAN, *supra* note 42, at 839.

97. *Id.* at 843.

98. *Id.*

99. *Id.*

100. See *id.* (describing that sometimes acquisitions "become tests of machismo for the managers involved" because neither side wants to lose the battle).

101. *Id.*



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firm.<sup>102</sup> This choice should be very heavily dictated by the acquisition motive identified in Step 1.

*i. Choosing a Target*

If the motive is synergy, the choice of target will depend on the source of that synergy. For example, if the goal is to gain operational synergy and the firm's plan is to use the target to streamline operations to reduce costs (economies of scale), the target should operate in the same business as the acquirer.<sup>103</sup> If functional synergy is sought, the target should be an industry leader in areas where the acquiring firm needs improvement.<sup>104</sup> For financial synergy, the target should possess the financial make up that the acquirer is looking for.<sup>105</sup> For example, if the acquirer holds cash slack (excess cash), it should identify a target with high-yield projects but limited cash. Similarly, if the acquirer is seeking tax benefits to shelter income, then it should find a money-losing target with plenty of unused net operating losses.

If the motive is to obtain control in order to replace incumbent management, "the target firm will be a poorly managed firm in an industry where there is potential for excess returns."<sup>106</sup> Generally, a target ripe for takeover will have widely dispersed stock holdings and the current market price should evidence no indication that the existing managers will be replaced.<sup>107</sup>

If diversification is motivating the acquisition, the target should be in a business that is unrelated and uncorrelated to that of the acquirer. For example, a firm operating in a cyclical market is best served to try to acquire a counter-cyclical or, at least, non-cyclical firm to get the most out of its investment.<sup>108</sup> For example, an ice cream stand could acquire a hot chocolate stand to increase sales in the winter months. This would provide the business with year-round cash flows.

Lastly, if the acquisition motive is undervaluation, the target firm must be trading below what the acquirer believes is the actual value of that target, and if the motive is managerial self-interest, the choice of target will likely reflect managerial interest rather than economic reasons.<sup>109</sup>

Once again, the target chosen by the acquiring firm should be selected because it fits the acquisition motive, rather than some other reason. Importantly, if a firm has

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102. DAMODARAN, *supra* note 42, at 843.

103. See *id.* at 844 (detailing that the typical target firm will vary when the motive for an acquisition is operating synergy); Junge, *supra* note 79, at 5, 12–13 (illustrating that in general an acquisition of related companies may allow for realization of economies of scale).

104. See DAMODARAN, *supra* note 42, at 844.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

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more than one acquisition motive (e.g., control and synergy), then the selection of a target should be guided by the leading motive.

*ii. Valuing the Target*

After the acquirer identifies the target that best suits its acquisition motive, the managers must value the target firm, given the motive.<sup>110</sup> While valuation techniques are not within the scope of this paper, the basic goal of the valuation process at this stage in the acquisition is to identify the value of the premium for synergy or control.<sup>111</sup> To do this, the bidder should first calculate the current value of the target given its existing investing, financing, and dividend policies.<sup>112</sup> Next, the acquiring firm must determine the future value of the combined firm given how the acquirer plans to use the target firm's assets.<sup>113</sup> For example, if the acquisition motive is to take control of a poorly managed target and replace its managers, then the bidder must determine which policies and practices will be altered once the new managers are in place. It can then project the increased profitability that will result from such changes to determine the value of the target firm with optimal management. The difference between the value of the firm with optimal management *and* the target's current value is the value of the premium (in the example, the value of control).<sup>114</sup> Thus, the acquiring firm should not pay more than the target's current value *plus* the value of the premium, otherwise the acquirer will overpay. Similarly, if the acquisition motive is focused on synergies, then the acquirer should determine the value of that synergy and pay no more than the current value of the target firm *plus* the value for synergy. Damodaran provides a detailed and useful discussion of valuation techniques given various acquisition motives.<sup>115</sup>

*3. Step 3 – Financing the Acquisition*

By the time the acquirer selects its potential target, the next phase in the acquisition process is the structuring phase. In this stage of the process, the bidder must determine how much to pay for the target and how to finance the purchase price.<sup>116</sup> There are also various accounting and tax implications for the acquirer to consider when deciding how to structure the deal, though this paper will not discuss accounting and tax considerations.<sup>117</sup>

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110. See DAMODARAN, *supra* note 42, at 843–57 (outlining different methods of valuing the target firm).

111. *Id.* at 844–45.

112. *Id.* at 845.

113. *Id.* at 848.

114. *Id.* at 849.

115. See *id.* at 843–57 (walking through different firm valuation techniques).

116. DAMODARAN, *supra* note 42, at 857.

117. See *id.* at 858–59.

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As explained above, the purchase price of any acquisition will reflect the current value of the target combined with the value of the synergy or control premium.<sup>118</sup> Thus, in determining how much to pay for the target, the acquirer should identify a ceiling price it is willing to pay. “If the acquirer pays the full value, there is no surplus value to claim for the acquirer’s [share]holders and the target firm’s [share]holders get the entire value of the synergy and control premiums.”<sup>119</sup> As such, the acquirer is wise to pay less than full value in order to make efficient use of corporate time and resources spent on the deal.

Next, the acquirer must determine how it will pay for the deal.<sup>120</sup> The bidder can finance the acquisition in one of two ways: debt or equity.<sup>121</sup> Commonly, acquisition consideration will include a combination of the two and the proper ratio used will depend on the acquirer’s particular financial situation.<sup>122</sup> First, if a firm wishes to use debt to finance the purchase price, it must have debt capacity available otherwise the cost of capital will absorb the premium value. Secondly, a firm could fund the purchase price with equity. Damodaran has identified three ways in which an acquirer can use equity to fund a transaction. The first is to spend cash if the bidder has enough cash on hand.<sup>123</sup> Alternatively, the bidder can issue a public offering to raise sufficient cash to fund the acquisition.<sup>124</sup> Thirdly, the acquirer can use its own stock to fund the purchase price.<sup>125</sup> This third option is called a stock swap where shares in the acquiring firm are exchanged or “swapped” for shares in the target firm.<sup>126</sup> A stock swap may be the preferred payment method for target companies because applicable U.S. laws allow for the target’s shareholder to defer capital gains taxes on the exchanged shares.<sup>127</sup> However, a stock swap can be a riskier payment method than cash because the acquirer’s stock price can fluctuate between the signing of the merger agreement and when the deal actually closes.<sup>128</sup>

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118. See *supra* notes 110–15 and accompanying text.

119. DAMODARAN, *supra* note 42, at 857.

120. *Id.* at 858.

121. *Id.*

122. *Id.*

123. *Id.*; *Acquisition Payment Methods*, ACCOUNTINGTOOLS (last visited Feb. 15, 2017) <http://www.accountingtools.com/acquisition-payment-methods>.

124. See DAMODARAN, *supra* note 42, at 858.

125. *Id.* (describing that an acquiring firm’s managers judge the perceived value of stock when it is issued to raise funds or offered as payment on acquisitions).

126. *Id.*

127. *Id.*; see also 26 U.S.C. § 354 (1998) (stating that exchanges of stock pursuant to a corporate reorganization are not to be recognized as a gain or a loss so long as the principal received does not exceed the principal surrendered).

128. See DAMODARAN, *supra* note 42, at 858–59.

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4. *Step 4 – Making It Work Post-Closing*

Once the deal closes and ownership is exchanged for the purchase price, the real work begins. It is now up to the acquirer's management team to deliver on the promise of returns from the company's investment. Not all mergers are success stories. KPMG conducted a study in 1999 examining 700 merger deals between 1996 and 1998 in which it concluded "only 17% [of deals] created value for the combined firm, 30% were value neutral, and 53% destroyed value."<sup>129</sup> Certain firms, such as GE, Cisco and Browning Ferris, have made a name for themselves by successfully increasing in value over time using a growth by acquisition business model.<sup>130</sup> What is it that makes firms like GE so effective in delivering the premium value? Damodaran has identified a few trends from his research:

1. Firms that evaluate synergy carefully before an acquisition are 28% more likely to succeed than firms that do not;
2. Mergers involving firms of equal size have a lower probability of succeeding than acquisitions of smaller firms by larger firms;
3. Acquisitions focused on buying small private businesses for consolidation have more success than acquisitions of publicly traded firms;
4. Hostile acquisitions seem to deliver greater post-acquisition returns than friendly deals.<sup>131</sup>

What prevents acquirers from achieving the goal that motivated the merger in the first place? Damodaran pinpointed a few of the most common reasons for failed mergers.<sup>132</sup> Seemingly, the most common reason a merger fails can be linked to a lack of a post-merger plan in order to deliver on synergy and control.<sup>133</sup> "Firms in many mergers seem to believe that the value enhancements associated with synergy and control will arise on their own. In reality, however, firms must plan for and work at creating these benefits."<sup>134</sup> In successful acquisitions, the acquirer is prudent to develop a meticulous post-closing plan to monetize the premium.

Another common misstep occurs when the acquirer fails to consider external constrictions such as unions or governmental restraints.<sup>135</sup> For example, if a post-closing merger plan involves laying off an employee division, the new management

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129. *Id.* at 863.

130. *Id.* at 864.

131. *Id.* at 864–65.

132. *Id.* at 865–66.

133. *Id.* at 865.

134. DAMODARAN, *supra* note 42, at 865.

135. *Id.* at 866.

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team will surely face pushback from target employee unions. Culture shock from combining employees of one firm with another, lack of accountability, and managerial egos have also been noted as common trends in failed mergers.<sup>136</sup> In sum, careful and diligent forethought in the very early stages of an acquisition is critical to a successful merger.

## III. PLAYING DEFENSE: AN OVERVIEW OF TAKEOVER DEFENSES

As described above, a corporate takeover can be friendly or hostile depending on how the target company's management team receives the bidder's initial acquisition offer.<sup>137</sup> Many logical reasons can motivate a takeover such as anticipated synergies, potential for revenue enhancements, likely reduced operating costs, and/or beneficial tax treatments.<sup>138</sup> However, various reasons exist for the management of a target company to resist a takeover; for example, the managers might believe the firm has hidden values unknown to the market.<sup>139</sup> Alternatively, they might believe resistance will increase the offer price and, of course, the ever-potential managerial ego could affect a manager's actions.<sup>140</sup>

While most corporate takeovers in the U.S. are friendly in nature,<sup>141</sup> takeovers can become hostile.<sup>142</sup> If the target's managers are not interested in entertaining a bidder's offer, the bidder can bypass the managers by making a tender offer directly to the target's stockholders.<sup>143</sup> "This process happens over the opposition of the target company's management, and it usually leads to significant tension between the target company's management and that of the acquirer."<sup>144</sup> With this in mind, managers of companies ripe for acquisition can employ certain defensive strategies to deter unwanted acquisition advances. Such defense strategies can be bifurcated with the offer itself serving as the dividing line between the two categories: Pre-offer takeover defenses (alternatively, preemptive corporate defense strategies), and post-offer takeover defenses (alternatively, responsive corporate defense strategies).

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136. *Id.* at 865–66.

137. *See supra* notes 42–50 and accompanying text.

138. *See supra* note 78 and accompanying text.

139. Richard S. Ruback, *An Overview of Takeover Defenses*, in *MERGERS AND ACQUISITIONS* 49, 51 (Alan J. Auerbach, ed., 1987).

140. *Id.* at 51–53.

141. Troy Adkins, *Warding Off Hostile Takeovers*, INVESTOPEDIA, <http://www.investopedia.com/articles/investing/041913/warding-hostile-takeovers.asp> (last visited Feb. 15, 2017).

142. *See supra* note 50 and accompanying text.

143. *See supra* notes 52–58 and accompanying text.

144. Adkins, *supra* note 141.

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*A. Pre-Offer Takeover Defense Strategies*

This section describes several types of takeover defenses that a company's managers can put in place to ward off takeover attempts *before* the company is identified as a potential target for acquisition. These strategies are considered preemptive because they are most effective in deterring a takeover attempt before it happens, rather than scaring a bidder away after it makes an offer.

*1. Differential Voting Rights*

A good preemptive line of defense for potential takeover targets would be to establish stock securities that have differential voting rights ("DVRs"). Also commonly called "dual class recapitalization," these plans rework the firm's equity structure by dividing the equity into two classes with different voting rights<sup>145</sup>: preferred shares and common shares. The preferred shares may have superior voting rights, e.g., ten votes per share, while the common shares may have inferior voting rights, e.g., one vote per share. The preferred shares will be distributed to all shareholders but can then be exchanged for common shares, which will carry higher dividends or increased marketability; this induces shareholders to exchange their preferred shares (with superior voting rights) for more common shares (with inferior voting rights but increased marketability).<sup>146</sup> "This shifts the voting power of the corporation. Managers with relatively small equity holdings can control a majority of the votes after recapitalization. This gives managers veto rights over control changes."<sup>147</sup> This can be a very effective preemptive strategy because even if a bidder acquires all of the target's equity, it would lack a sufficient number of votes to replace the incumbent managers or cause the target to merge with the bidder firm.

*2. Employee Stock Ownership Plan*

Another preemptive move a company can make is to establish an Employee Stock Ownership Plan ("ESOP"). This is a tax-qualified retirement plan that provides a company's workforce with stock ownership in the company.<sup>148</sup> Often provided at no up-front cost to the employees, these plans offer tax savings to both the corporation and the shareholders.<sup>149</sup> By establishing an ESOP, employees of the corporation hold ownership in the company, which, in turn, "means a greater percentage of the company will likely be owned by people that will vote in conjunction with . . . the

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145. Ruback, *supra* note 139, at 60.

146. *Id.*

147. *Id.*

148. Adkins, *supra* note 141.

149. *Id.*

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target's management rather than with the . . . potential acquirer.”<sup>150</sup> An ESOP is beneficial because it can increase employee morale, build camaraderie within the organization, and encourage employees to side with the managers if a corporate raider enters the picture.<sup>151</sup>

### 3. Super-majority Voting Provisions

Most corporate charters provide for a simple majority (50.1%) to approve a merger.<sup>152</sup> A super-majority corporate charter amendment would increase the requisite approval threshold.<sup>153</sup> By requiring a higher percentage of shares to approve a merger, sometimes as much as 80%, hostile takeover bidders are forced to obtain more votes to take control of the target firm.<sup>154</sup> This, in effect, can make the acquisition more expensive by requiring a more enticing offer to the shareholders.

### 4. Golden Parachutes

A golden parachute is a benefits package “given to top executives in the event that the company is taken over by another firm and the executives are terminated as a result of the takeover.”<sup>155</sup> Benefits can include stock options, cash bonuses, and hefty severance pay.<sup>156</sup> These packages provide a layer of takeover defense because the would-be-acquirer is forced to fund the exit payout costs under with the golden parachute contracts. This, in turn, increases the costs of taking control of a company and replacing incumbent managers.

150. *Id.*

151. Larry Myler, *An Employee Stock Ownership Plan (ESOP) Could Increase Employee Engagement And Promote Intrapreneurship – Here's How*, FORBES (Oct. 11, 2013), <http://www.forbes.com/sites/larrymyler/2013/10/11/an-employee-stock-ownership-plan-esop-could-increase-employee-engagement-and-promote-intrapreneurship-heres-how/#3a400cb830b5>.

152. See *Types of Mergers and Acquisitions: U.S. Legal Highlights*, STERN SCH. OF BUS. AT N.Y.U., <http://people.stern.nyu.edu/igiddy/reorganization.htm> (stating that mergers generally require the approval of a majority of shareholders in the target and the acquiring company).

153. See DAMODARAN, *supra* note 42, at 867.

154. Ruback, *supra* note 139, at 57; Donald J. Evans et al., *Model Business Corporations Act: Implications for Takeover Contests*, 42 ABA BUS. LAW. 575, 578 (1986-87) (explaining that the Model Business Corporations Act as well as all but three states, now have provisions allowing for super majority provisions in corporate charters).

155. *Golden Parachute*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/goldenparachute.asp> (last visited Feb. 15, 2017); 19 AM. JUR. 2D *Corporations* § 2167 (2015) (defining Golden Parachute as a benefits package given to “senior executives who are dismissed, or in certain circumstances, resign as a result of a takeover”).

156. *Golden Parachute*, *supra* note 155.

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5. *Staggered Board Election*

A staggered board of directors is a board that is made up of different classes of directors.<sup>157</sup> Also known as a classified board, this charter provision classifies board members into, for example, three groups and each year only one group is up for re-election.<sup>158</sup> “This makes it difficult for a hostile bidder to gain immediate control of the target firm, even if the bidder owns a majority of the common stock.”<sup>159</sup> Thus, when a hostile bidder tries to acquire a company with a staggered board, it must wait at least one year—and sometimes more—before it can gain control of the board to implement its new corporate agenda. This limitation can decrease the bidder’s willingness to bid and can also provide an additional obstacle in the bidder’s efforts to obtain financing.<sup>160</sup>

6. *Poison Pill*

The poison pill lies at the forefront of takeover defense controversy since the Delaware Supreme Court’s 1985 decision upholding the plan’s legality.<sup>161</sup> “The key concept behind the poison pill is that it deters a potential acquirer from purchasing the stock of the target by making a takeover unprofitable.”<sup>162</sup> Poison pills often come in one of two forms. A “flip-in” plan allows existing shareholders (excluding the acquirer) to buy more shares of the target’s stock at a price considerably below market value.<sup>163</sup> By allowing existing shareholders to purchase additional shares at a severely discounted price, the investors get instant profits and, more importantly, the acquirer’s shares become diluted making the takeover attempt more unattractive and expensive.<sup>164</sup> Conversely, a “flip-over” plan allows shareholders to purchase shares in the acquiring company at a discounted price after the merger.<sup>165</sup> For example, target shareholders would gain the right to buy stock in the acquirer’s company on a two-for-one basis in any subsequent merger. In a poison pill, these purchasing rights remain inactive until “triggered” by the target’s board. A triggering event would occur when an outside bidder obtains a threshold block of shares, for example, 20% of the company’s outstanding shares.<sup>166</sup>

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157. See DAMODARAN, *supra* note 42, at 867.

158. Ruback, *supra* note 139, at 56; Evans, *supra* note 154, at 577 (indicating that the Model Business Corporation Act allows for staggered boards).

159. Ruback, *supra* note 139, at 56.

160. *Id.* at 57.

161. *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985).

162. See Barry & Hatfield, *supra* note 12, at 642.

163. *Id.*

164. Adkins, *supra* note 141; 19 AM. JUR. 2D *Corporations* § 2172 (2015) (explaining that poison pills dilute the value of the acquirer’s holdings).

165. See Barry & Hatfield, *supra* note 12, at 642.

166. Ruback, *supra* note 139, at 58.



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Both forms of the poison pill are considered severe takeover defenses because they can insulate incumbent managers completely from hostile takeovers and the resulting effect is a stark devaluation of the firm's equity. It should also be noted that the effectiveness of a poison pill can increase substantially if combined with a staggered board, as described above. "Hostile bidders that manage to win one seat allow staggered boards the opportunity to defend the company they represent against the takeover by implementing a poison pill tactic to further deter the takeover, effectively guaranteeing continuity of management."<sup>167</sup> It should further be noted that the poison pill is considered a preemptive strategy because companies most often have the plan in place long prior to a takeover attempt.<sup>168</sup> However, the pill would not be triggered until the takeover attempt is underway. It is also possible for a company to quickly pass a poison pill plan in response to a takeover attempt, though such action is likely to result in shareholder suits against the managers and directors due to fiduciary constraints.<sup>169</sup> For this reason, the poison pill may be considered a responsive plan.

*B. Post-Offer Takeover Defense Strategies*

These types of defensive takeover strategies are ones that can be executed only *after* a company is identified as a potential takeover target by a bidder. Commonly referred to as responsive strategies, companies are poised to employ these devices to ward off a potential bidder after the bidder makes its initial move.

*1. Greenmail*

The first responsive takeover defense strategy, known as greenmail, refers to a targeted repurchase where a company buys a block of its own stock from an

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167. *What is a Staggered Board?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/05/staggeredboard.asp> (last visited Feb. 3, 2017); *supra* notes 157–60 and accompanying text.

168. See, e.g., Eric Posner & Glen Weyl, *How to Make Poison Pills Palatable*, N.Y. TIMES (July 17, 2013), [https://dealbook.nytimes.com/2013/07/17/how-to-make-poison-pills-palatable/?\\_r=0](https://dealbook.nytimes.com/2013/07/17/how-to-make-poison-pills-palatable/?_r=0) (demonstrating how Rupert Murdoch's News Corporation divided into two entities and inserted a poison pill defense into their charters to shield them from hostile takeovers).

169. When directors take defensive action against a hostile takeover there is enhanced scrutiny requiring the directors to show that: 1) they had reasonable grounds for believing that a danger to corporate policy or effectiveness existed; and 2) the response was reasonable and proportional to the threat. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). To satisfy the first prong the directors must articulate the perceived threat and show they acted with "good faith and reasonable investigation." *Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 92 (Del. Ch. 2011). The second prong examines the response and asks whether it was preclusive or coercive and if not whether it was proportional to the threat posed. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1367 (Del. 1995). This burden will inevitably be made tougher if the poison pill is passed after a takeover has begun, as demonstrating good faith and reasonable investigation requires a showing of deliberate process and consideration, which is undermined when time is constrained. If the board fails to meet the prongs of the *Unocal* test, they will not have business judgment protections and will need to show entire fairness. *Id.* at 1377 n.18.

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individual investor or small group of investors, usually at a substantial premium.<sup>170</sup> In essence, the target company is inducing the acquiring firm to withdraw its offer and sell the newly acquired shares back to the target firm at a profit.<sup>171</sup> One of the first instances of this takeover defense came in 1979 when Carl Icahn purchased 9.9% of Saxon Industries stock for \$7.21 per share.<sup>172</sup> In response, Saxon repurchased its own shares from Icahn at \$10.50 per share to prevent Icahn's takeover plans.<sup>173</sup> While greenmail can be an effective responsive takeover defense because it seeks to eliminate the hostile bidder, it can be extremely expensive for the target company as evidenced in the Icahn-Saxon example above.<sup>174</sup> Additionally, corporate raiders are becoming increasingly less likely to accept greenmail offers due to the imposition of capital gains tax on gains derived from these types of hostile takeover tactics.<sup>175</sup>

## 2. *White Knight*

Another responsive takeover tactic is for the target company to create an alliance with an investor known as a white knight.<sup>176</sup> A white knight is a friendly investor who, with the support of the target's board, acquires the target's controlling shares before the hostile bidder does so.<sup>177</sup> Typically, the white knight agrees to pay a premium above the hostile acquirer's offer and, after the acquisition, will restructure the company in a manner supported by the target's managers.<sup>178</sup> The difficulty in this strategy is finding an acquirer to serve as the white knight. By entering the picture after a hostile bidder's offer, a white knight could start a bidding war, which can make the acquisition price exceedingly high.

## 3. *Asset and Liability Restructuring*

The key principle to this final responsive takeover strategy is to make the company less attractive in hopes that the bidder will rescind its tender offer.<sup>179</sup> There are

170. See Adkins, *supra* note 141; 19 AM. JUR. 2D *Corporations* § 2214 (2015) (explaining that "greenmail" refers to a defensive tactic of buying the acquirer's shares in the company at a premium to thwart the takeover attempt).

171. See DAMODARAN, *supra* note 42, at 867.

172. See Adkins, *supra* note 141.

173. *Id.*

174. PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 198 (4th ed. 2007).

175. Adkins, *supra* note 141; see 26 U.S.C. § 5881 (2004) (setting tax rates on profits from "greenmail" transactions).

176. See GAUGHAN, *supra* note 174, at 197.

177. *Id.* at 205.

178. See Adkins, *supra* note 141; 19 AM. JUR. 2D *Corporations* § 2179 (2015) (deciphering the phrase "white knight" to mean a friendly investor and alternative acquirer who will support the company's current management).

179. See GAUGHAN, *supra* note 174, at 197.

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various ways for a potential target company to accomplish this depending on firm-specific characteristics. First, the target could alter its asset structure by divesting assets the bidder wants (commonly referred to as the “Crown Jewel” defense), purchasing assets the bidder does not want, or purchasing assets that would create antitrust or regulatory problems for the bidder.<sup>180</sup> The aforementioned crown jewel defense can be combined with the white knight defense where the target sells its key asset(s) to a friendly bidder thus preventing the hostile bidder from obtaining the asset(s). Alternatively, the target could restructure the right side of its balance sheet by incurring needless debt, spending excess cash, or issuing voting securities to friendly hands thereby increasing the number of shares required by a hostile bidder.<sup>181</sup>

Regardless of a management team’s reason for fighting a takeover attempt, a careful selection of defensive strategy is paramount. Consider the situation in which Cersei Lannister has found herself at the conclusion of Season 6 of *Game of Thrones*.<sup>182</sup> Daenerys Targaryen is coming for Cersei’s seat with great fury.<sup>183</sup> Cersei could employ the crown jewel defense by selling the Throne to another House. Of course, she would rather die than give up the Throne so this is an unlikely option.<sup>184</sup> She might also consider aligning herself with a white knight. Unfortunately for Cersei, she has made far more enemies than friends, which leaves her mostly alone in her endeavors.<sup>185</sup> Lastly, she can always stand her ground and fight toe-to-toe with Daenerys in an attempt to win the proxy fight or convince her shareholders—the citizens of King’s Landing—to decline Daenerys’ tender offer. In any event, the Lannisters seem to have found themselves in a precarious position with Daenerys, Varys and Tyrion Lannister coming for the Iron Throne.

## IV. CONCLUSION

A plethora of takeover defense strategies exist across the board for corporate managers and directors to oppose hostile takeover attempts. However, a larger question remains regarding a manager’s fiduciary duty to his shareholders. Not surprisingly, shareholders and managers often have different attitudes toward the market for corporate control. Shareholders are generally in favor of ensuring the company is susceptible to a takeover because such a possibility keeps the managers disciplined and, if a takeover does occur, the shareholders nearly always stand to receive a significant premium on their investment. Managers, on the other hand,

180. Ruback, *supra* note 139, at 64; 19 AM. JUR. 2D *Corporations* § 2162 (2015) (exploring the “crown jewel” defense which involves disposing of the business’ main asset to make the acquisition less appealing).

181. Ruback, *supra* note 139, at 64.

182. *Game of Thrones: Winds of Winter* (HBO television broadcast June 26, 2016).

183. *Id.*

184. *Id.*

185. *Id.*

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have almost diametrically opposite incentives, as they would prefer that their actions be wholly unconstrained. Beyond that, most managers of publicly traded companies stand to lose their jobs if a takeover occurs. If, however, a management team elects to fight a hostile takeover attempt, a few things should be noted about the strategies discussed above.

First, any defense that allows incumbent managers to hold a veto to hostile offers is alarming for any shareholder.<sup>186</sup> Poison pills and DVRs, while quite effective in terms of fighting off the hostile bidder, prevent the market for corporate control from running efficiently. Second, defenses that purposely destroy a company's balance sheet are dangerous.<sup>187</sup> Asset and liability restructuring can be effective in certain instances, however shareholders stand to suffer significant losses once key assets are sold or needless debt is incurred. Lastly, defenses that inhibit managers from holding takeover veto rights and do not destroy the firm's balance sheet, for example, staggered boards, ESOPs, super-majority voting provisions, and other "shark repellent amendments" likely do not harm the shareholders' investment position and thus are good defenses to use. It is important to note that any takeover defense can act to reduce the market's efficiency. However, these efficiency metrics fail to account for human emotion, which is of course a critical component for those in charge of corporations when such grave decisions must be made. With American capitalism and all of its greed, the market for corporate control can be a perilous place. After all, "when you play the *Game of Thrones*, you win or you die. There is no middle ground."<sup>188</sup>

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186. Ruback, *supra* note 139, at 65.

187. *Id.*

188. *Game of Thrones: You Win or You Die* (HBO television broadcast May 29, 2011) (quoting Cersei Lannister in her final confrontation with Eddard Stark).

