After Twenty-Two Years, Section 203 of the Delaware General Corporation Law Continues to Give Hostile Bidders a Meaningful Opportunity for Success

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Introduction

In their article, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008*, Professor Guhan Subramanian and co-authors Steven Herscovici and Brian Barbetta ("SHB") claim to present "the first systematic empirical evidence since 1988 on whether Section 203 gives bidders a meaningful opportunity for success"[1] after studying a small sample (sixty) of "hostile" or "unsolicited" tender offers for Delaware target companies from January 1, 1988, to December 31, 2008.[2] They found that six hostile bidders (or 10%) went from less than 15% ownership in the target to more than 85% in a single tender offer,[3] as required for exemption from Delaware's antitakeover statute without prior board approval or approval by two-thirds of the stockholders.[4] They also found that no hostile bidder achieved 85% ownership in a single tender offer between 1990 and 2008.[5] Based on this "empirical evidence," they claim that the constitutionality of Section 203 "is up for grabs."[6] After reading their article and examining their data, we conclude that SHB have failed to provide a reason to reexamine the constitutionality of Section 203.

The SHB article comes after twenty-two years of vibrant takeover activity in Delaware. According to SDC Platinum,[7] from January 1, 1988, through Decem-

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1. Guhan Subramanian, Steven Herscovici & Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008*, 65 Bus. Law. 685 (2010) [hereinafter SHB].
2. *Id.* at 713.
3. *Id.* at 716.
4. *See* Del. Code Ann. tit. 8, § 203(a)(1)–(3) (2001 & Supp. 2008).
5. SHB, *supra* note 1, at 687.
6. *Id.* at 685, 688.
7. SDC Platinum is a product of Thomson Reuters, which also owns Thomson One, the database SHB use for their study. SDC Platinum provides data on approximately 672,000 mergers and acquisitions worldwide from 1985 to the present. We did a search of the database on February 1, 2010.

ber 31, 2008, there were 1,101 tender offers for Delaware targets, 145 (or 13%) of which were hostile (i.e., the target's board rejected the offer, but the acquirer persisted) or unsolicited (i.e., the acquirer made an offer without prior negotiations with the target board). In at least 73 of the 145 hostile/unsolicited tender offers, the bidder held less than 15% of the target's stock prior to commencing the tender offer and sought to acquire over 85%. Of those seventy-three, twenty-nine (or 40%) were ultimately completed, while forty-three were withdrawn.[8] Moreover, of the forty-three withdrawn, at least twenty-three of those targets agreed to be acquired in a white-knight type transaction. When laid against the reality that a meaningful number of hostile/unsolicited tender offers can and do result in a takeover, without even reaching the question of how many of the unsuccessful offers were not "beneficial" to stockholders, SHB provide no basis, let alone empirical evidence, to support their argument that the constitutionality of Section 203 is "up for grabs."

Relevant Legal Standard

A state statute such as Section 203 of the Delaware General Corporation Law will be found constitutional under the Supremacy Clause as long as it does not frustrate the purpose of the Williams Act.[9] As SHB acknowledge, the basic purpose of the Williams Act is to put investors "on an equal footing with the takeover bidder."[10] If Section 203 furthers the federal policy of investor protection, it does not frustrate the objectives of the Williams Act and, accordingly, is not preempted.[11]

Certainly, Section 203 furthers the federal policy of investor protection. It was enacted to "shield shareholders from the coerciveness of front-end loaded, two-tier offers by preventing the offeror from effecting the second step of the offer unless the target's board of directors and, in some instances, the target's shareholders approve the transaction,"[12] and it has been successful in stopping such coercive practices. Section 203 also gives target boards some leverage in resisting unsolicited, underpriced tender offers that are not beneficial to shareholders.[13]

When the constitutionality of Section 203 was first examined in *BNS Inc. v. Koppers Co.*, the U.S. District Court explained that Section 203 does not circumvent

8. SDC reports the outcome of one of the seventy-three hostile/unsolicited tender offers as "unknown."

9. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 79 (1987).

10. *CTS*, 481 U.S. at 82. *See* SHB, *supra* note 1, at 694.

11. *See CTS*, 481 U.S. at 83.

12. BNS Inc. v. Koppers Co., 683 F. Supp. 458, 464 (D. Del. 1988).

13. Such offers can also have a coercive effect. *See In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 442 (Del. Ch. 2002) ("In a tender offer . . . a non-tendering shareholder individually faces an uncertain fate. That stockholder could be one of the few who holds out, leaving herself in an even more thinly traded stock with little hope of liquidity and subject to a § 253 merger at a lower price or at the same price but at a later (and, given the time value of money, a less valuable) time. . . . For these reasons, some view tender offers as creating a prisoner's dilemma—distorting choice and creating incentives for stockholders to tender into offers that they believe are inadequate in order to avoid a worse fate.").

the goals of the Williams Act even though it may give target boards a significant advantage in fighting unwanted takeovers.[14] To the contrary, the statute may have "substantial deterrent effects on tender offers . . . so long as hostile offers *which are beneficial to target shareholders* have a meaningful opportunity for success."[15] Section 203 does *not* have to let bad offers succeed to be constitutional, and in fact, if it did let bad offers succeed, it would frustrate, and not further, the Williams Act's purpose of investor protection. In *BNS*, the district court concluded that, "on this record, the statute appears to offer hostile bidders the necessary degree of opportunity to effect a business combination" and upheld the statute.[16]

In the two cases following *BNS* in which the district court reconsidered the constitutionality of Section 203—*RP Acquisition Corp. v. Staley Continental, Inc.*[17] and *City Capital Associates Ltd. Partnership v. Interco, Inc.*[18]—the plaintiff proffered the affidavit of Dr. Gregg A. Jarrell to support the argument that Section 203(a)(2) did not give bidders a meaningful opportunity for success because "[t]he 85 percent exception is illusory."[19] In the affidavit submitted in *RP Acquisition*, Jarrell studied 412 tender offers between January 1981 and March 1988.[20] He concluded that thirteen of twenty-nine (or 45%) successful tender offers that began and ended as "hostile," defined as "offers in which no merger agreement is ultimately negotiated between bidder and target," did not achieve an 85% tender and therefore would not have met the 85% exemption under Section 203(a)(2).[21] Based on this evidence, the district court concluded that sixteen of twenty-nine (or 55%) of the successful hostile tender offers in Jarrell's study reached 85% ownership in a single tender offer and, therefore, "had a meaningful opportunity for success."[22] The court also noted that, even if it excluded the hostile tender offers in which management eventually acquiesced and tendered their shares, thirteen of the twenty-six (or 50%) achieved 85%.[23]

Three months later in *City Capital*, Jarrell studied 459 tender offers between January 1981 and August 1988.[24] Revising his definition of "hostile" to mean "offers in which no merger agreement is ultimately negotiated between bidder and target" *and* in which target management did not tender their stock,[25] Jarrell found that eleven of twenty-four (or 45.8%) tender offers that began and ended as "hostile" did not achieve 85%.[26] Based on that data, 54.2% of the successful

14. *BNS*, 683 F. Supp. at 469–70.
15. *Id*. at 469 (emphasis added).
16. *Id*. at 470.
17. 686 F. Supp. 476 (D. Del. 1988).
18. 696 F. Supp. 1551 (D. Del. 1988).
19. *RP Acquisition*, 686 F. Supp. at 482.
20. *Id*. at 484.
21. *Id*. at 482.
22. *Id*. at 482–83.
23. *Id*.
24. Affidavit of Dr. Gregg A. Jarrell ¶ 4, City Capital Assocs. Ltd. P'ship v. Interco, Inc., 696 F. Supp. 1551 (D. Del. 1988) (No. 88-424-JJF).
25. *Id*. ¶ 17.
26. *Id*. ¶ 19.

hostile tender offers in his study achieved 85%. The district court found that Jarrell's updated data had not changed significantly, observing that "[t]he limited opportunity which *BNS* left for future constitutional challenges of § 203 requires a much greater evidentiary showing than that which has been presented here."[27] Twenty-two years later, SHB provide no basis to disturb the district court's judgment. Indeed the Jarrell analyses, which were not distorted by the poison pill for which the SHB analyses fail to control, remain the only direct evidence of the ability of unsolicited and hostile acquirers to achieve the 85% threshold.

Greater Evidentiary Showing Required

In a constitutional challenge, the challenging party has the burden of showing the statute is unconstitutional "because of the presumption of constitutionality accorded Acts of the Delaware General Assembly."[28] The party asserting that an Act of the General Assembly is unconstitutional "must show that the question of constitutionality of the attacked Act is fairly debatable."[29] "Unless this hurdle is surmounted, [the] Court cannot consider arguments which contest the constitutionality of a statute."[30] Moreover, even "[i]f the party is able to establish that the issue of constitutionality is fairly debatable[,] he is confronted with another, more serious, obstacle in his path. He must, in order to overcome the presumption of constitutionality, establish clearly and convincingly the lack of constitutionality of the statute."[31] In other words, to meet its burden of rebutting the presumption of Section 203's constitutionality, the plaintiff must "show clearly and convincingly" that Section 203 "contravenes the letter or spirit of the . . . Supremacy Clause[] of the U.S. Constitution" on the theory that it is preempted by the Williams Act.[32] SHB fail to meet that high evidentiary burden with the data they present, which is lacking in a number of ways.

First, the sample that SHB use is too limited. They consider the 145 hostile or unsolicited tender offers in the time period but then expressly exclude, among others, hostile "bids in which the target agreed to the offer before the expiration of the initial tender offer," yielding a sample of only sixty transactions.[33] While understatedly acknowledging that the exclusion of hostile bids that turned friendly before the expiration of the initial tender offer introduces "the possibility of sample selection bias (specifically, truncation),"[34] SHB offer three justifications for this game-changing exclusion. They begin by proffering the "straightforward" reason

27. City Capital Assocs. Ltd. P'ship v. Interco, Inc., 696 F. Supp. 1551, 1555 (D. Del. 1988).
28. Wylain, Inc. v. TRE Corp., 412 A.2d 338, 342 (Del. Ch. 1979).
29. *Id.* (citing Wilmington Med. Ctr., Inc. v. Bradford, 382 A.2d 1338, 1342 (Del. 1978); Justice v. Gatchell, 325 A.2d 97, 102 (Del. 1974)).
30. *Id.*
31. *Id.* (citing *Justice*, 325 A.2d at 102; State Highway Dep't v. Del. Power & Light Co., 167 A.2d 21, 27 (Del. 1961)).
32. *Id.* at 343.
33. SHB, *supra* note 1, at 713.
34. *Id.*

for the exclusion—that there is no data available as to the number of shares tendered before a transaction turns friendly prior to the expiration of an initial offer.[35] This is an acknowledgement of the absence of meaningful data to support their hypothesis, not a reason to push forward to a conclusion. In an effort to address this obvious deficiency, they make the heroic assumption, with no empirical basis, that unsolicited bids that turn friendly before the expiration of the initial tender offer are "more like friendly bids than hostile bids."[36] This sleight-of-hand, definitional exclusion of initially hostile bids that turned friendly before the end of the initial offer period effectively eliminates from their database all unsolicited/hostile tender offers that may have ultimately had 85% or more tendered but were considered by the target board to be sufficiently beneficial to stockholders to merit negotiations. That an initially hostile bid results in a negotiated acquisition does not change the unsolicited/hostile nature of the takeover. The fact remains that the offer was still unsolicited or initially opposed by the target's board but, instead of resisting until the end, the board used whatever leverage it had, including the poison pill and Section 203, to negotiate the best possible deal it could for the stockholders to whom it owed fiduciary duties. Last, SHB seek to justify the exclusion by pointing out that, by reason of the prevalence of the poison pill during this sample period, "Section 203 was rarely, if ever, the binding constraint against a hostile tender offer."[37] This purported justification is, in fact, an admission that all the data upon which they rely is skewed by reason of the inability to control for the poison pill variable.

Not only does the exclusion of bids that became friendly before the initial tender offer expired create a gap in the data, it reflects SHB's unstated but underlying assumption that directors will not respond positively to unsolicited/hostile offers that are likely to surpass the 85% threshold. That assumption is in direct contradiction with the view of mankind that underlies the presumption of the business judgment rule that, in making a business decision, directors will act on an informed basis, in good faith, and in the honest belief that their actions are in the best interests of the corporation and it stockholders.[38] Presumably, an unsolicited or hostile bid that does not ultimately result in a negotiated transaction is one that the board, subject to all of its fiduciary duties under Delaware law, and after considering the price as compared to the target's value metrics, has refused to embrace as not being in the stockholders' best interests. One cannot assume, as SHB appear to do in advocating the exclusion of hostile offers that turn friendly, that directors faced with compelling offers will act for entrenchment purposes and not in the best interests of the stockholders.[39] In that connection, even in their small sample,

35. *Id.*

36. *Id.*

37. *Id.*

38. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

39. *See* Grand Metro. Pub. Co. v. Pillsbury Co., 558 A.2d 1049, 1055 (Del. Ch. 1988) ("[W]hen a board [of directors] considers a takeover bid, it is obliged to determine whether the offer is in the

SHB make no effort to compare the intrinsic value of the targets in bids that failed to the value of those in bids that resulted in negotiated acquisitions; they fail to discern on some objective basis which failed offers might have been beneficial to shareholders and which were not.

As SHB concede, there is no way to know which of the excluded bids reached or might have reached 85%.[40] Nonetheless, if you put those excluded bids back into the sample, it would at least show that 41.4% of the unsolicited/hostile tender offers were successfully completed by the initial offeror. Even using their own sample of sixty, 33% of the initially unsolicited/hostile bids resulted in completed transactions, a percentage that is larger than the small number (four out of thirty-four, or 12%) that SHB appear to concede would be sufficient to be constitutional.[41]

Finally, to bolster their case indirectly, SHB looked at offer premiums, but *only* in their sample of sixty bids—which, as we noted, admittedly excludes unsolicited offers that became friendly prior to the expiration of the initial tender offer period—to conclude that a bidder would have to offer a premium of 110% to achieve an 85% tender.[42] When discussing their figure showing the percentage of shares tendered as a function of the arbitrage spread, SHB state that "twenty-two out of the fifty-seven targets (39%) had negative arbitrage spreads."[43] They fail to relate that negative arbitrage spreads indicate the expectation or presence of a higher offer. They also fail to examine how many of those targets or, for that matter, any of the targets in their database, received a higher offer from another party. Later, they present a graph of a linear regression model with the results of the analysis of the percent tendered as a function of the premium offered.[44] SHB describe the R-sq of 13% of this regression of thirty-five data points as "reasonable."[45] Because an R-sq is a measure of fit, the reasonableness of an R-sq of 13% is a matter of judgment. In our judgment, it is unreasonable to extrapolate from a regression analysis that fails to explain 87% of the variation in the dependent variable (Percent Tendered) that a premium of 110% is necessary to achieve an 85% tender. Even if the fit were adequate, it is dangerous to draw conclusions through extrapolation beyond the data. For example, if a relation with good fit (high R-sq) explained how your weight tripled between the age of five (50 lbs.) and fifteen (150 lbs.), would you expect your weight to triple again by the time you are twenty-five years old (450 lbs.)? SHB also do not tell us the confidence interval on this estimate of a 110% premium needed to secure an 85% tender. As you move away from the

best interests of the corporation and its shareholders and, if the board gives a negative answer to that inquiry, a Delaware court will not substitute its judgment for that of the board, provided that the answer the [b]oard gave can be 'attributed to any rational business purpose,' and provided further, that it is determined that the standards required by *Unocal* have been met." (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 726 (Del. 1971)).

40. SHB, *supra* note 1, at 713.
41. *Id*. at 730.
42. *Id*. at 721.
43. *Id*. at 719.
44. *Id*. at 721.
45. *Id*.

mean, the dispersion increases and with it the confidence interval. This estimate of 110% could easily be accompanied by a 95% confidence interval of 50% or more. If it were 50%, all you could say is that 95% of the time, the premium is expected to be between 60% and 160%. SHB ask too much from too little data.

Strategic Behavior and the Poison Pill Overlay

SHB also appear baffled by their own data suggesting that, while what they concede to be a meaningful number of offers reached 85% prior to 1987, that number, by their count, fell off to zero in the next two decades.[46] They then speculate about any number of causes, including various forms of strategic behavior. However, they engage in no substantive analysis of significant changes since 1989, which include the influence of the poison pill on both investor and board behavior and the significant increase in institutional ownership over the twenty-year period following the Jarrell affidavits.[47]

If one indulges in SHB's assumption that the poison pill "was the binding constraint on a bidder's strategy" in the past twenty years,[48] that alone renders their data irrelevant. SHB acknowledge that "Section 203 was rarely, if ever, the binding constraint against a hostile tender offer" during the time period they examine.[49] How, then, can they conclude from studying unsolicited/hostile tender offers in that time period that the constitutionality of Section 203 is "up for grabs"?[50] Excluding unsolicited offers that turned friendly before the initial tender period ended, the fact that no offers in the past nineteen years achieved 85% at best suggests that, with the leverage of the poison pill and consistent with their obligations as articulated by the Delaware Supreme Court in 1985 and 1986 in *Unocal* and thereafter in *Revlon* and their progeny,[51] boards in the past twenty years frequently have negotiated with bidders to achieve the best result attainable in those circumstances where it appeared that an unsolicited offer would ultimately achieve an 85% threshold.

SHB come close to addressing this point, acknowledging that "[i]n any deal, there is (almost always) some price that, if offered, would get the bidder to 85%

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46. *See id.* at 721–22.

47. In 1981, institutional investors owned about 38% of U.S. stocks. *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 Am. U. L. Rev. 225, 245–46 & n.60 (2007) (citing Carolyn Kay Brancato & Patrick A. Gaughan, The Growth of Institutional Investors in U.S. Capital Markets tbl. 10 (1991 update)). That number grew to approximately 45% in 1989. *Id.* at 245. By 2007, institutional investors owned 76.9% of the largest 1,000 companies in the United States. Task Force of the ABA Section of Bus. Law Corporate Governance Comm., Report: Delineation of Governance Roles and Responsibilities, 65 Bus. Law. 107, 135 (2009) (citing Carolyn Kay Brancato & Stephan Rabimov, Conference Bd., The 2008 Institutional Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations tbl. 19 (2008)).

48. SHB, *supra* note 1, at 708.

49. *Id.* at 713, *see id.* at 687, 705.

50. *See, e.g.*, *id.* at 729, 736.

51. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

of the target's shares"[52] and that an argument might be made "that Section 203 shut down hostile tender offers, but then channeled them into negotiated acquisitions or proxy contests."[53] If that argument were accepted, presumably SHB would agree—based on their observation that Section 203 was not "a binding constraint"—that the poison pill was the effective channeling force during the twenty-year period upon which they base their analysis.

Notwithstanding what they characterize as "the intuitive appeal" of this argument,[54] they reject it as an impeachment of their methodology and their ultimate "up for grabs" conclusion. However, neither of their reasons for doing so is persuasive.[55] First, they suggest that, as a matter of doctrine, the three Delaware U.S. District Court decisions that sustained the constitutionality of Section 203 would reject the concept of examining the "hostile-turned-friendly pathway" in assessing the viability of the 85% out.[56] Of course, there is no such "doctrine," as the facts giving rise to that argument and the persuasive role of the poison pill (which was in its infancy when the cases were decided) were not addressed by the courts in its decisions.

Second, they argue that the "hostile-turned-friendly pathway" should be ignored because a hostile bidder does not have a "meaningful opportunity for success" in obtaining board control of a target with a staggered board in a proxy contest.[57] Whether that is right or wrong begs the question of whether it would make any sense to exclude from a modern-day assessment of a "meaningful opportunity for success" the significant number of unsolicited/hostile transactions which, as a result of incumbent board acquiescence, turned friendly and were concluded in the face not only of Section 203, but also the concededly more potent poison pill. The obvious answer to this question is "no."

Conclusion

There is no merit to SHB's gratuitous belief, which arguably drives their effort to create an issue where none exists, that Section 203 illustrates a "race to the bot-

52. SHB, *supra* note 1, at 725.
53. *Id*. at 726.
54. *Id*.
55. SHB's admitted speculation that a possible "wait and see" approach by institutional investors to tendering in the face of a poison pill would not be large enough to impeach their conclusions, *id*. at 727, also is not convincing. Wholly apart from the concededly "murky" law as to whether dropping a pill condition would require a new offer, *id*. at 727 n.231, historically there has been no perceived risk that a buyer would do so and buy through the pill. As to the target, it is hard to imagine a board redeeming a pill at the last moment and stranding its "wait and see" stockholders. *Cf*. Gilbert v. El Paso Co., 490 A.2d 1050 (Del. Ch. 1984), *aff'd*, 575 A.2d 1131 (Del. 1990) (directors of target corporation did not breach fiduciary duties in agreeing to negotiate with the hostile acquirer prior to the expiration of the initial tender offer and requiring as a condition of the friendly agreement that the acquirer launch a second tender offer in order to allow the "wait and see" stockholders, including some of the directors, who had not tendered into the first offer, to tender their shares in the second offer).
56. SHB, *supra* note 1, at 726.
57. *Id*.

tom" in regulatory competition among states.[58] As they repeatedly acknowledge, Section 203 is less restrictive than other state antitakeover statutes.[59]

While SHB suggest that lowering the Section 203(a)(2) threshold to 70% would cure their perceived constitutionality concerns,[60] that percentage appears to have been selected from pure air. It is at least equally likely that, by depriving well-intentioned directors acting in good faith of the leverage to extract the best price for the stockholders of target corporations, a lower threshold would be contrary to the Williams Act's purpose of investor protection because it would enable the success of coercive, underpriced hostile tender offers. The reasons for the 85% requirement, as noted in SHB's relatively accurate legislative history of the statute, remain as vital today as they did when the statute was enacted. There is no basis for lowering the threshold to 70%, as they advocate, just as there is no evidence that any tender offer, much less a fully priced one, has failed simply because it could not get to 85%.[61]

In the twenty years following the enactment of Section 203, and giving some credence to SHB's data, it appears that defensive measures such as the poison pill and independent directors' willingness to negotiate with unsolicited bidders before a tender offer terminates have affected the number of unsolicited/hostile offers that go to conclusion without board intervention to negotiate an optimal resolution. As we have seen, 33% of the unsolicited/hostile offers in SHB's meager sample, at least 40% of the broader universe of hostile/unsolicited offers when transactions that turned friendly before expiration of the initial tender are added, and at least 71% if one also includes subsequent white-knight transactions, resulted in acquisitions. This supports the premise, appropriately from the perspective of stockholders, that unsolicited offers have a meaningful opportunity to result in successful takeovers and the constitutionality of Section 203 is decidedly not "up for grabs." At the very least, the Jarrell data upon which the initial determinations of constitutionality were based remains unimpeached by SHB's subsequent data which, by reason of the uncontrolled poison pill variable, is meaningless.

58. *Id*. at 736.

59. *See id*. at 688, 696 (noting that thirty-two other states have similar "business combination statutes" to Delaware's, that most "are just as or more potent than Section 203," and that Delaware's business combination statute "was milder than New York's").

60. *Id*. at 730–33.

61. To support their contention that the 85% threshold is an impossible standard, SHB quote a statement from Richard Hall, a partner at Cravath, Swaine & Moore LLP, that "[a]lmost no one gets an 85% percent vote on anything that is opposed by management." *Id*. at 721–22. In the article in *The Deal Magazine* from which that quote was taken, Hall continued, "If that's the factual underpinning for 203, then Guhan's probably right." David Marcus, *Wachtell v. Harvard, Again*, The Deal, Oct. 30, 2009, http://www.thedeal.com/newsweekly/insights/safe-harbor/wachtell-v.-harvard,-again.php. Hall then added that he believed the poison pill remained a more powerful takeover defense than Section 203. *Id*.