INTRODUCTION

The amount of corporate restructuring, in the form of acquisitions and mergers, has virtually exploded in the 1980s. Since 1979, the number of mergers has increased at an annual rate of almost twenty percent — nearly triple the rate of the previous three decades.¹

This increase has not gone unnoticed. In fact, it has been a cause of concern among shareholders, target managements and politicians who see takeovers as a threat or as an economically useless exercise whereby greedy individuals seek to take advantage of others for personal gain.

This Article explores the charges that have been leveled against acquisitions and mergers and the defenses that have been offered in response to those charges. In so doing, this Article attempts to clarify the issues and suggest policies that will protect those who stand to be unjustly harmed while not impeding the rights of consenting adults to enter into contracts and form associations.

THE INCREASE IN ACQUISITION AND MERGER ACTIVITY

Acquisition and merger activity has increased in the past decade due to a number of factors, most notably the general deregulatory environment, fierce foreign competition and a change in viewpoint by the Federal Trade Commission.² Much merger activity has occurred in the oil, banking, finance, insurance and transportation industries due to deregulation. Other mergers have been triggered by competitive pressures.³ Mergers between 1979 and 1985 grew at an annual rate of 19%, compared to a 6.9% growth rate between 1948 and 1979. The inflation-adjusted value of mergers was $128.6 billion in 1985, compared to $85.1 billion in 1979.⁴ The following statistics track the

¹ Prychitko, Corporate Takeovers and Shareholder Interests, CITIZENS FOR A SOUND ECONOMY FOUND., ISSUE ALERT No. 13, April 16, 1987, at 1-2.
² Id. at 2.
³ Id. (citation omitted).
⁴ Id.
increase in the value of mergers since 1979.\footnote{5}

**Mergers and Acquisitions of U.S. Corporations**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>Total Value* (millions of 1982 dollars)</th>
<th>Average Value* (millions of 1982 dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>1,526</td>
<td>85,103</td>
<td>56</td>
</tr>
<tr>
<td>1980</td>
<td>1,568</td>
<td>89,153</td>
<td>57</td>
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<tr>
<td>1981</td>
<td>2,326</td>
<td>137,062</td>
<td>59</td>
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<tr>
<td>1982</td>
<td>2,295</td>
<td>125,394</td>
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<tr>
<td>1983</td>
<td>2,344</td>
<td>114,504</td>
<td>49</td>
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<tr>
<td>1984</td>
<td>2,999</td>
<td>242,135</td>
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<tr>
<td>1985</td>
<td>3,293</td>
<td>128,638</td>
<td>39</td>
</tr>
<tr>
<td>1986**</td>
<td>1,548</td>
<td>70,027</td>
<td>45</td>
</tr>
</tbody>
</table>

*The value of a merger is the value of all considerations paid for the acquired interest.

**First two quarters.

**Who Benefits by an Acquisition or Merger?**

One of the charges made by those who oppose hostile takeovers is that a few individuals gain at the expense of the majority — a utilitarian argument.\footnote{6} Takeovers are seen as a mere paper shuffling exercise by which some individuals gain, while capital market efficiency is impaired.\footnote{7} Yet a number of studies strongly indicate that such is not the case. Takeovers do not just result in a change from a generic Management Team A to Management Team B. Rather, takeovers often result in the lower quality Management Team A being replaced by the higher quality Management Team B.

Takeovers can also benefit shareholders by rearranging corporate assets more efficiently, which is reflected in the form of a higher stock price for the shareholders and higher profits for the company.\footnote{8}

\footnote{5. Id. The 1979-84 data relied upon by Prychitko was provided in Beckett, Corporate Mergers and the Business Cycle, ECON. REV. - FEDERAL RESERVE BANK OF KANSAS CITY, May 1986, at 16. The 1985-86 data was provided in the 1986 May-June, July-August, and September-October issues of MERGERS AND ACQUISITIONS.}

\footnote{6. Prychitko, supra note 1, at 1.}

\footnote{7. Id. at 6 (citing R. REICH, THE NEXT AMERICAN FRONTIER 150 (1983)).}

The shareholders who usually gain the most are the shareholders of the target company. Shareholders of the "predator" company also benefit although their gain is usually less.

Consumers and other businesses also tend to benefit by corporate restructuring. Consumers who purchase the company's products benefit because the restructured company now produces products of higher quality, lower price or both. Other businesses benefit because the consumers who purchase the restructured company's lower priced products now have more money to purchase other goods and services. For example, if Target Company sold widgets for $100 each before restructuring, and after restructuring could sell a higher quality widget for $90, the consumers of Target Company's widgets would now be able to obtain the same number of widgets plus $10 worth of other goods and services. John, one such Target Company customer, uses his $10 to purchase pastries at a local pastry shop. Jim, another customer, buys an extra tie at the local clothing store. Both the pastry shop owner and clothier benefit by Target Company's restructuring because it enables them to make sales that otherwise would not have been possible. The baker and clothier, in turn, make purchases they otherwise would not have been able to make because they now have an extra $10. This process continues indefinitely.9

Countless individuals benefit because a company of which they have never heard is restructured to operate more efficiently. These countless individuals are invisible in the sense that they cannot be identified. Certainly, they cannot be organized into a special interest group (which in fact they are, because they stand to benefit by corporate restructuring). The vast majority of this group, perhaps 99.99%, do not even realize that they are the indirect beneficiaries of corporate restructuring. Indeed, many of them probably see corporate restructuring as something "shady" or "evil," because of the widespread psychological tendency to regard something not understood in an unfavorable light.

Those who stand to lose as a result of corporate restructuring — the management of the target company — form a small, identifiable group. This small but powerful group often enlists the aid of government to stop the restructuring. The reason they cite is noble — protecting the company's shareholders from "greedy" raiders. The real reason, however, is one of self-interest; they stand to lose their jobs if the takeover is successful.10

9. This line of thought has been developed by Frederic Bastiat and Henry Hazlitt, among others. See F. Bastiat, Selected Essays on Political Economy (1964); H. Hazlitt, Economics in One Lesson (1979).

10. A whole body of literature, the Public Choice School of Economics, is built around this phenomenon in which a small, concentrated group can pressure govern-
MOBIL-MARATHON-U.S. STEEL

The Mobil Oil-Marathon Oil-U.S. Steel case is one example of how a takeover attempt increases shareholder wealth. In 1981, Mobil Oil and U.S. Steel both tried to take control of Marathon Oil. U.S. Steel's eventual success resulted in savings of $500 million in taxes within the first year after the takeover. In addition, U.S. Steel saved $1 billion or more over the life of one of Marathon's oil fields due to the way the oil field was valued for tax purposes. Robert Reich called this fact mere "paper advantages," but in reality it was much more than just a paper profit. The tax savings could be plowed back into the business to create additional jobs and earnings for shareholders.

Mobil announced its plan to acquire sixty-seven percent of Marathon for eighty-five dollars per share. Mobil wanted Marathon because Marathon owned the highly productive Yates oil field in Texas. Mobil thought it less expensive, i.e., more economically efficient, to acquire an existing oil field than to find and develop new fields that might be less productive. In effect, Mobil would be buying oil for $3 to $3.50 per barrel instead of spending twelve to fifteen dollars per barrel to drill for undiscovered oil. The millions of dollars Mobil would save in exploration and drilling costs could be used for other investments, any one of which would benefit its shareholders and whomever was the recipient of Mobil's investments. Marathon's shareholders would also benefit by the proposed acquisition because they would receive eighty-five dollars a share for stock that had been worth only $67.50 just a few weeks earlier.

Marathon's president fought Mobil's offer because he wanted Marathon to remain independent. However, if the president was truly concerned about protecting shareholder interests, he could have let the shareholders decide by not interfering in the offer. If the shareholders wanted to remain independent, all they had to do was reject Mobil's offer. Yet Marathon's president tried to prevent his own company's shareholders from having the opportunity to make the decision. To a disinterested observer, it could easily appear that

ment officials into passing laws which benefit that small group but are detrimental to society in general. For the seminal work on Public Choice Economics, see J. BUCHANAN AND G. TULLOCK, THE CALCULUS OF CONSENT - LOGICAL FOUNDATION OF CONSTITUTIONAL DEMOCRACY (1962). Much of Buchanan's and Tullock's subsequent work expands on this theme, as does the work of the Center for Public Choice at George Mason University in Fairfax, Virginia.

11. Prychitko, supra note 1, at 8 (citing R. REICH, THE NEXT AMERICAN FRONTIER 146 (1983)).
12. Id. at 9 (citing A. MICHAEL AND I. SHAKED, TAKEOVER MADNESS 53 (1986)).
13. Id. (citing Harold D. Hoopman, president of Marathon Oil Company, as quoted in N.Y. TIMES, Nov. 12, 1981).
he was protecting his own interests to the detriment of the shareholders.

Marathon's president also wrapped his defense in the American flag by pointing out, shortly after the energy shortage caused by the Arab oil embargo, that not a single barrel of oil would be added to the nation's oil reserves as a result of the acquisition. Although he correctly observed that purchasing existing oil reserves would not add to the nation's total oil reserves, Marathon's falling stock price was an indication that Marathon was not managing its reserves efficiently. Perhaps Mobil could do it more efficiently.

Marathon went to court, using section 7 of the Clayton Act. Marathon argued that the acquisition by Mobil would reduce competition in the retail gasoline industry. After obtaining a restraining order against Mobil, Marathon sought a friendly takeover by a company such as Standard Oil of California or Gulf Oil. Yet a takeover by another oil company would also (perhaps) reduce competition and take away Marathon's independence.

The important point that was missed in this takeover attempt was that Mobil's offer conveyed valuable information to the market. The acquisition would allow Mobil to purchase oil at $3 to $3.50 a barrel, when the cost of purchasing outside oil would be three to five times that price. Mobil's lower cost would enable it to compete more effectively against both domestic and foreign oil companies, which would benefit both Mobil and Marathon stockholders and American consumers. Were it not for the antitrust barrier blocking the acquisition, other companies could have offered the Marathon shareholders competitive offers, further increasing Marathon's stock price to the benefit of Marathon's shareholders.

While Mobil's attorneys attempted to overcome the antitrust barriers, U.S. Steel made several offers for Marathon. Eventually, U.S. Steel and Marathon agreed on an average price of $106 per share, and U.S. Steel made the acquisition. The deal included the right of U.S. Steel to purchase the Yates oil field at a certain price if Marathon were acquired by a third party. Thus, Marathon's most valuable asset was "locked up." Mobil initiated a court action to have the lock-up provision declared invalid, claiming that the provision inhibited competitive bidding for Marathon. Mobil eventually succeeded in its challenge of the lock-up provision, but lost the antitrust suit. It thus appears that Mobil did not gain much for all its efforts.

Whether the asset lock-up was anticompetitive is questionable.

14. *Id.* at 10.
Michael and Shaked think that the lock-up actually increased competition:

[T]he court was simply speculating as to whether any other parties would have made bids for Marathon. In view of the ruling in the antitrust case, no other oil company could be expected to fight U.S. Steel successfully. In short, since no other bidders were likely to bid anyway, granting the options were not demonstrated to have inhibited bidding. If it had any effect, it was to inspire U.S. Steel to enter the race in the first place, as it would not have bid for Marathon without obtaining the options.

As U.S. Steel was induced to bid because of the options . . . granting the options most likely served to improve shareholder returns, not diminish them.15

This analysis suggests that the real villain might have been the antitrust laws, which prevented other potential bidders from entering the battle.

CARL ICAHN AND MARSHALL FIELD

Carl Icahn's attempt to takeover Marshall Field ("Field") is another example of how hostile takeover attempts, even if unsuccessful, can give corporate management an incentive to restructure to increase efficiency. Due to previous takeover attempts, Field's management restructured the company so that it could ward off future attempts by using an antitrust shield. It opened stores where potential acquirers already did business, and diversified operations. Potential purchasers would think twice before attempting to take over Field because of possible antitrust violations. In effect, this posturing protected Field's entrenched management.

Despite this posturing, Field's stock price dropped from thirty-six dollars per share in 1977 to the mid-teens four years later. Carl Icahn, thinking that Field's stock was under-priced, began purchasing shares at fifteen dollars. Field's management went to the Securities and Exchange Commission for protection, claiming that Icahn planned to sell off Field's assets. Field obtained a temporary restraining order, which gave it time to plan a defense. Shortly thereafter, another company, Batus, offered Field up to thirty dollars a share, and the two companies soon merged.16

Batus was considered a "white knight" that saved Field from Icahn the plunderer. Yet Icahn's takeover attempt provided a valu-

15. Id. at 17 n.14 (citing A. MICHAEL AND I. SHAKED, TAKEOVER MADNESS 86 (1986)).
16. Id. at 11.
ble service to Field and the market by exposing Field's inefficient use of resources. Field's president was demoted and replaced by Batus management. While Icahn did not succeed in his takeover attempt, he was rewarded for his efforts. The stock he purchased for fifteen dollars per share rose to thirty dollars in just six months. The shareholders who did not sell to Icahn also benefitted by the swift price increase. Finally, Batus management has shown that it can do a more efficient job of managing Field's assets than did Field's previous management.\textsuperscript{17}

\textbf{OTHER EXAMPLES}

There are many other examples of how successful or unsuccessful takeover attempts benefit the economy in general and shareholders in particular. For instance, General American Oil stock was selling in the mid-thirties in late 1982 when Mesa Petroleum tried to acquire it for forty dollars per share. Phillips Petroleum shortly thereafter acquired General American for forty-five dollars per share, thereby generating a tidy profit for General American's shareholders.\textsuperscript{18} Another example involves Lily Tulip going private in 1981 in a $150 million leveraged buyout. Three years later it went public again, selling just over half of its stock for $45 million. Two years after that, it was taken over by Fort Howard Paper at a price of $366 million.\textsuperscript{19}

Michael Jensen and Richard Ruback conducted a thorough study of corporate takeovers to determine the effect of a takeover on shareholders' equity.\textsuperscript{20} They found that, on the average, the stock value of target companies increased between eight percent and thirty percent when the takeover was successful.\textsuperscript{21} Acquiring firm shareholders did fare as well, but did not experience losses. In another study of seventy-two companies, stockholders experienced an average stock price increase of fifty-six percent in a leveraged buyout, without harming outside stockholders. Abnormal stock price increases upon the announcement of going private, those price changes adjusted to eliminate the effects of marketwide price changes, averaged thirty percent.\textsuperscript{22} Goldman Sachs, an investment firm, estimates that sev-

\begin{itemize}
\item 17. \textit{Id.} at 12.
\item 18. \textit{Id.}
\item 19. \textit{Id.}
\item 20. Jensen & Ruback, 11 J. FIN. ECON. at 5-50.
\item 22. Jensen, \textit{supra} note 8, at 109, 118.
\end{itemize}
enty percent of the Standard and Poor's 500 stock index increase between January, 1984 and October, 1985 was caused by corporate restructuring.\(^\text{23}\)

Target company shares tend to rise in value by between sixteen percent and thirty-four percent according to some estimates.\(^\text{24}\) A Securities and Exchange Commission study found that shareholder wealth increased by $167 billion between 1981 and 1986 as a result of takeovers.\(^\text{25}\) Another study found that takeovers created at least $400 billion in shareholder wealth over a ten-year period ending in the mid-1980s, an amount equal to fifty-one percent of the cash dividends paid to investors by the entire corporate sector over the same period.\(^\text{26}\) John D. Paulus, chief economist for Morgan Stanley, found that industries in which the amount of restructuring is above average also have above average gains in productivity — three times the national average.\(^\text{27}\)

Below is a summary of the abnormal stock price changes found in the Jensen and Ruback study.\(^\text{28}\)

**ABNORMAL PERCENTAGE STOCK PRICE CHANGES ASSOCIATED WITH ATTEMPTED CORPORATE TAKEOVERS**

<table>
<thead>
<tr>
<th>Takeover Technique</th>
<th>Successful Target</th>
<th>Successful Bidders</th>
<th>Unsuccessful Target</th>
<th>Unsuccessful Bidders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tender Offers</td>
<td>30%</td>
<td>4%</td>
<td>-3%</td>
<td>-1%</td>
</tr>
<tr>
<td>Mergers</td>
<td>20</td>
<td>0</td>
<td>-3</td>
<td>-5</td>
</tr>
<tr>
<td>Proxy Contests</td>
<td>8</td>
<td>NA</td>
<td>8</td>
<td>NA</td>
</tr>
</tbody>
</table>

**WHO LOSES?**

The target company's incumbent management is the obvious potential loser in a successful takeover. The incumbent management is replaced by the acquiring corporation's management. Thus, incumbent management is often the sparkplug of any attempt to thwart a hostile takeover. To the extent that the incumbent management succeeds, the target company's shareholders lose, because the company's


\(^{28}\) Jensen & Ruback, 11 J. Fin. Econ. at 7-8.
management is not being replaced by a better, more efficient management. An entrenched management is extremely difficult to oust by shareholder vote. Takeovers do the job that shareholder votes often cannot.

**Poison Pills**

Poison pills are financial schemes implemented by management to make a company a less attractive takeover target. Poison pills may take several forms, many of which involve debt restructuring, preferred stock, discriminatory targeted repurchases, or poison pill rights. An important question to ask is: who benefits and who loses by the introduction of a poison pill?

The obvious losers are the potential raiders. A raider may decide not to attempt a takeover because of a poison pill. Such an attempt may be unsuccessful and costly. Even if the attempt is successful, the cost of success is higher when there is a poison pill.

The less obvious losers are the target company’s shareholders. The evidence suggests that target company shareholders tend to benefit by a takeover, thus, thwarting a takeover by use of a poison pill (or by any other means) prevents them from earning a premium on their stock. Ironically, it is management, the supposed protector of shareholder interests, that adopts the poison pill.

Another group that stands to lose by companies’ use of poison pills is consumers. When a raider is prevented from taking over a company and making more efficient use of the assets than the incumbent management, the company will not upgrade quality and reduce cost. The result is that consumers will continue to pay higher prices to purchase lower quality good or services.

An even less obvious class of losers consists of the thousands of other industries that would obtain extra business if the target company was taken over and run more efficiently. If the target company’s sales were $10 billion before the acquisition and the raider was able to cut costs to the point where the company could reduce prices by ten percent, an extra $1 billion of customer funds would become available to purchase other goods and services even if the number of units sold did not increase. Customer A might decide to use the $10,000 it saves to purchase an additional machine for its factory. Customer B might use its $15,000 in savings to buy another car for the corporate fleet. Customer C might use its $100,000 in savings to invest in employee education or training. Customers A, B and C all benefit because they are able to buy goods or services they could not have afforded in the absence of the takeover. The companies that sell the machine to Customer A, the car to Customer B and the edu-
cation and training to Customer C also benefit because of the takeover, as do the Customer C employees who receive the education and training.

There is no way to predict with certainty what a target company's customers would do with their cost savings, but the fact that they would do something cannot be denied. Even if all they do is deposit the savings in bank accounts, the fact that the money is there (perhaps earning interest) means that it is available for a bank to use to make loans to businesses or individuals. The increased supply of money available for loans creates downward pressure on interest rates, which benefits anyone who borrows money. The general economic law that "as supply increases, price decreases" applies to the supply of money as well as to the supply of any other commodity.

If all these groups stand to lose by the introduction of a poison pill, why is it used? Someone must benefit by their introduction. An easy way to determine who benefits is to look at who introduces the poison pill because it is usually the advocate that tends to benefit. The advocate of poison pills is invariably the incumbent management. It is not difficult to see how management benefits by the introduction of a poison pill. Poison pills decrease the chances of a successful takeover. If a takeover is successful, a high percentage of managers stand to lose their jobs. Therefore, management adopts a poison pill to prevent job losses.

Thus, it appears that management is working against the interest of its shareholders by introducing a poison pill. Yet some courts have upheld the right of management to use poison pills. In one case, the Delaware Supreme Court upheld the right of management to restrict the right of its shareholders to sell their stock, an interesting result in light of the fact that management is supposed to be the agent of the stockholders.

As a result of this case, corporations are adopting poison pills in record numbers. Two recent studies found that the mere announcement that a poison pill has been adopted causes the company's stock price to fall, perhaps because of the decreased likelihood of a successful takeover, which would cause the stock price to rise.

However, not all courts have ruled that management may interfere with shareholder voting rights. New York and New Jersey.

29. According to one report, up to fifty percent of top management lose their jobs within three years of a takeover. See Jensen, supra note 8, at 39.
32. Jensen, supra note 8, at 43.
have crushed some poison pills, and an Illinois court, while dissolving one poison pill, allowed the same company to adopt a different poison pill a few weeks later.35

GREENMAIL

"Greenmail" is seen in the popular press as something evil, a bribe paid to a raider to prevent a takeover attempt from proceeding. The raider is seen as being unjustly enriched at the expense of the target company and its shareholders. Greenmail is a payment top management makes to protect shareholders from a corporate raider. It is perceived as an evil, but, in relation to a hostile takeover, it is perceived as the lesser of two evils.

Greenmail payments do, indeed, stop takeover attempts. However, an economic analysis of greenmail payments raises questions as to their propriety. Because evidence suggests that target company shareholders (as well as consumers and the economy in general) tend to benefit from takeovers, should management prevent a takeover by paying greenmail? Rather than protecting shareholders, it appears that paying greenmail harms shareholders because it prevents them from obtaining the benefits generated by a takeover — primarily an increase in the price of their stock. Consumers are also harmed because blocking a takeover prevents the new owners from using the acquired assets more efficiently, which would lead to higher quality products or services at lower prices.

Preventing takeovers by paying greenmail tends to protect management, many of whom would lose their jobs if the takeover attempt were successful. Thus, it appears that management, unwittingly or not, pays greenmail to protect themselves against job loss, to the detriment of shareholders and consumers.

Paying greenmail is actually a form of targeted repurchase. It could be construed as being unfair to a large group of shareholders because it involves an offer to repurchase the shares of one or a small group of shareholders at a premium, an offer that is not extended to all shareholders. Ironically, it is the greenmailer who is offering the other shareholders the opportunity to sell their shares at a premium, an offer the company's management is trying to prevent from being made or accepted.

Recent studies indicate that a stock's price increases between the
initial purchase by the greenmailer and the later repurchase by the company.\textsuperscript{36} Thus, shareholders benefit rather than suffer harm because the price of their stock is bid up. If the greenmailer is bought out by management, the shareholders lose the premium.\textsuperscript{37} However, the stock price might not return to its pre-takeover attempt level because the market may anticipate that there will be other attempts that could prove successful. Conversely, if the company’s financial position is considered weakened as a result of having to pay a large sum to thwart a takeover, the stock price may slide below its original level. The company will thus be considered a less desirable investment.

\section*{Golden Parachutes}

The subject of “golden parachutes” has become controversial in recent years. As takeovers become more sophisticated and “junk” bond financing makes it possible to take over even the largest companies, top management is no longer protected by working for a very large firm. That fact, together with the fact that about half\textsuperscript{38} a target company’s top management are no longer with the company three years after the takeover, creates a tremendous amount of anxiety in managers and gives them a strong incentive to seek ways to protect themselves in the event of a takeover.

Briefly, a golden parachute is a severance contract designed to compensate high-level corporate officials for losing their jobs if their company is taken over. Most commentators view such contracts as shareholder “ripoffs” because the high-level employee benefits to the detriment of the shareholders. This analysis is simplistic, however, because there is much more involved than initially meets the eye. There are circumstances under which shareholders can benefit by having the corporation enter into golden parachute contracts with top management employees.

Golden parachute contracts can help reduce the conflict of interest that would otherwise exist between top management and shareholders. Management may resist a takeover attempt that would be in the shareholders’ interest because they stand to lose their jobs if the takeover is successful. A properly constructed golden parachute contract will eliminate or at least reduce this potential conflict of interest because management would be less likely to thwart a takeover.


\textsuperscript{37} This result is discussed in Bradley, Desai & Kim, \textit{The Rationale Behind Interfirm Tender Offers: Information or Synergy?}, 11 J. Fin. Econ. 183 (1983).

\textsuperscript{38} Jensen, \textit{supra} note 8, at 39.
attempt if their incomes were protected by golden parachutes. Evidence suggests that merely announcing the existence of golden parachute contracts raises a company's stock price by about three percent.\(^3\) This price rise may be due to the investing public perceiving that a takeover attempt is more likely than before, but it may also be because the market perceives that the potential conflict of interest between management and the corporation has been reduced, thus making the stock a better investment. In all likelihood, both of these factors have an effect on the increase in the company's stock price.

Evidence suggests that takeovers are good for the stockholders of the target company, as well as for the general consuming public. It thus seems logical that company policy should be to encourage top management to negotiate takeovers that appear to be in the shareholders' best interests and government should do nothing to prevent the practice. Yet some present legislation, such as the Deficit Reduction Act of 1984, penalize companies and managers who enter into golden parachute contracts. Moreover, state and federal officials are advocating placing further restrictions on the use of golden parachute contracts.\(^4\) As stated earlier, a properly structured golden parachute contract reduces top management's conflict of interest. Legislation that restricts or prohibits such contracts actually works against the shareholders' interests and the interests of the economy in general because takeovers also tend to be in the consumers' interest. Thus, the logical solution would be to repeal legislation that restricts companies from entering into golden parachute contracts with their top management.

However, not all golden parachute contracts resolve the conflict of interest problem. Depending on how the contract is structured, it may serve to further entrench management and, therefore, work against the shareholders' interest. One way to ensure that such contracts work would be to extend them only to the members of top management who would be negotiating the takeover and implementing the later restructuring. Extending golden parachute contracts to lower level managers not involved in takeover negotiations would be more difficult to justify on shareholder interest grounds. Moreover, extending too many golden parachute contracts raises the cost of the acquisition. The target company thus becomes less attractive to po-

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40. The Internal Revenue Code, title 26 of the United States Code, limits the amount of golden parachute compensation that may be deducted as salary expense and places a nondeductible excise tax on the excess. See I.R.C. §§ 280G(b)(4)(A), 4999(a).
potential raiders without any corresponding increase in benefits to the shareholders.

Golden parachute contracts may also make it easier for a company to attract qualified top management. Golden parachute contracts are a form of compensation, a salary substitute, an insurance policy against job loss, and, potentially, a supplemental retirement plan. The absence of a golden parachute provision in an employment contract makes a job offer less attractive to a potential top-level manager. Companies that do not offer golden parachute contracts would probably have to offer higher salaries to entice potential top managers to join the company.

Not all golden parachute contracts are in the best interests of shareholders. If the golden parachute is too "golden," top management might be too willing to sell the company. They may take the first offer that comes along rather than negotiate a higher price for their shareholders.

Managers and board members who hold significant amounts of stock in a company will have less incentive to take the first offer than those who own little or no stock. Thus, a company might provide incentives to encourage top management and board members to own stock in the company. Yet present insider trading laws provide a disincentive to the ownership of stock by such individuals. As a result, some top managers and board members sell their stock so that they will not be accused of insider trading.41 Offering stock options and restricted stock appreciation rights that are exercisable only if control of the company changes is one possible solution to this problem.

WHAT ROLE SHOULD GOVERNMENT PLAY?

The question of what role government should play in the takeover area is a difficult one which is complicated by the fact that more

than one government is involved in regulating corporate acquisition
and merger activity. One author has suggested that the states should
retain primary responsibility for setting the legal framework for cor-
porate takeovers, with the federal government's role to be that of
protecting shareholder ownership rights when management attempts
to use state law to block the wishes of the majority of shareholders.42

At the federal level, the Williams Act is the principal securities
legislation regulating tender offers. The Williams Act, the part of
the Securities and Exchange Act of 1934 that requires anyone con-
templating a tender offer to announce such an intention well in ad-
vance of the offer (sections 13(d) and (e), and sections 14(d), (e) and
(f)), makes it easier for target managements to thwart a takeover.
Several authors have argued that because shareholders tend to ben-
efit by takeovers, legislation which makes it easier to thwart a take-
over may be against the shareholders' interest.43

Some states have passed laws requiring more disclosure and
longer waiting periods than federal law. Ostensibly designed to pro-
tect shareholders, these laws often act to protect management at the
expense of shareholders.44 A Federal Trade Commission study found
that the New York anti-takeover statute caused a one percent decline
in stock value, a decline of $1.2 billion.45 A Securities and Exchange
Commission study found that the Ohio anti-takeover statute also cost
shareholders a substantial amount of money.46 Until a few years ago,
such restrictive legislation was held to impose an undue burden on
interstate commerce.47

42. Buttarazzi, S. 1323—The Murky Issue of Corporate Takeover Laws, THE HERI-
TAGE FOUND., ISSUE BULL. NO. 142, July 11, 1988, at 1.
43. A number of authors have addressed this point in recent years. See Bubb, Hos-
tile Acquisitions and the Restructuring of Corporate America, THE FREEMAN, May
1986, at 166; Buttarazzi, supra note 42, at 1; Coffee, Grundfest, Romano &
Weidenbaum, Corporate Takeovers: Who Wins; Who Loses; Who Should Regulate?,
Market for Corporate Control: The Empirical Evidence Since 1980, J. ECON. PERSP.,
Winter 1988, at 49; Jensen, Takeovers: Folklore and Science, supra note 8, at 109;
Manne, supra note 41, at A27, col. 3; Prychitko, supra note 1, at 10; Romano, The Poli-
tical Economy of Takeover Statutes, 73 VA. L. REV. 111 (1987); Note, Antitakeover Leg-
islation: Not Necessary, Not Wise, 35 CLEV. ST. L. REV. 303 (1987); Bandow, Curbing
Raiders is Bad for Business, N.Y. Times, Feb. 7, 1988; Woodward, How Much Indiana's
44. See Romano, supra note 43.
45. L. SCHUMANN, STATE REGULATION OF TAKEOVERS AND SHAREHOLDER
WEALTH: THE EFFECTS OF NEW YORK'S 1985 TAKEOVER STATUTES, FEDERAL TRADE
COMM'N, BUREAU OF ECON. STAFF REP., Mar. 1987, at 40 (available from the FTC's
Public Reference Branch).
46. OFFICE OF THE CHIEF ECONOMIST, SEC. AND EXCH. COMM'N, NEWS RELEASE 87-
27, SHAREHOLDER WEALTH EFFECTS OF OHIO LEGISLATION AFFECTING TAKEOVERS 2
(May 18, 1987).
47. Edgar v. MITE Corp., 457 U.S. 624, 646 (1982). In MITE, the Supreme Court
INDIANA

The federal view of state takeover statutes changed in 1987, when the United States Supreme Court held an Indiana takeover statute to be constitutional on both commerce clause and supremacy clause grounds. In the wake of this case, more than half the states have already passed statutes that help deter takeovers of corporations in their states if management opposes the takeover attempt. The Indiana law denies voting rights to any entity acquiring "control shares" in certain Indiana corporations unless the other shareholders grant permission to reinstate them. An economic study of the Indiana takeover statute found that the law cost shareholders of Indiana corporations $2.65 billion — a more than six percent loss, based on the $41 billion total value of corporations incorporated in Indiana. This finding flies in the face of the Court's opinion that the statute benefits shareholders.

Woodward speculates that the Indiana legislature passed the law either because it believed the claims of management that takeovers harm shareholders (in spite of the overwhelming evidence to the contrary), or that it was afraid that takeovers would cause companies to be restructured or moved out of state, thus causing a loss of jobs to Indiana residents. Woodward points out that Amoco, the largest publicly held company in Indiana, accounts for $21 billion of the $41 billion of equity of Indiana's publicly held companies. The anti-takeover law has cost Amoco shareholders $1.7 billion, or 7.5% of their investment. The shareholder loss amounts to $44,000 for each of Amoco's 40,000 domestic employees. If the statute benefitted only

held an Illinois takeover statute to be an unconstitutional abridgement of the commerce clause. Id. Some Justices also thought it violated the supremacy clause because it was inconsistent with the Williams Act, which ostensibly balances offeror and target company interests and provides investors with information. Id. at 631. As a result of that decision, some states have amended their laws to comply with the requirements of MITE. Other states have repealed their takeover laws or ceased to enforce them rigorously. Butler and Ribstein discuss this point in State Anti-Takeover Statutes and the Contract Clause, 57 U. Cin. L. Rev. 611 (1988).

50. Woodward, supra note 43. The study was conducted by Susan E. Woodward and J. Gregory Sidak.
51. Other studies confirm this finding. Government protection of incumbent management in New Jersey caused the stock prices of 87 affected companies to fall by 11.5%. Stock prices for 74 companies incorporated in Ohio dropped by 3.2%, or $1.5 billion, after the legislature passed restrictive anti-takeover legislation, according to a Securities and Exchange Commission study. New York's statute cost stockholders $1.2 billion, or one percent of stock value, according to a Federal Trade Commission estimate. See Bandow, supra note 43.
union employees, fifteen percent of Amoco's workforce, the cost per employee is even higher — $295,000 each. This amount is a high price for shareholders to pay for relocation and job training costs in the event of a shift in employment. In reality, the Indiana statute protects incumbent management at the expense of the shareholders, ninety-eight percent of whom live in states other than Indiana.

A general rule of economics is that whenever there is competition, quality increases and cost decreases. When there is competition, consumers can increase their standard of living by choosing the cheapest and best products or services and ignoring those that are shoddy and more expensive. When this general rule of economics is applied to state competition for corporations, however, the benefits of competition are not so apparent. State legislatures seem to be rushing to protect management at the expense of shareholders and it is management rather than shareholders who often determine in which state to incorporate. The only choice shareholders have is to invest in companies that are incorporated in states that protect their interests, if they can find any.

An alternative to this state competition would be to have the federal government preempt state regulation in the takeover area. This solution, however, would probably be no solution at all because the federal government is at least as willing as the state legislatures to enact legislation that protects management. The Williams Act is a perfect example of such legislation. The suggested alternative also raises constitutional problems. Moreover, such federal action would bring us one step closer to a unified state and one step further away from federalism, a result contrary to what (at least some of) our founding fathers envisioned.

Woodward mentions a middle ground that preserves a state's corporate law while at the same time protecting shareholders. Under a federal opt-in law, states could enact whatever corporate law changes they wished, but shareholders of companies that were incorporated before such laws were passed could vote to be excluded from the changes. In effect, it is a contract issue. Whether a state legislature can alter the terms of a contract between affected parties should be decided by the affected parties. One drawback of this solution is that it would raise transaction costs because shareholders would have to vote whenever the legislature amended the law. However, based

52. For a detailed exposition of this thesis, see M. FRIEDMAN & R. FRIEDMAN, FREE TO CHOOSE (1980).
53. At least two authors have called for repeal of the Williams Act. See Manne, The Real Boesky-Case Issue, supra note 41, at A27, col. 1; Note, Antitakeover Legislation: Not Necessary, Not Wise, supra note 43, at 315.
54. Woodward, supra note 43.
on recent studies showing the extent of shareholder losses caused by takeover legislation, it appears that the increased transaction costs involved in additional voting would be more than offset by the savings that result from shareholders exempting themselves from laws that benefit management at their expense.

DELAWARE

The Delaware law is even more important than Indiana's because Delaware is the leading state for incorporation.55 About 180,000 corporations are incorporated in Delaware, including nearly half of the companies listed on the New York Stock Exchange56 and more than half of the Fortune 500 companies. The Delaware law thus has almost the effect of a national anti-takeover law.57

The Delaware statute places difficult obstacles in the path of a fifteen percent shareholder. A fifteen percent shareholder cannot complete a takeover unless: (1) he or she acquires, in one block, eighty-five percent of the target’s outstanding stock, other than that held by directors and officers; (2) two-thirds of all outstanding shares other than the bidder’s are voted in favor of the acquisition; or (3) the board and shareholders vote to exempt themselves from the law.58 As a result of the new Delaware statute, corporate raiders could use proxy fights rather than tender offers to gain control.

Other aspects of the Delaware statute should be noted. Raiders often sell part of the target company to raise funds to pay for the acquisition. Under the Delaware statute, this technique will be much more difficult to utilize because the raider is prohibited, under certain circumstances, from taking possession of the target company for three years. Using two-tiered transactions whereby the raider offers cash to the first group of shareholders and stock or bonds to a second group will also become more difficult.

THE WILLIAMS ACT

The Williams Act59 was enacted by Congress in 1968 to regulate tender offers.60 More specifically, the Act requires raiders to give ad-

57. This point is attributed to economist Robert Samuelson in J. Buttarazzi, supra note 42, at 2; see also Bandow, supra note 51.
vance warning that they are going to attack, and to disclose other de-
tailed information as well. Anyone who acquires, directly or
indirectly, a five percent beneficial interest in a particular security
must disclose detailed information outlining the acquiror's back-
ground, identity, source of funds, and acquisition plans. The number
of shares owned and any agreements between the acquiror and other
persons must also be disclosed.\textsuperscript{61} The party acquiring five percent
must disclose the information to the target company, the Securities
and Exchange Commission and the exchange on which the stock is
being traded.\textsuperscript{62} Once the offer is announced, the offeror may not
make purchases other than through the tender offer.\textsuperscript{63} Open market
purchases (at a lower price) are forbidden.

The Williams Act also gives the target company shareholders the
right to withdraw any tendered shares within seven days after the
tender offer is published or within sixty days from the date the origi-
nal offer was made.\textsuperscript{64} This deadline has been extended by the Securi-
ties and Exchange Commission to fifteen business days from the start
of the offer and ten business days from the start of any competing
offer, provided the original raider knows about the competing offer
and has not accepted the shares the shareholders seek to withdraw.\textsuperscript{65}
If the offer is for less than all the shares of a particular class and the
shareholders tender more shares than the offeror is willing to
purchase, the offeror must purchase the shares on a pro rata basis.\textsuperscript{66}
Originally, the Williams Act proration requirement applied only to
shares tendered within the first ten days of the offer, but the Securi-
ties and Exchange Commission later extended the requirement to the
entire offer period.\textsuperscript{67} If the raider increases consideration during the
offer period, all tendering shareholders are entitled to receive the
same deal — the highest price offered.\textsuperscript{68} The Williams Act also pro-
hibits any untrue statements or material omissions of facts, or any
fraudulent, deceptive or manipulative acts or practices.\textsuperscript{69}

Because acquisitions and mergers are good for the economy in
general, and for target company shareholders in particular, it seems
logical that government should not place artificial hurdles in the way
of consenting persons who wish to engage in such activity. Yet it ap-
ppears that the Williams Act is one of those hurdles. The Act is aimed

\begin{itemize}
\item \textsuperscript{61} 15 U.S.C. § 78m(d)(1) (1982).
\item \textsuperscript{62} Id.
\item \textsuperscript{63} 17 C.F.R. § 240.10b-13 (1988).
\item \textsuperscript{64} 15 U.S.C. § 78n(d)(5) (1982).
\item \textsuperscript{65} 17 C.F.R. § 240.14d-7 (1988).
\item \textsuperscript{66} 15 U.S.C. § 78n(d)(6) (1982).
\item \textsuperscript{67} 17 C.F.R. § 240.14d-8 (1988).
\item \textsuperscript{68} 15 U.S.C. § 78n(d)(7) (1982).
\item \textsuperscript{69} 15 U.S.C. § 78n(e) (1982).
\end{itemize}
at reducing the number of tender offers made and increasing the cost of those that are made. Raiders must give advance notice of their intent, thus giving entrenched management the opportunity to thwart the takeover bid. Once the declaration to acquire is made, the raider can no longer purchase shares on the open market where the price may be lower. A premium must be paid on all shares subsequently acquired. If the shares are acquired at more than one price, the raider must later make up the price differential to those shareholders who willingly sold previously at a lower price.

Once the decision is made to acquire the target company, it is in the raider's best interest to acquire as many shares as possible before it is known that the acquisition is being made. The Williams Act limits the number of shares that the raider can acquire before disclosing its intentions, which both places a chilling effect on acquisition activity and drives up the cost of any acquisition attempt. Both the shareholders and the raider are harmed by this result. The shareholders are harmed because they would benefit if the acquisition attempt was successful. The raider loses because the disclosure rule drives up the cost of the acquisition and makes it less attractive.

Prior to the enactment of the Williams Act, potential raiders could be secretive in formulating tender offer plans. They would place tender offer ads in major newspapers over the weekend and when the newspapers hit the stands they would be ready to buy. They could limit the offering period to a very short time, such as a week, and would know within a matter of days whether the takeover attempt was successful. The high interest charges they paid on the money borrowed for the takeover could be kept to a minimum. But with the extended offer terms required by the Williams Act, the interest charges accumulate over a much longer time period, thus increasing the cost of the acquisition attempt and reducing the takeover's chance of success.

The Williams Act caused corporate raiders to change the way they do business. Raiders had to determine how many shares they could acquire at a given price before actually disclosing their intent to the public. As a result of this development, risk arbitrageurs began helping raiders by prepositioning or warehousing blocks of shares before the tender offer was made public. The arbitrageurs' actions might have taken place with or without collusion, but the fact that their actions increase the chances of a successful takeover should be noted. These so-called dealers in insider information benefit the economy by helping to make takeover bids successful:

The tender offer is the most important and beneficial financial invention of the 20th century. Its very existence has probably added hundreds of billions of dollars to American
capital values. Without it, noncontrolling shareholders in companies with widely diffused ownership would be nearly helpless in the face of managerial incompetence, self-dealing or inattention to business.\textsuperscript{70}

The Williams Act protects entrenched management at the expense of shareholders, harms the economy and consumers in general and increases the price corporate raiders must pay. The logical step, therefore, would be to repeal that piece of legislation.\textsuperscript{71} Yet some senators, such as Senator Metzenbaum, would tighten tender offer regulations, an action that would worsen the situation.\textsuperscript{72} Before Congress changes the law, it should determine what possible effects such changes would have on various groups. Based on Senator Metzenbaum's position, it appears that Congress (or at least Senator Metzenbaum) has not yet made that determination.

CONTRACT AND PROPERTY LAW ASPECTS OF ACQUISITIONS AND MERGERS

Although the United States Supreme Court held that Indiana's takeover law was constitutional under the commerce and supremacy clauses,\textsuperscript{73} some constitutional questions remain open. In 1987, Oklahoma's federal court invalidated Oklahoma's Control Shares Acquisition Act as an unconstitutional burden on interstate commerce.\textsuperscript{74} The Indiana and Oklahoma statutes can be distinguished, however, in that Indiana's law applied only to corporations incorporated in Indiana, while the Oklahoma law applied to corporations incorporated in any state.

The constitutional provision that directly affects the authority of state governments to pass anti-takeover laws is the contract clause of the United States Constitution.\textsuperscript{75} The contract clause prohibits states from passing any law impairing the obligation of contracts. While this prohibition has eroded almost to the point of nonexistence in recent decades, a number of legal scholars have had some success in its revitalization.\textsuperscript{76} Part of the problem arises because courts tend to

\textsuperscript{70} See Manne, supra note 41.
\textsuperscript{71} At least two other authors have called for repeal of the Williams Act. See Manne, The Real Boesky-Case Issue, supra note 41, at A27, col. 1; Note, supra note 43, at 315.
\textsuperscript{72} Manne, The Real Boesky-Case Issue, supra note 41, at A27, col. 1.
\textsuperscript{73} CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637, 1648-49 (1987).
\textsuperscript{74} TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022, 1029 (1987).
\textsuperscript{75} U.S. Const. art. I, § 10.
view corporations as existing by state grant (corporations are viewed as being creatures of the state) rather than as a series of contractual relations that include shareholders, management, employees, creditors and others. Numerous court cases have helped to dissolve contract clause protections, although two recent cases provide a ray of hope that contract clause protections may be at least partially restored.

The thrust of the contract clause argument is that consenting adults should be able to enter into a contractual relationship without interference by the state. The state should protect contractual relationships, rather than impair them. State takeover laws that restrict the contractual relationship are therefore unconstitutional, or should be.

Henry N. Butler and Larry E. Ribstein have developed the contract clause argument in depth. They see a contract as existing among management, shareholders, creditors and others. If shareholders cannot freely transfer all the incidents of ownership that supposedly attach to their shares, such as voting rights, because of a state law, their ability to contract is being impaired. The Indiana law is one example where the right to transfer voting rights is lost. Incidentally, shareholders who purchased stock before the law was passed with the intent of eventually gaining a controlling interest have that right taken away from them without just compensation, which seems to be a violation of the takings clause.

A major reason that anti-takeover statutes are not seen as unconstitutional violations of the contract clause is that the courts view corporations as creatures of the state rather than a series of mutually beneficial contractual relationships between consenting adults. This

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78. For a summary of the background of the contract clause, see Home Bldg. and Loan Ass'n v. Blaisdell, 290 U.S. 398, 448-83 (1934) (Sutherland, J., dissenting).
81. Butler & Ribstein, 57 U. CIN. L. REV. at 611.
82. CTS, 107 S. Ct. at 1639-52.
83. U.S. CONST. amends. V, XIV. For a thorough analysis of the takings clause, see R. EPSTEIN, Takings (1985). State anti-takeover laws often discriminate against minority shareholders and limit the market for shares, which also seems to impair the right of contract. They also tend to involuntarily restrict shareholder suffrage. See J. Buttarazzi, supra note 42, at 3.
judicial view goes back to Roman law and at least as far back in
American law as Justice Marshall's decision in Trustees of
Dartmouth College v. Woodward,84 which is still considered valid.85
Under this view, states may unilaterally alter contracts and infringe
on property rights of the contracting parties. Yet a wealth of evi-
dence exists that clearly shows corporations to be highly contractual
in nature.86 Anderson and Tollison point out that the "creation of
the state" view of the corporation is a myth.87

A. Machen pointed out the fallacy in his "concession theory" in
1911 stating:

Still more erroneous is it to speak of corporate personality as
a privilege conceded by the state. This notion that corporate
personality is some mysterious gift from a higher power, be-
stowed like manna from heaven, goes back, like so much
that is confusing in this matter of the corporate entity, to the
Roman law. Corporate personality is not a concession from
the state, and it is not properly a privilege. So far as it is
real, it is a fact recognized but not created by the state; and
so far, if at all, as it comes from the state, it is imaginary,
and is, therefore, like any other imaginary gift, of no value.
All manner of injustice and false reasoning have resulted
from the conception of the corporate personality as a great
privilege presented to loyal subjects by a gracious
sovereign.88

Butler and Ribstein point out that a state corporate filing no
more creates a corporation than a birth certificate creates a baby.89
The state merely provides a standard form to facilitate the process
for the contracting parties. Contrary to the Marshallian view (John,
not Alfred), the state is not a party to the incorporation contract, just
as the state is not a party to a sales contract when the contracting

84. 17 U.S. (4 Wheat.) 518, 636 (1819).
85. CTS, 107 S. Ct. at 1652.
86. Butler & Ribstein, 57 U. CIN. L. REV. at 615-17 (elaborating on the contractual
nature of corporations). At page 618, footnote 13, the authors cite: Alchian & Dem-
setz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV.
777 (1972); Coase, Nature of the Firm, 4 ECON. N.S. 386 (1937); Diamond & Verrecchia,
Optimum Managerial Contracts and Equilibrium Security Prices, 37 J. FIN. 275
(1982); Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288
(1980); Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs,
and Ownership Structure, 3 J. FIN. ANAL. 305 (1976); Klein, Crawford & Alchian, Ver-
tical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L.
87. Anderson & Tollison, The Myth of the Corporation as a Creation of the State,
88. Machen, Corporate Personality, 24 HARV. L. REV. 347, 361 (1911). This cita-
tion is part two of a two-part article. Part one is at 24 HARV. L. REV. 253 (1911).
89. Butler & Ribstein, 57 U. CIN. L. REV. at 620.
The contract clause was still healthy in 1897 when the Supreme Court unanimously decided in *Allgeyer v. Louisiana* that a Louisiana law prohibiting a legal person from purchasing insurance from a non-Louisiana insurance company to protect Louisiana property violated the equal protection and due process clauses of the fourteenth amendment. But cracks were starting to appear in the foundation of the absolute freedom to enter into contracts. The *Allgeyer* Court took the position that the freedom to contract was not absolute, but was subject to regulation. The contract clause still had some force in 1905 when the Court, in *Lochner v. New York* held a New York statute that limited working hours to sixty per week and ten per day to be an unconstitutional violation of the defendant's due process rights.

A few years later, the Court upheld the right of an employer to fire an employee for refusing to agree not to join a union. In *Adkins v. Children's Hospital*, the Court held a minimum wage law unconstitutional, because it violated the right of an employer and employee to enter into a mutually beneficial contract.
The Supreme Court thus generally upheld the right of consenting adults to enter into contracts free from state interference, with one major exception. This major exception to the unbridled freedom to contract was recognized (created?) by the court in cases when the business was affected with a public interest or a public calling. The problem then became one of definition and judicial judgment.99

This generally noninterventionist attitude began to change shortly after Coppage v. Kansas.100 In Bunting v. Oregon,101 the Court ignored Lochner in holding that a law regulating working hours was valid.102 In Euclid v. Ambler Realty Co.,103 the Court upheld a zoning law, thus chipping away at the right of individuals to do with their property as they saw fit, and reducing economic liberty from a different angle — that of a taking.104 In Nebbia v. New York,105 the Court upheld a New York law prohibiting milk dealers from selling milk for less than nine cents a quart, thus protecting the milk industry's interests at the expense of consumers.106 The Court determined that the seller's due process and equal protection rights were not violated by the restriction, yet his right to contract obviously was violated because he could not enter into contracts to sell

1657 (1970); Kosters and Welsh, The Effects of Minimum Wages on the Distribution of Changes in Aggregate Employment, 62 AM. ECON. REV. 323 (1972); Mincer, Unemployment Effects of Minimum Wages, 84 J. POL. ECON. 87 (1976); Moore, The Effect of Minimum Wages on Teenage Unemployment Rates, 79 J. POL. ECON. 897 (1971); Ragan, Minimum Wages and the Youth Labor Market, 59 REV. ECON. STAT., May 1977, at 129; Welch, Minimum Wage Legislation in the United States, 12 ECON. INQUIRY 285 (1974); Welch, The Rising Impact of Minimum Wages, REGULATION, Nov.-Dec. 1978, at 28; Welch & Cunningham, Effects of Minimum Wages on the Level and Age Composition of Youth Employment, 60 REV. ECON. STAT., Feb. 1978, at 140-45. The point is that the courts and legislatures, in attempting to be compassionate, are using faulty economic theory. The result is that contractual rights are being violated and the individuals that are supposedly being protected are in fact being harmed because of this judicial and legislative action.


100. 236 U.S. 1 (1915). See supra note 96 and accompanying text.
101. 243 U.S. 426 (1917).
102. Id. at 438-39.
103. 272 U.S. 365 (1926).
104. Id. at 397.
106. Id. at 539.
milk for less than nine cents a quart without being accused of a crime. With *Nebbia*, the Court rejected its old standard, holding that due process demands only that the law is not arbitrary or unreasonable and that it have a substantial relation to the goal to be achieved. This case represents the beginning of the end of economic due process.

In the next few years, the freedom to contract was eroded at a much faster pace. In *Home Building and Loan Association v. Blaisdell,* the Supreme Court upheld a Minnesota statute that altered the terms of mortgage agreements. The reason given was that the state reserves the right to safeguard the vital interests of its people. This idea is dangerously open-ended because it could lead to major encroachments on individual rights. Once it has been established that the state can make decisions for individuals, when does it end? Everybody knows that white sugar products are bad for our health. What is to prevent the state from safeguarding our vital interests by outlawing them? Caffeine falls into the same category, as does nicotine, alcohol, red meat, bad movies, bad books, bad plays and any number of other items. Once the door is opened, it is a matter of judicial judgment as to what should be protected and what should not. The absence of clear guidelines creates uncertainty and increases transaction costs.

By 1937, there was much precedent to justify judicial interference in the freedom to contract. In that year the Supreme Court, in *West Coast Hotel v. Parrish,* overruled *Adkins* by upholding a Washington minimum wage law. The Court’s rationale was that the statute was a reasonable exercise of legislative discretion, the same standard used in *Nebbia*. At this point, it could be said that economic due process was dead. And for the next forty years neither did the contract clause provide any protection against state interference with contracts. Only twice during that time did the Supreme Court apply the contract clause to invalidate a state statute.

The late 1970s saw somewhat of a revival of the contract clause.

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108. Id. at 447. Hale discusses the history of this idea in *The Supreme Court and the Contract Clause: III*, 57 HARV. L. REV. 852, 873-83 (1944).
110. 300 U.S. 379 (1937).
111. Id. at 398-400.
112. Bernard H. Siegan agrees with this assessment. See B. SIEGAN, supra note 76, at 145.
In *United States Trust Company v. New Jersey*, a 1962 statutory covenant between New York and New Jersey limited the ability of the Port Authority of New York and New Jersey to subsidize rail passenger transportation from revenues and reserves pledged as security for consolidated bonds issued by the Port Authority. In 1974, New York and New Jersey retroactively repealed the 1962 covenant. United States Trust Company, as trustee for, and a holder of, Port Authority bonds, filed suit for declaratory relief, claiming that the 1974 New Jersey statute impaired the obligation of the states' contract with the bondholders in violation of the contract clause. The Supreme Court, in a four to three decision with Justices Stewart and Powell not participating, held that the contract clause prohibited the retroactive repeal of the 1962 covenant.

Repealing the covenant totally eliminated an important security provision for the bondholders, thus impairing the obligation of the states' contract. The covenant's security provision was purely a financial obligation and thus not necessarily a compromise of the states' reserved powers that cannot be contracted away. Such impairment of contracts can be upheld, according to the Court, only if it is both reasonable and necessary to serve an important public purpose. In *United States Trust* the impairment was neither necessary to achieve the states' plan to encourage private automobile users to shift to public transportation nor reasonable in light of changed circumstances. Repeal was not essential because New York and New Jersey could have made a less drastic modification of the covenant. In the alternative, they could have adopted alternative means of discouraging automobile use and improving mass transit without modifying the covenant at all. Although the Court did not hold that the contract clause was an absolute bar to contract modifications, it at least recognized that the contract clause was not completely dead.

The following year, in *Allied Structural Steel Company v. Spannaus*, the Court invalidated a state law that impaired private agreements. The statute required employers who employed more than 100 workers and who were leaving the state to fully vest their employee pension plans for those employees who had at least ten years of service even if the terms of the pension agreement did not call for full vesting after such time. However, in this particular case it appeared that the state statute was specifically aimed at one partic-
ular company.\textsuperscript{117} In several later cases, the Court made it clear that it would be more likely to invalidate state laws impairing the contract of a particular company than laws of more general application which impaired contracts only incidentally.\textsuperscript{118}

Lower court decisions rendered after these two cases do not indicate any movement toward greater protection of economic contracts. In fact, the lower courts seem most hesitant to protect the public against state interference with contractual obligations.\textsuperscript{119} However, a few courts have struck down statutes that impair contracts.\textsuperscript{120}

While the Supreme Court's recent decisions do not go far enough to please economic libertarians, they do go a long way toward revitalizing the contract clause. Consenting adults now have somewhat more protection (though very little) against state interference when entering into economic contracts than they did before \textit{United States Trust} and \textit{Spannaus}. But the Court has a long road to travel if it is to return to the language of the constitution, which states that "[n]o [s]tate shall . . . pass any . . . [l]aw impairing the [o]bligations of [c]ontracts."\textsuperscript{121} Richard A. Epstein states the case most forcefully:

The interpretation of the contract clause prevailing in the Supreme Court reduces the clause to yet another emaciated form of substantive due process. Even if we are unable to settle on the correct reading of the clause, we can be certain that the Supreme Court's present interpretation is both wrong and indefensible . . . [T]he clause as construed today creates at most a faint presumption against legislative interference with existing contracts . . . . The contract clause is not a technical nuisance to be undermined by clever stratagems and verbal slights of hand. It is an essential part of our basic constitutional scheme of limited government. It

\textsuperscript{117} \textit{Spannaus}, 438 U.S. at 247-48.


\textsuperscript{119} Some lower court cases that have not protected contracts from state impairment include: Northwestern Nat'l Life Ins. Co. v. Tahoe Regional Planning Agency, 652 F.2d 104, 106 (9th Cir. 1980); Appling County v. Municipal Elec. Auth., 621 F.2d 1301, 1306 (5th Cir. 1980); Morseburg v. Balyon, 621 F.2d 972, 979 (9th Cir. 1980); Augustin v. Quern, 611 F.2d 206, 210 (7th Cir. 1979); Todd Shipyards Corp. v. Witthuhn, 596 F.2d 899, 903 (9th Cir. 1979); Kargman v. Sullivan, 582 F.2d 131, 134-35 (1st Cir. 1976); Andre v. Board of Trustees, 561 F.2d 48, 51 (7th Cir. 1977).

\textsuperscript{120} \textit{Garris v. Hanover Ins. Co.}, 630 F.2d 1001, 1003 (4th Cir. 1980); \textit{E&E Hauling, Inc. v. Forest Preserve Dist.}, 613 F.2d 675, 679 (7th Cir. 1980); \textit{Marvel v. Dannemann}, 490 F. Supp. 170, 175-76 (D. Del. 1980).

\textsuperscript{121} \textit{U.S. Const. art. I, § 10}. 
should be so read.\textsuperscript{122}

CONCLUDING COMMENTS

The recent increase in takeover activity has not caused corporate inefficiency; rather, it is the result of corporate inefficiency. Attaching labels to the process, such as "hostile" takeovers or "friendly" mergers merely injects emotion into the inquiry. Such terms are used by entrenched, inefficient management to bolster their case. Those terms do not describe the reality of the situation, that inefficient management is being replaced with efficient management.

The price system acts as a signalling device to the market. In the case of stock prices, a falling stock price sends out a signal to corporate management, shareholders and potential raiders that a company is becoming less efficient. One method of reversing this downward slide into unprofitability and potential corporate demise is to allow others to purchase the company and try to improve its operations. The very thought that a company can be taken over provides existing management with an incentive to increase profitability and act in the shareholders' best interest because failure to do so could result in loss of their jobs. Increasing productivity also has the effect of making the economy more healthy, making workers' jobs more secure and giving consumers better products at lower prices.

Laws that prevent or restrict the ability of outsiders to take over a company impede this healthy process to the detriment of stockholders, workers and consumers. A small group of entrenched managers hiding behind the securities or antitrust laws benefit at the expense of thousands or millions of others. It is time that these laws were changed so that inefficient management cannot be protected at the expense of the majority.

\textsuperscript{122} Epstein, 51 U. Chi. L. Rev. at 750-51.