PRE-OFFER DEFENSIVE MEASURES AGAINST CORPORATE TAKEOVERS UNDER AMERICAN AND PHILIPPINE LAW

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I. INTRODUCTION

It goes without saying that the American business environment is a dynamic as it is unpredictable. Nevertheless, it is largely due to these features that American law in response thereto, has evolved and developed, creating all sorts of legal innovations. One such innovation which has developed quite rapidly is the takeover bid. Introduced in the United States in the mid-sixties, the takeover bid was an English technique for acquiring control in a publicly held corporation.[1] The means by which a takeover bid was then accomplished was through the plain and simple tender offer[2] but since then, American corporations have improved on this and devised several, often complex and ingenious variations on this technique for acquiring corporations. Acting on the premise that it is cheaper to buy than to build and that acquisition are necessary for corporate expansion and diversification, target corporations have been assaulted by "Saturday night specials,"[3] various types of "bear hugs,"[4] and "casual passes."[5] Correspondingly, target corporations have in the spirit of self-preservation defended themselves with techniques such as "sandbag,"[6] "white knight,"[7] and the "shark repellant"[8] provisions.

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1 Yoran, *Advance Defensive Tactics Against Takeover Bids,* 21 Am. J. of Comp. Law 531 (1973).

2 *Id.*

3 A "Saturday Night Special" is an announcement of a tender offer which is effective for a limited period of time. The purpose of this offer is to surprise the target with an offer and pressure him, through time constraints, into accepting. I. M. Lipton & E. Steinberger, *Takeovers & Freezeouts* §1.04(1).

4 The basic "bear hug" is an offer of a specific price made to the target management without a public announcement. The absence of such an announcement will, it is hoped, lessen the pressure on management to decide, and likewise create the impression that the takeover will be "friendly." Another variation of which is the "strong bear hug" consists of an offer with a simultaneous public announcement whereas a "super strong bear hug" consists of the same but with a condition that if there is opposition from the target, the offering price will be decreased. *Id.* §1.04(2)

5 A "casual pass" consists of notifying the target of an interest on the part of the potential bidder to buy the corporation without any specified price buf the intention of initiating friendly negotiations related thereto. *Id.* at §1.04(3).

6 A "sandbag" as the term connotes impedes the completion of the acquisition through dilatory tactics. The target agrees to negotiate but in its negotiation adopts measures to lengthen and/or complicate the negotiation. *Id.* §6.04(5).

7 A "write knight" is an entity which is considered friendly by target management and sought by the target to sell its shares so as to avert the unsolicited takeover attempt. *Id.* at §6.05(5)c.

8 "Shark repellant" provisions refer to the generic term given to defensive charter

No doubt, from the various terminology alone, peculiar and novel as they may sound, the legal hybrid of the corporate takeover has flourished and given rise to a whole sub-branch of corporate law. Consequently, extensive articles and commentaries involving takeovers have been written by American lawyers and legal scholars. Comparative studies have also been published in anticipation that certain of these techniques might take root in countries with similar corporate systems. In a similar vein, and more important because American corporate law has in the past served as a legal matrix for Philippine corporate law,[9] this paper will present a comparative analysis of the pre-offer defensive measures that may be utilized by American and Philippine corporations vis-a-vis their respective legal systems. The first part will consist of identifying some of these pre-offer defensive measures, focusing on the contextual circumstances of the law and the particular takeover situation. Likewise, the question as to the legality of these defensive measures will be looked into with reference to some specific cases. The second part will be devoted to a comparison of these techniques as they may occur within the Philippine legal context. A case decided by the Philippine Supreme Court entitled *Gokongwei v. San Miguel Corporation*[10] involving the legality of a by-law amendment will be analyzed along with its implications relevant to this study. The last part will deal with particuar observations and conclusions derived from the juxtaposition of these two legal systems.

II. PRE-OFFER DEFENSIVE MEASURES UNDER AMERICAN LAW

Corporate takeovers during the majority part of the 1970's and the early 1980's were accomplished mainly through the tender offer.[11] The acquiring corporation (bidder) would "tender an offer"[12] to the shareholders of the target corporation and would immediately or gradually, depending on the target's reaction, acquire control. Because of the high incidence of take-

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and by-law amendments designed to repel and/or discourage unsolicited takeovers. See Gibson, *The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept*, 34 Stan. L. Rev. 775, at 777 (1982); Black and Smith, *Antitakeover Charter Provisions: Defending Self Help for Takeover Targets*, 36 Wash. Lee L. Rev. 699 (1979); Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques* 34 Bus. Law 537 (1979) Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 Bus. Law 1441 (1976); Smith, *Fair Price and Redemption Rights: New Dimensions in Defense Charter Provisions*, 4 Del. J. Comp. L. 1 (1978).

9 Previous to the enactment of the New Corporation Code, the law governing Philippine corporation was the Corporation Law (Republic Act No. 1459) which was drafted in April 1, 1906 to "introduce the American corporation into the Philippine Islands as the standard commercial entity and to hasten the day when the *sociedad anonima* of the Spanish law would be obsolete." *Harden v. Benguet Consolidated Mining Co.*, 50 Phil. 141, at 145-146 (1927). At that time, the Corporation Law consisted of "a codification of American corporate law" and since then, Philippine corporate law developments have been influenced by American law on the matter.

10 89 SCRA (1979). (SCRA refers to Supreme Court Reports Annotated.)

11 A. Fleischer, *Tender Offers: Defenses, Responses, and Planning* at V (1983).

12 Although there is no statutory definition attached to a "tender offer" it may generally be defined to be "a publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale at a specified price." Note, *The Develop-*

overs of this type, potential targets or corporations which felt vulnerable to attack[13] began initiating defensive measures to repel and/or discourage any potential raider. Not unlike adopting a preventive medical program against the corporate takeover disease, these defensive measures were initially addressed to the unsolicited takeover bid and were incorporated into the system via the by law or charter amendment.

The pre-offer defensive measures as they have developed may be classified generally into two categories: a) those designed to entrench the target's management in its present position thereby delaying or otherwise impeding a raider's takeover attempt, and b) those designed to frustrate the second step of a two-step acquisition process thereby discouraging a would be raider from attempting an acquisition[14] The various devices falling under these two categories will be discussed herein below.

A. *Management Entrenchment Provisions*

As mentioned previously, the primary purpose of management entrenchment provisions is to create delay between the time a successful bidder acquires a majority of the target's shares and the time he replaces the majority of the board of directors to effectuate actual control. Under normal circumstances, that is, without these provisions, a successful bidder may easily replace the board directors or alter the composition of the board at the generally provided for annual election of board directors.[15] With these provisions incorporated, it is hoped by the target management that the factor of delay will discourage potential bidders from attempting a takeover. Needless to state, these provisions will be ineffective in cases where the bidder considers the target corporation a prize well worth waiting for.

The most basic provision of this type is the provision providing for a staggered election of the board of directors where a certain percentage, usually one third, of the directors would be elected annually with varying terms of office.[16] Thus, in the typical example where one third of the directors would be elected annually, a successful raider would still have

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ing of "Tender Offer" Under the Securities Exchange Act of 1939, 86 Harv. L. Rev. 1250, 1251 (1973). See also Aranow & Einhorn, *Essential Ingredients of the Cash Tender Invitation*, 27 Bus. Law 415 (1972).

[13] The characteristics of corporations vulnerable to attack were "weak management, widespread stock ownership, including limited management holdings, large blocks of stock in institutional hands, broad geographical shareholder distribution, book or liquidation value higher than market value, and little or no outstanding debt." *Id.* 3-4; see Troubh, *Characteristics of Target Companies*, 32 Bus. Law 1301 (1977).

[14] Hochman & Folger, *supra* note 8, at 537; Freidenberg, *supra* note 8, at 39, 43.

[15] *E.g.*, Cal. Corp. Code §301(a) (West 1977); ABA-ALI Model Bus. Corp. Act Ann. 2d §36 (971 & Supp. 1977).

[16] There may however be statutory restrictions depending on the state of incorporation. *E.g.*, Del. Code Ann. Tit. 8, §141(d) (1979) provides that Delaware corporations may at most classify directors into three classes with each class to be elected once every three years. NY Bus. Corp. Law §704 (McKinney, 1965) provides that New York corporations at most may classify directors into four classes See Lipton & Steinberger, *snpra* note 3, at §6.03 (2)a; Fleischer, *supra* note 11, at 19-26.

to wait for at least two years before acquiring majority control (two thirds majority in this case) of the board.

Aside from the possible effect of delay, it would be worth mentioning that the adoption of this provision is further justified by the argument that the presence of "continuing" directors at any given time stabilizes and cushions the corporation from any abrupt change caused by the newly elected and sometimes inexperienced directors.[17] Presumably the value of prior experience shall keep the corporation in safe waters.

In order to ensure the efficacy of deterrence of the provision, several other provisions have to be adopted in conjunction with it. One such provision would be to provide that directors may be removed only for "cause." Before this may be adopted, the extent to which local statutory provisions would allow for the limitation of the shareholder's right to remove directors would have to be considered.[18] Likewise, because of the absence of an explicit statutory definition as to what would constitute cause which would be a sufficient ground for removal, it has been necessary to augment this provision by subsequently defining "cause." The most stringent definition of cause usually refers to criminal or quasi criminal types of conduct wherein an adjudication or conviction is made by a court of competent jurisdiction.[19] If so adopted, such an amendment could preclude a majority shareholder who has called a special meeting, from putting to shareholder vote the removal of a director on the mere allegation of "cause." With these provisions, the majority shareholder would then have to first undergo the tedious process of litigating the matter of a director's conduct before the courts.

It should be noted however that there are public policy arguments against these provisions defining "cause." There may be instances (as when a director is involved in divulging trade secrets or confidential corporate information) where the cause alleged may be difficult, if not impossible to establish. Moreover, there is the possibility that a director charged with such, may be granted immunity in exchange for vital testimony. These provisions therefore impinge on the shareholder's right to remove a director for cause.[21]

Another alternative provision in line with the classified board would be to require a supermajority vote for removal of a director. Under some state statutes, this is clearly allowed[22] but insofar as Delaware's law is

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17 Hochman & Folger, *supra* note 8, at 538.

18 *E.g.*, Under Delaware's law, shareholders may remove directors with or without cause but in classified boards, removal must be for cause. Del. Code, tit. 8, §141(k) (Mitchie 1978); N.. law allows removal of directors for cause if stated in the articles. N.Y. Bus. Corp. Law §706(6) (McKinney 1978).

19 Smith, *supra* note 8, at 3; Black and Smith, *supra* note 8, at 715.

20 Hochman & Folger, *supra* note 8, at 541.

21 Smith, *supra* note 8, at 4.

22 *E.g.*, N.Y. Bus. Corp. Law §706 (Mckinney 1978); ABA-ALI Model Bus. Corp. Act Ann. 2d §39 (1971 & Supp. 1977).

concerned, it should be noted that its validity has not been decided by the courts. Section 141 (k) provides:

> Any director of the entire board of directors may be removed, with or without cause, by holders of a majority of the shares that are entitled to vote at an election of directors, except .. in the case of a corporation whose board is classified... shareholders may effect such removal only for cause (underscoring supplied).

Arguably, the majority vote requirement could refer to the removal of directors with or without cause in both unclassified and classified boards, in which case a supermajority vote would not be allowed. If, however, the exception of classified boards where removal may be only for cause is to be emphasized, one could equally argue that in such cases, a supermajority vote is implicitly allowed. Still and all, some corporations have adopted it[23] in the hope that even if it be later declared invalid, any potential raider will first have to consider litigating the issue before the courts. Moreover, the primary purpose of creating delay would still be achieved.

Faced with the classified board constraints and a supermajority vote requirement to remove any director, a successful bidder turned majority shareholder (50% or more) may still acquire immediate contro by packing the board with his own representatives; rather, he may cause an amendment increasing the number of directors to be passed, and pursuant to the amendment, he could pack the board and thus acquire immediate control.[24] To prevent this possibility, a charter amendment circumscribing the power to increase the number of directors and likewise the power to fill vacancies has been devised. Typically, such powers, although commonly and previously belonging to shareholders, are reserved by such an amendment solely for the board of directors. A further variation on this type of amendment is to prescribe a limit as to the number of directors a corporation may have[25] which most often corresponds to the present number of the existing board.[26] In addition, it may also be provided that in case of vacancies in the board, particular persons designated in advance by the directors should serve as directors for the remaining term corresponding to such vacancy.[27] The latter provision has not been frequently put to practice though, for the reason that the alternative director/designee may not be suitable from the existing directors' point of view, should the situation arise that they themselves create a new directorship.[28]

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23 Fleischer, *supra* note 11, see Exh. 19, Extract from Proxy Statement of American Fidelity Insurance Co. (March 29, 1975); II Fleischer, *supra* note 11, at 833; Exh. 10 Proxy Statement of Foster Wheeler Corp. (March 18, 1983). II Fleischer, *supra* note 11, at 693.

24 Hochman & Folger, *supra* note 8, at 542; Fleischer, *supra* note 11, at 22.

25 Most state corporate statutes allow for the fixing of the number of directors in the certificate of incorporation. E.g., Del. Code Ann. tit. 8, §141 (b), N.Y. Bus. Corp. Law §702 (Mckinney Supp. 1977); ABA-ALI Model Bus. Corp. Act Ann. 2d §36 (1976).

26 Fleischer, supra note 11, at 23-24.

27 Smith, *supra* note 8, at 4.

28 *Id.*

Other alternative provisions which provide for management continuity operate similarly in that they curtail and/or qualify certain traditional shareholders' rights. Specifically the shareholders' right to call a special meeting, which in this case would probably involve the issue of takeover, is another such right which is affected. A provision eliminating or severely limiting the exercise of such a right is usually included in the target's defense arsenal. The exercise of such right may be qualified however, by allowing special meetings only in cases where there is a demand by a supermajority of the shareholders or in cases where the directors so decide.[29] Likewise, the practice of a corporation allowing written consent by shareholders with regard to their approval of a corporate action is also taken into consideration as a right which should be limited for defensive purposes.[30] A charter provision stating that no action may be taken except in the annual shareholders' meeting or special meeting impliedly prohibits the practice.

It is important to note that the foregoing provisions overlap in terms of the intended effects. The proper choice of which defensive provision to adopt would depend on the particular circumstances of a possible takeover scenario. One rule of thumb, however, would need to be borne in mind, regardless of which provisions are utilized. This is that a supermajority requisite to alter, amend, or repeal any of the foregoing amendments, should accompany said amendments. Otherwise known as lockup amendments, these amendments prevent shareholders who may later acquire a majority from reinstating the original provisions which do not have the defensive character, thereby rendering all the defenses useless. Before this supermajority amendment may be adopted, state corporate statutes have to be looked into. Certain difficulties may arise as to whether these provisions may be allowed as a matter of law. For instance, under Section 109(a) of Delaware's General Corporation Law,[31] charter provisions limiting the shareholder's power to adopt, amend, or repeal by laws are expressly prohibited. To circumvent this rule, it has been suggested that a charter amendment providing that matters normally covered by the corporate by laws (such as the election and duties of corporate officers, the classification of the board, the filling of vacancies, etc.) shall be covered by the certificate or charter of incorporation.[32] Still and all, there exist different problems which are brought about by particular state statutes. It is therefore a matter of adjusting or adopting these provisions to a particular state statute.

Aside from considering the local statutes in implementing this provision, another factor merits consideration and that is the attitude of regulatory authorities towards supermajority provisions. The New York Stock Exchange has an indefinite position on these provisions. Although it had previously allowed the listing of companies which adopted supermajority

[29] Fleischer, *supra* note 11, at 24; Black and Smith, *supra* note 8, at 716-717.
[31] Del. Code tit. 8 §109(a) (Mitchie 1978).
[32] Hochman & Folger, *supra* note 8, at 545.

provisions, it has however gone as far as stating its objections against supermajority provisions which require a specified vote of persons other than the substantial shareholders.[33] Under Wisconsin law, there is a more definite attitude against these provisions as expressed by the Wisconsin Securities Commissioner:

> Such articles and by law provisions, which are ostensibly designed to discourage take-over attempts, serve not only to prevent shareholders from making a choice if and when a takeover occurs, but also to curtail the shareholders' ability to exert any significant influence in the future affairs of the corporation. As a consequence, whatever voting rights the shares carry are significantly limited by the restrictive provision.[34]

This attitude is likewise reflected in the proposed Model Business Code which requires a supermajority vote to adopt a supermajority provision.[35]

B. *Shareholder protection provisions*

A common pattern of takeovers involves the two step acquisition process where a bidder first attempts to acquire a substantial number of shares and then decides to consolidate his position by forcing a squeezeout of the minority shareholders through a merger. Shareholder protection provisions are designed specifically to hinder this second step by prescribing for substantive requirements which a bidder turned substantial shareholder must comply with. In adopting these provisions, the costs of the second step transaction usually increase, not to mention the inherent difficulties in complying with these requirements, thereby discouraging a potential raider from making an attempt.

1. *Basic Supermajority Provision*

The most basic of these provisions is the supermajority provision which requires a supermajority affirmative vote for any second step transaction with an interested shareholder.[36] Although the usual transaction covered by the provision is a merger, other types of business transactions or combinations are also included in its coverage. Similar to the transactions requiring majority shareholder approval as provided by state corporation statutes, these transactions refer to sales, leases, exchanges, distribution, liquidation or disposition of all or substantially all of the property and assets of the corporation, the acquisition of all or sustantially all of another corporation's assets other than in the ordinary course of business, the issuance of securities, etc. The principal difference, in these provisions, aside from the super-

[33] Fleischer, *supra* note 11, at 45-48; See N.Y.S.E. Company Manual at A-30 and A-31 (Aug. 1, 1977) (amended 1983). See also S.E.C. Rel. No. 34-15230 Oct. 13, 1978).

[34] Proposed Revision to Wisconsin Administrative Code Rules of the Commission of Securities (Comment Draft, July 1979). See Fleischer, *supra* note 1, at 15, 16 n. 34; Hochman & Folger, *supra* note at 456.

[35] ABA-ALI Model Bus. Corp. Act Ann. 2d §143.

[36] Fleischer, *supra* note 11, at 26-30; Lipton & Steinberger, *supra* note 3, 6-31 to 6-34.

majority requirement is that they apply to transactions involving an "interested" shareholder which is usually defined to be a 5% or 10% shareholder. It is more often the case, however, that the 5% qualification is utilized in the definition since federal law requires disclosure of stock ownership at the minimum percentage of 5%.[37]

The supermajority percentage required for approval of the second step transaction may either be fixed or floating The fixed percentage requirement often provides for 80% shareholder approval with a 10% shareholder.[38] On the other hand, the floating percentage provides for a gradual scale of required percentages proportionate to the amount of shares held by the interested shareholder.[39] Moreover, there may also be the further qualification that votes of the interested shareholder shall not be counted in determining the required supermajority percentage. This would effectively increase the required supermajority percentage as the "interested" shareholder's ownership increases.

An added feature to provisions of this kind would be to require that, in determining the requisite supermajority percentage in a shareholder election, the percentage be based on the number of outstanding shares entitled to vote and not on those actually cast. With this qualification, abstentions would therefore be counted as negative votes.[40]

As gleaned from its features, these provisions actually entitle minority shareholders to a greater role in determining whether the corporation should adopt a certain action, specifically in this case, the second step transaction. A minority shareholder may easily thwart any attempt simply by not voting in favor of the second step transaction despite the majority's support, and in effect, there may occur a tyranny of the minority. In addition, there may be difficulties encountered by the existing directors if these provisions are applicable without exception. For instance, a board-approved transaction may never get shareholder ratification because of this supermajority requirement, and to be sure, such a requirement may even be as damaging to the welfare of the corporation as a takeover attempt, if proper measures are not taken. To solve this difficulty, escape clauses which provide exceptions are incorporated into this provision. Thus, where a transaction involving a target corporation and its subsidiary is presented for shareholder approval, the supermajority percentage requirement is dispensed with. Likewise, the same would hold true of a board-approved transaction such as a sale to a shareholder considered friendly by management, otherwise known as a white knight.[41] With regard to board approval, it is important to further qualify that such an approval must be by unani-

[37] 15 USC §78 m(d) (1976).
[38] Fleischer, *supra* note 11, at 26.
[39] Hochman & Folger, *supra* note 8, at 549.
[40] *Id.*
[41] See Note 7.

mous or supermajority vote of the directors or to be more stringent, by "continuing directors," which are typically defined to be either directors elected to the board prior to the acquisition of a certain percentage of shares by the interested shareholder or any director subsequently appointed by such directors.[42] The inclusion of this qualification is necessary to preclude the possibility that a successful bidder turned majority shareholder may still be able to pack a board with his representatives and thus easily obtain the necessary votes for board approval. With this requirement of supermajority approval by continuing directors, the successful bidder will have no other option but to wait for the next election.[43]

2. *Fair Price Provision*

As the foregoing supermajority provisions have shown, their principal effect was to frustrate the second step transaction. There still remains a vulnerable area with regard to the treatment of minority shareholders in the event that the raider would be operating or negotiating from a position of strength. More than likely, a raider having obtained a majority through a front end loaded transaction,[44] would squeeze the majority who would then have to accept a lower price for their shares than those that were involved in the tender offer. To assure fair treatment for these minority shareholders, another type of a supermajority provision has been devised to protect the minority shareholders' pecuniary interest. Known as the "fair price" provision, these provisions likewise tie in the requisite supermajority vote[45] for transactions involving any substantial shareholder[46] with the distinctive exception that should certain conditions relating to the price of shares be met, the normal majority requisite for approval would operate. The conditions referred to require that a substantial shareholder offer the minority shareholders targeted to be squeezed out a price equal to or greater than the highest of:

1) a price which reflects the same percentage premium (based on the target's stock price immediately prior to the announcement of the second step transaction) as the initial offer (based on the target's stock price immediately prior to the commencement of the initial offer);

2) the highest price paid by the offerer for any of the target's shares during the offer; or

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42 Hochman & Folger, *supra* note 8 at 551-552.

43 *Id.*

44 A "front end loaded" transaction consists of an offer where the preliminary price in the tender offer is substantially higher than the price offered at the second step acquisition. Fleischer, *supra* note 11, at 435-436.

45 The requisite percentage varied from 66% to as high as 95%. *Id.* at 30.

46 Under this provision, a substantial shareholder is typically defined to be an entity owning directly or indirectly, 20% to 30% of the target's shares. *Id.*

3) an amount equal to the target's average earnings per share over the preceding four fiscal quarters multiplied by the offerer's price/earning ratio.[47]

As shown above. these provisions assure the minority shareholders that they will receive a "fair" price and therefore need not tender for fear of an unfair freezeout. In certain instances, as when the increase of the stock's market price has incorporated the tender offer premium into its price and has remained at that level, the minority shareholder may even receive a double premium.[48] The second alternative's apparent purpose is to guarantee that they will receive nothing less than the premium price paid to the tendering shareholders while the third alternatives assures the minority shareholder that the stock's price will reflect the benefit realized by the offerer as a result of the freezeout, by the use of such formula.[49]

For further protection, it has been suggested that the offerer be required to add a premium to the fair price obtained under the formula, the premium which is to be tacked on to a specified percentage (i.e., 50%) of "the highest consolidated balance of domestic and foreign cash, cash equivalents, and marketable securities" held by the target during a specified period. Such a requirement would in effect allow the minority shareholder to participate in a partial liquidation of the target's assets.[50]

Other conditions relating to the fair price provision may also be imposed vis-a-vis the substantial shareholder. Among these are a) disallowing the offeror from engaging in any transaction with the target,[51] b) prohibiting any reduction in the rate of dividends (except under specified circumstances), c) prohibiting any further acquisition of shares by the substantial shareholder/offeror except as part of its initial acquisition, d) requiring that the target's board at all times be represented by continuing directors in proportion to the shares belonging to the minority disinterested shareholders, e) prohibiting any change in the target's capital structure, f) requiring that the public shareholders be notified through a proxy statement of all the relevant information including a recommendation by the continuing directors and/or an opinion of a reputable banking firm as to the soundness or fairness of the proposed transactions.[52]

The assurance offered by the fair price provision, that the minority shareholders will receive at least the same price as those who had tendered their shares, should they be subsequently squeezed out, effectively reduces

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[47] Hochman & Folger, *supra* note 11, at 554; Smith, *supra* note 8, at 13-22; Fleischer, *supra* note 11, at 30. For examples of this provision, see II Fleischer, *id.* at 693, 893, & 839.

[48] Smith, *supra* note 8at 14-16.

[49] *Id.* at 17.

[50] *Id.*

[51] *E.g.*, the offeror may not avail, indirectly or directly, of any loan, advance, guarantees, pledges, or other financial assistance from the target *Id.*

[52] Fleischer, *supra* note 11, at 33.

pressure to tender when the offer is announced. In fact, these provisions have even induced shareholders to hold on to their shares in the hope that they may later obtain a better price once the raider obtains control. The case of Chicago Pneumatic Corporation is illustrative of this. It had informed its shareholders, after learning that another company had acquired 5% interest, that those who would hold out their shares might be able to obtain a better price at a later time.[53]

More important, however, these provisions prevent a bidder from obtaining a target corporation at a bargain price, to the prejudice of minority shareholders who have held out. Consequently, the raider will have to be financially capable; needless to state, financially weak bidders will effectively be discouraged by these provisions.

As in the traditional supermajority provisions, the fair price provisions encounter several difficulties. It is argued that directors should not be prevented from engineering the completion of a second step transaction by these provisions, especially when it is purportedly to be in the best interests of the target corporation. To remedy this, an escape clause has been devised, not unlike the one provided for by the traditional supermajority provision, which provides that if a merger is approved by a certain fixed percentage of the board consisting of a designated number of continuing directors then the supermajority requisite should be waived.[54] One commentator has pointed out however that this particular proviso allowing for a waiver is precisely the situation which the fair price provision seeks to provide protection against. It is argued that this exception may be subject to abuse, such as in the case when the incumbent management decides to "sell out" the corporation.[55] In any event, the adoption of such an escape clause should be carefully considered, weighing the advantages and potential disadvantages. It would not be amiss to state, however, that should such a clause be adopted, the fiduciary standard of duty of directors is assumed, particularly with respect to the continuing directors.

Another related problem arises with regard to the actual adoption of such a provision. Specifically, if a company already has incorporated the traditional supermajority provisions, the question arises as to whether this fair price provision constitutes an amendment of the supermajority provisions so as to require a supermajority vote for approval. In order to circumvent the supermajority requirement, it has been suggested, perhaps facetiously, that the new fair price provision be viewed as an addition and therefore separate from the previously adopted supermajority provision.[56] This would apparently subject the fair price provision to only a majority

[53] Hochman & Folger, *supra* note 8, at 555.
[54] Fleischer, *supra* note 11, at 29.
[55] Smith, *supra* note 8, at 13.
[56] Smith, *supra* note 8, at 21; Hochman & Folger, *supra* note, at 555.

approval. Whether such reasoning can withstand judicial scrutiny has not however been determined by the courts.

3. *Right of Redemption Provision*

The supermajority provision demonstrated itself to be a fertile area from which defensive measures may be formulated. Several variations and refinements have been devised, the most recent and extended example being the right of redemption provision. Unlike the fair price provision which in a way encourages tender offers for any and all shares, the right of redemption provision clearly discourages an offeror from making a tender offer for less than all of the outstanding shares of the target corporations by making it mandatory that the offer extend to 100% of the target's outstanding shares.[57] Utilized by the Rubbermaid Corporation in 1978,[58] this provision provides that if any entity owning 50% or more of the outstanding common shares acquires shareholders shall be entitled to have their common shares redeemed by the corporation for a specified period of time (usually within 30-45 days) at a price equal to the greatest of:

a) book value per share;

b) the highest price paid by the 50% owner for any shares acquired pursuant to the tender offer or in market and privately negotiated transactions; or

c) the highest negotiated market price at which the target stock was traded within the last 18 months from the date of notice of redemption.[59]

The similarity between the fair price and the right of redemption provision is obvious; the minority shareholders receive no less than the tendering shareholders. In the last alternative, it is important to note that the 18 month period is provided in recognition of the fact that the right of redemption may accrue several years after the tender offer and that at such time the tender offer may not reflect the value of the share in question.[60]

In addition, it is also provided that upon acquisition of 50% of the target's outstanding shares by a single shareholder, the corporation shall notify the shareholders that their right of redemption has ripened under the provision. In the event that the corporation fails to notify the shareholders or make the required payment of the shares, the provisions grant the shareholders the right to initiate the appropriate legal action.[61] In real terms, this grant is not substantial in that even without such a grant, any shareholder may still bring an action on the basis of a breach of contract.

57 Smith, *supra* note 8, at 22-23.
58 II Fleischer, *supra* note 11, at 707.
59 Smith, *supra* note 8, at 24; Fleischer, *supra* note 11, at 30-35.
60 Smith *supra* note 8 at 24.
61 Fleischer, *supra* note 8, at 38.

The more important consideration, however, would be as to what appropriate remedy would be prayed for.

Ostensibly, these provisions create a number of questionable legal effects. Foremost is the question as to the ability of a corporation to redeem shares. As most statutes provide, a redemption of shares is subject to capital requirements (i.e., no redemption is allowed if it would impair the capital of the corporation).[62] And in cases where no such prohibition exists, there is the problem of the fiduciary duty of the directors should they decide to liquidate assets or reduce capital to create surplus.[63] Likewise there is the question as to whether redemption would be applicable to common shares since redemption privileges are usually made applicable to preferred shares. In evaluating the feasibility of these provisions, the state corporate statutes will have to be looked into.

C. *Other Pre-offer defensive measures*

There are other defensive measures which fall within the periphery of the two previous classifications but were not included because of their peculiar characteristics. Nevertheless, they merit discussion as provided for below.

1. *Dilution of Bidder's Stock*

Considered to be a potent defensive measure, stock issuances and their subsequent transfer to "friendly" parties[63] are designed primarily to dilute a raider's stock ownership interest. It must be borne in mind however that such a stock issuance would necessarily presume an availability of common shares which may be issued as authorized by the shareholders. If there are no available shares for sale or transfer, as in the case where the target's capitalizaiton is adequate, a charter amendment to increase the number of shares and to authorize the board to issue such shares at its discretion would be in order. Aside from the potential defensive attributes thereto, the advisability of adopting such an amendment is apparent, particularly when one considers the financial matters often require speedy resolution.[64] The only difficulty would be that such a power may be subject to abuse.

The dilution of the raider's stock ownership will adversely affect his tender offer in that the raider will have to buy a larger block of shares. Barring the possibility that the issuance proportionately depresses the market price of the target's shares, the cost of acquiring control will be substantially increased. A financially unstable bidder will then have to think twice before

62 *Id.*

63 *E.g.*, sales to allies or placement in an Employee Stock Option Plan are considered to be sales to friendly parties. Employees are unlikely to sell to unknown buyers. Freidenberg, *Jaws III: The Impropriety of Shark Repellant Amendments as a Takeover Defense*, 7 Del. J. Comp L. 32, at 37 (1982).

64 *Id.*

making a takeover attempt; a financially strong and patient raider shall not be so easily deterred.

A variation on the stock issuance defensive measure involves a charter amendment authorizing the creation of a new class of preferred stock; the terms, conditions, and issuance of which would be left entirely to the discretion of the board of directors. The availability of a "blank check" preferred stock would enable a target, upon the information of a takeover attempt, to issue such shares to a "friendly" party with disproportionate voting rights or with class voting rights on issues such as mergers or similar transactions, or even election of a specific number of directors.[65] This variation does not effectively dilute the raider's path for control of the target. To acquire effective control, the raider must concentrate on acquiring the preferred shares or litigate on the validity of such provision.

2. *Consideration of Social and Economic Effects Provisions*

Another type of defensive measure is the provision which authorizes the board to consider certain non-financial factors in its evaluation of a tender offer. Under Rule 14e-2[66] as promulgated under section 19(e) of the Securities and Exchange Act of 1934,[67] the target management upon learning of a tender offer, must within 10 business days from the commencement of the offer, notify the shareholders of its position[68] regarding the tender offer and disclose to the shareholders the reasons for its position. The adoption of this provision would allow the directors to evaluate the social and economic effects on the corporation's employees, suppliers, customers, and community in which it operates, and on the basis thereof, defensive actions and even rejections of tender offers may be justified.[69] Likewise, such an amendment may provide a good defense for management should a shareholder decide to sue the board for rejecting a bid.[70]

3. *Regulatory Considerations*

A target's acquisition of a business which is subject to governmental regulation may also serve as a repellant against takeovers. If a target acquires a business involving a radio and/or television station, an insurance company, domestic air carriers, defense facilities, or public utilities, or rather one which would require a license to operate, then per the regulatory pattern, a change in the control of the target corporation would be subject to review and regulatory approval. As such, the possibility that a license may be

[65] Hochman & Folger, *supra* note 8, at 547.
[66] 17 C.F.R. §240.14c-2 (1980).
[67] 15 U.S.C. §78n(e) (1976).
[68] The management may either a) recommend acceptance or rejection of the offer; b) express its neutrality; or c) notify the shareholders that it is unable to take a position. Fleischer, *supra* note 11, at 149.
[69] *Id.* at 39.
[70] *Id.* at 40.

revoked or the acquisition disapproved might constitute a deterrent.[71] More important, there is the other consideration of time which has to be taken into account; because of the period required for regulatory investigation and/or approval, the actual transfer of control may be somewhat delayed. The factor of delay, vis-a-vis the bidder's intention to immediately implement new corporate policy may in fact determine whether a bidder will make an attempt or not. Underlying the target's acquisition, it must be emphasized that such must be based on a legitimate business purpose. Otherwise, shareholder suits which may be meritorious will be forthcoming.[72] As a final note, if an acquisition is attempted by a foreign raider, additional restrictions may have to be contended with such as statutory restrictions of foreign equity participation with respect to particular businesses. If the compliance thereof will be difficult, if not impossible, it will definitely prevent any takeover attempt by a foreign corporation.[73]

4. *Availing of Antitrust Laws*

Another defensive measure which takes into account similar considerations as the previous provision involves an acquisition of a business or adoption of plans to expand into new geographic markets that in effect would create an antitrust impediment for a particular raider As in the previous tactic, there must be information as to the identity of the potential raider. If the raider is particularly associated with a business, then the acquisition by a target of a competing or related industry might be sufficient to deter that particular raider. As in the previous provision, it must be emphasized that the acquisition should also be based on a legitimate business purpose.[74]

D. *Validity of Pre-offer Defensive Measures*

1. *Extrinsic and Intrinsic Validity*

In an effort to remove these defensive obstacles, target shareholders and raiders have attacked their validity by bringing suit against corporate management. Suits of this nature usually consist of allegations of procedural infirmities in the adoption of these measures and/or substantive irregularities

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[71] Hochman & Folger, *supra* note 8, 558; Lipton and Steinberger, *supra* note 3, at 6-42 to 6-43.

[72] Fleischer, *supra* note 11, at 57.

[73] *E.g.*, the Federal Communications Act, 47 U.S.C. §1301 (13), 1371 which prohibits the granting of a broadcast license to a) any alien; b) foreign company; c) a company whose officers or directors are aliens or where more than 20% of the capital stock is owned by or voted by aliens or their representatives; or d) a company which is directly or indirectly controlled by any other company whose officers are aliens or where 25% of its capital stock is owned or voted by aliens or their representatives. See also The Federal Aviation Act, 49 U.S.C. §1301(13), 1371; The Merchant Marine Act, 46 U.S.C. §802, 883, 883-1; The Edge Act 12 U.S.C. §619, 1841.

[74] The question as to the purpose of such an acquisition may serve as basis for a shareholder suit as in the case of *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168. (N.D. Ill 1980), aff'd. 686 F2d 271 (7th Cir. 1981), cert. denied 102 S. Ct. 658 (1981).

in the measure itself. In resolving the issue of validity, American courts have therefore focused on two aspects, namely the extrinsic validity, i.e., whether or not federal and state procedural rules were complied with, and the intrinsic validity, i.e., whether or not the measure itself is authorized by the enabling provisions of the state's corporate law and/or whether or not the measure is reasonable vis-a-vis the particular circumstances of the takeover situation.

The procedural rules determining the extrinsic validity of a provision basically refer to the SEC disclosure obligations and the shareholder ratification requisite as provided for by the target's corporate charter. Inasmuch as the majority of the charter and by-law emendments often require shareholder approval,[75] the SEC proxy rules, in particular Sec. 14 of the Securities Act of 1934[76] come into operation. In addition, the SEC has formulated guidelines[77] for the required disclosures in anti-takeover proposals for the purpose of assuring the shareholders that sufficient information will be available for their perusal. Accordingly, the proxy materials must disclose, among others, the nature of the anti-takeover provision, the reasons for its adoption, the advantages and disadvantages to both the shareholder and the incumbent management, the mechanics of its operation, and its overall effects.[78] In short, these disclosure obligations are designed to afford the shareholder adequate information to make the correct choice on the matter.

Notwithstanding these detailed disclosure obligations, one commentator[79] has raised the issue as to whether the disclosure of the target corporation's reasons for the adoption of an amendment should necessarily include disclosure of managerial self-interest and job entrenchment, or in other words, its "real" motive. The court in the case of *Elgin National Industries v. Chemetron Corp.*[80] posited the view that explicit disclosure was not necessary in view of the obviousness of such motive as reflected in the proxy statement. In that case, plaintiff alleged that the proxy statement had failed to allege that the general effect of the proposed amendment for a staggered board of directors and supermajority provision was "to entrench and per-

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[75] For charter amendments, e.g., ABA-ALI Model Bus. Corp. Act Ann. 2d §59(c); Del. Code Ann. tit. 8, §242(c) (1) (Mitchie 1978) N.Y. Bus. Corp. Law §803a (Mckinney 1978).

By law amendments on the other hand do not always require shareholder approval. E.g., ABA-ALI Model Bus. Corp. Act Ann. 2d §27 (1971) which grants the power to amend by laws to directors unless otherwise provided in the charter. Other states confer such power solely on the shareholders unless the charter provides that directors shall also exercise such power but in no case shall the shareholders' right to amend be limited. E.g., Del. Code Ann. tit. 8, §109(a) (Supp. 1980); N.Y. Bus. Corp. Law §601 (a) (Mckinney Supp. 1980).

[76] 15 U.S.C. §78n (a) (1976); Particularly relevant is Rule 14a-9, §14(a)-9, 17 CFR §240 14-a-9 (1980) which prohibits false or misleading statements.

[77] Securities Exchange Act Rep. No. 15230, (1978 Transfer Binder) Fed. Sec. L. Rep. (CCH) 718, 747 (Oct. 13, 1978).

[78] *Id.* See Fleischer, *supra* note 11, at 47-51.

[79] Freidenberg, *supra* note 63, at 52.

[80] 299 F. Supp. 367 (D. Del. 1969).

petuate management's control of Chemetron,"[81] as opposed to the actual statement which stated that the general effect of said amendment was "to make it difficult for a potential acquirer to obtain control of the Board of Directors."[82] The court held:

> "In the absence of some intended act or wrongdoing by candidates who seek reelection there appears to be no reason why the stockholders should be advised that the proposed amendment may tend to facilitate management perpetuating itself in control.[83]

Other cases support this analysis and rightly so.[84] The arguments offered may be analogized to the classic question which asks: which is the correct description of a glass containing water? Is it half full or half empty? Needless to say, both description are obvious and complementary. The nondisclosure of motive therefore may not be so hidden after all.

Be that as it may, the American courts have been consistent in their treatment of "motive." Once the procedural requisites of disclosure and ratification are met, it would be very difficult to successfully question the extrinsic validity of any defensive measure, much less the motive behind such measure. The case of *Stockholders Committee for Better Management of Erie Technological Producers, Inc. v. Erie Technological Products, Inc.*[85] supports this view explicitly. In this case, a by-law amendment creating a staggered board of three classes was adopted which effectively precluded a minority shareholder from electing one member. Because the majority of the stocks were owned by people affiliated with management and management personnel, the amendment was ratified. Despite the amendment's purpose of preventing the minority from electing a director, the court held that "the purpose or motives are immaterial because even where a director's motive is suspect, the approval of his action by a majority of the shareholders removes this possible objection."[86]

Notwithstanding possible inherent infirmities in a defensive measure, it appears that the court would rather emphasize the factor of shareholder ratification in determining the validity of an amendment. This view has been adopted by other courts, particularly in the case of *Seibert v. Milton Bradley Co.*,[87] where the Supreme Judicial Court of Massachussetts rejected the plaintiff's contention that the supermajority provision was unlawful in restricting the shareholder's right to vote because the shareholders had

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[81] *Id.* at 372.
[82] *Id.*
[83] *Id.* at 373.
[84] *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221 (SDNY 1975); *Stedman v. Stores*, 308 F Supp. 881, 887 (SDNY 1969); *Selk v. St. Paul Ammonia Prods., Inc.* 597 F. 2d (8th Cir. 1979).
[85] 248 F. Supp. 380 (1965).
[86] *Id.* at 389.
[87] Slip. Op. Civ. No. 77-464 (Mass. Super. Jan. 31, 1979), *aff'd.* 405 N.E. 2d 131 (Mass. 1980).

themselves ratified the provision and therefore could just as well repeal it if they wanted to.[88]

2. *Textual Analysis*

In determining the intrinsic validity of defensive measures, most American courts, in particular the Delaware and Massachusetts courts, have resorted to a textual analysis in determining the validity of a particular provision. This mode of analysis involves an examination of the language of a statute vis-a-vis the challenged provision. Although criticisms have been raised against this method,[89] these courts have thus far utilized this singular mode. The cases illustrating this mode of analysis wherein a defensive measure is challenged have been sparse. Nevertheless, it would be worthwhile to discuss them, if only for the purpose of illustrating how conveniently such an analysis operates.

In the case of *Seibert v. Gulton Industries, Inc.*,[90] the defendants adopted a supermajority provision that required an 80 percent shareholder approval in order to consummate a merger with a 5% shareholder approval unless the directors had approved of the transaction prior to the acquisition of the 5% interest by said shareholder. Seibert questioned the provision, arguing that it was violative of Section 102(b)(4)[91] of the Delaware statute in that it created a dual voting standard or "shifting vote" was not expressly authorized by Section 102(b)(4), which allows adoption of the supermajority provision. Moreover, it was argued that the practical effect of such a provision conferred upon the directors the power to determine the percentage requirement for approval, thereby impinging upon the shareholder's right to vote. The Delaware court upheld the validity of said provision however; utilizing the textual mode of analysis, the court examined the language of Section 102(b)(4) which provides:

> §102. Contents of certificate of incorporation
> x x x
> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
> x x x
> (4) Provisions requiring for any corporate action the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power, or a larger number of directors, than is required of this chapter, x x x[92]

[88] *Id.*, Slip. Op. at 4.

[89] Gibson, *supra* note 8, at 808, where it is argued that such an approach while useful in evaluating other questions of corporate law, may not be applicable in corporate control issues because of the conflict of interest problem.

[90] Civ. Action No. 5631 (Del. Ch. June 21, 1979), *aff'd.* 414 A.2d 822 (Del. 1980). This case involves the same plaintiff in the *Bradley* case with the Massachusetts court relying on the Delaware court's reasoning.

[91] Del. Code Ann. tit. 8, §102(b) (4) (1975).

[92] *Id.*

Focusing on the phrase "any corporate action" the court concluded that the supermajority provision requiring different percentage fell within that classification; the percentage approval was just determined by the matter subject to vote and in this case, two situations were contemplated upon: a merger with as 5% shareholder which was approved by the board and the same merger which was opposed by the board.[93] In addition, the court found nothing in the provision to be violative of statutory or common law of public policy,[94] and as such, it was therefore valid.

Another case which illustrates this textual mode of analysis is the case of *Providence & Worcester Co v. Baker*[95] which involves a "scale voting" provision apportioning a shareholder's voting power according to the size of his or her stockholdings. The apportionment provided that for the first fifty shares, a shareholder would be entitled to one vote, and for every twenty shares above fifty, such would likewise be equivalent to one vote; however, the shareholder could not vote for more than one fourth of the total number of shares issued and outstanding unless as a proxy for other shareholders. Consequently, with this system, a shareholder would never be able to exercise a controlling vote regardless of the number of shares owned.

Plaintiff contended that the "scale voting" provision violated Section 212(a) of the General Corporation Law[96] which imposes a one vote per share requirement unless otherwise provided in the certificate of incorporation. According to the plaintiff, such a requirement implies that all shares in the same class must have the same voting rights and as such, the provision was illegal because it altered the voting rights of large shareholders. The court was of a different view, however, and focused their textual analysis on the exception of "unless otherwise provided in the certificate of incorporation," stating that it was therefore permissible to alter the one vote per share requirement. The court in its reasoning in effect made a dichotomy between the holder of the stock and itself; rather the restrictions of the scaled voting provision attached to the holder of the stock and not to the stock.[97] Insofar as the stock was concerned each share still possessed identical voting rights. Thus, despite the detrimental effect of such a provision on large shareholders, it was still held to be valid.

3. *Business Judgment Rule*

As shown by these two cases, the courts relied principally on an examination of the enabling provisions and proceeded to analyze the validity of the questioned provision on that basis. To be sure, such a method does

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[93] *Gulton*, Slip, op. at 7.

[94] Although public policy does go beyond textual analysis, it was a subsidiary importance in the court's analysis *Id.*

[95] 378 A.2d 121 (Del. 1977).

[96] Del. Code Ann. tit. 8, §212(a) (1974).

[97] *Providence & Worcester*, at 123.

not take into consideration other factors such as the overall effect of a provision vis-a-vis the corporate structure which allocates the rights and duties of shareholders and directors. In other words, the "wider" picture is virtually ignored.[98] Notwithstanding, it may be important to note that in adopting such a mode, the court presumes that directors exercise good faith in their business judgment, i.e., they are acting in accordance with what they believe to be in the best interests of the corporation and all of its stockholders. Such an assumption, as a matter of fact, is even built into most corporation statutes which provide that the business and affairs of corporations "shall be managed by or under the direction of a board of directors."[99] When applied to the unsolicited takeover situation, this assumption may not necessarily hold true in that in such a situation, the directors are burdened with a conflict in interests In deciding whether or not to oppose an unsolicited takeover bid, the directors are torn between their personal interest in maintaining their present positions and their fiduciary duty to the shareholders and the corporation. Thus, this conflict of interests problem is particularly relevant to the propriety and reasonableness of a particular defensive measure vis-a-vis the contextual circumstances of a takeover situation

Albeit the apparent conflict of interest, courts have been inclined to utilize the previously mentioned business judgment rule in their analysis of corporate conduct. As held in the case of *Panter v. Marshall Field & Co.*,[100] the business judgment rule provides that directors in exercising their fiduciary duties to the corporation —

> "enjoy a presumption of sound business judgment, reposed in them as directors which courts will not disturb if any rational business judgment can be attributed to their decision. In the absence of fraud, bad faith, gross over-reaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors."[101]

In this case, a stockholder brought an action questioning management's decision in rejecting a takeover bid and the defensive measures adopted. Management undertook to acquire property which would create antitrust problems for the potential bidder. The court supported the view that dircetors cannot be held to have breached their fiduciary duties when they reject a takeover bid if such decision is based on a full consideration of interests affected by such a proposal and likewise legal advice from an outside counsel. As to the propriety of the acquisition, the court applied the business judgment rule and upheld the validity thereof.

A further refinement of this rule was formulated in the case of *Johnson v. Trueblood*.[102] In this case, plaintiffs had argued that all that

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[98] In terms of balancing the interests of majority shareholders, minority shareholders and directors vis-a-vis the corporate structure, the textual analysis is inadequate.

[99] Del. Code Ann. tit. 8, §141 (1981).

[100] 486 F. Supp. 1168 (N.D. Ill. 1980), *aff'd.* 646 F. 2d 271 (7th Cir. 1981), Cert. denied 454 U.S. 1092 (1981).

[101] *Panter v. Marshal Field & Co.*, 646 F. Supp. 1168, at 1194.

[102] 629 F. 2d 287 (3rd Cir. 1980), *cert. denied* 450 U.S. 999 (1981).

was necessary to rebut the good faith presumption of the business judgment rule was to prove that retention of control was one of the motives for opposing a takeover bid, and not necessarily the primary motive. The Third Circuit Court disagreed and refined the rule particularly with regards to takeover situations. The Third Circuit Court applied the "primary purpose" test which provides that the business judgment rule may only be rebutted by a showing that the director's sole or primary purpose in opposing the takeover was retention of control. In the language of the court, it was held that the plaintiff

> "at a minimum... must make a showing that the sale or primary motive of the defendant (director) was to retain control. If (plaintiff) makes (such) a showing..., the burden then shifts to the defendant (director) to show that the transaction in question had a valid coporate business purpose."[103]

The court took cognizance of the fact that retention of control was always one consideration which directors took into account when acting on business questions which need not necessarily be confined to control situations. If the good faith presumption would be permitted to be overcome by the mere showing that retention of control was one of the motives, the business judgment rule would be destroyed and rendered useless.[104]

In terms of an explicit judicial pronouncement that held the business judgment rule to be applicable to the determination of whether a takeover is detrimental to the target, the case of *Treadway Companies, Inc. v. Care Corporation*[105] is a case in pont. In this case, the target adopted the defensive measures of selling a substantial block of its stock to a "white knight," Fair Lanes, Inc. The Second Circuit Court ruled that before the business judgment rule may be rebutted, the party challenging a defensive transaction must prove that the target director "acted in bad faith or in furtherance of their own interests, or for some other proper purpose."[105] If a proper corporate purpose is shown, the directors are protected and need not even prove that the terms of transaction were fair.

The very recent case of *Moran v. Household International, Inc.*[107] has utilized the business judgment rule in consonance with the present judicial trend.[108] In this case, an innovative defensive measure known as the "poison pill preferred" was adopted by the target management. The particular features of this defensive tactic involved the creation and subsequent issuance of preferred shares to the existing shareholders upon the occurrence of "certain triggering events." In essence, these events referred to situations where a person would acquire, indirectly or directly, the con-

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[103] *Id.* at 293.

[104] *Id.* at 292-293.

[105] 638 F.2d 357 (2nd Cir.), *rehearing denied* CCH Fed. Sec. L. Rep. 97, 705 (2nd Cir. 1980).

[107] Civ. Action No. 7730 (De. Ch. Jan. 29, 1985).

[108] For recent cases, see *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982), *aff'd mem.*, Nos. 82-1305 & 82-1307 (7th Civ. Mar. 5, 1982); *Warner Com-*

trol of at least 20% of Household's common shares or would make a tender offer or exchange offer for 30% of Household's outstanding stock. The issuance and exchange of the preferred stock was available only to the then existing common shareholders who were granted "rights" to purchase this new series of shares. The more deadly feature of this plan however involves a "flip over" of the right to acquire preferred shares in the event that "a merger or consolidation occurs under the terms of which Household's common shares are exchanged for securities of the acquiror." In such an event, the holder is entitled to purchase "common stock of the acquiror at a price reflecting a market value of twice the exercise price of the right"[109] or rather he may purchase the acquiror's stock for half its value (e.g., $200 worth of the acquiror's common for $100).

The Delaware Chancery Court upheld the plan, applying to it the business judgment rule. Morevoer, it acknowledged the "realities of the business world," quoting Chief Judge Seitz in the Johnson case as follows:

> "It is frequently said that directors are fiduciaries. Although this statement is true in some senses, it is also obvious that if directors were held to the same standard as ordinary fiduciaries the corporation could not conduct business. For example, an ordinary fiduciary may not have the slightest conflict of interest in any transaction he undertakes on behalf of the trust. Yet by the very nature of corporate life a director has a certain amount of self interest in everything he does. The very fact that the director wants to enhance corporate profits is in part attributable to his desire to keep shareholders satisfied so that they will not oust him."[110]

More important, the Delaware Chancery Court explicitly stated in the decision:

> "While the plan indirectly limits the alienation of shares and the conduct of proxy contest, those features are sustainable, within the parameters if the business judgment rule, as necessary to protect the corporation from the coercive nature of certain partial tender offers."[111]

The business judgment rule as applied by American courts today has evolved into a formidable rule and ally for target management. Because of the good faith presumption, directors are accorded substantial leeway in their determination as to whether or not to oppose a takeover. Along these lines, the court in *Panter* has even gone as far as stating:

> "Having so decided in good faith, with rational business purposes attributable to their decision, defendants had not only the right but the duty to resist by all lawful means persons whose attempts to win control of the corporation, if successful, would harm the corporate enterprise.[112]

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munications v. Murdock D. Del, 581 F. Supp. (1984) where the primary purpose standard was applied.

[109] *Household* Slip Op. at 8.

[110] *Id. Slip* Op. at 31-32 (quoting Johnson at 292).

[111] *Id.* Slip Op. at 54.

[112] *Panter,* 486 F. Supp. 1168, 1195 (N.D. Ill. 1980).

The court's recognition of this duty to approve a potentially harmful tender offer therefore clearly delineates the raider's difficulty in questioning the motive of target management's adoption of defensive measures.

III. PRE-OFFER DEFENSVE MEASURE UNDER PHLIPPINE LAW.

In comparison with the developments in takeover and defensive techniques as well as the corresponding relevant rules, the Philippine state of art is not very advanced. This is not to imply that there exists no activity of this nature; on the contrary, there have been well publicized proxy control battles in the past years. The principal difference is that takeover actions in the Philippines do not occur as frequently as in the United States. Likewise, the level of business activity which bears a direct relation with takeover bids has somewhat been reduced by recent political developments.[113] Notwithstanding; takeovers are likely to occur in the Philippines due to the present trend established by American business. It is in this light and perhaps expectation that the following analysis proceeds.

Philippine Corporation Code Considerations

The defensive techniques discussed in the foregoing section were as complex and imaginative as their counterparts in takeover techniques. The defensive measures formulated had to comply with and consider the state corporation statutes as well, and the complexity of these measures may be partly due to these rules. Under Philippine law, the type of defensive measure would depend on the New Corporation Code.[114] The New Corporation Code had, like its predecessor the Corporation Law,[115] "borrowed" some of its features from some American state statutes but then again because of the unique combination of its provisions, it may be considered unique and different from other state corporation statutes Reference will constantly be made to its provisions to determine the viability and validity of the defensive measures discussed below.

A. *Management Entrenchment Provision*

The first type of defensive measure which was dealt with in the foregoing section was the management entrenchment provision. The most basic of this type was the provision providing of a staggered board of directors. Under the Corporation Code, there exists no specific provision which deals with classified boards. The only relevant provision in Sec. 23 of Title III which provides:

> "SEC. 23. The Board of Directors or Trustees. Unless otherwise provided in this Code, the corporate powers of all corporations formed

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[113] Due to the recent political developments, particularly the assassination of opposition leader Benigno Aquino, Philippine economy has been adversely affected. N.Y. Times, Oct. 11, 1983, at IV, 1, Col. 3.

[114] Batas Pambansa Blg. 68 (1980).

[115] Republic Act No. 1459 (1966).

> under this Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors of trustees to be elected from among the holders of stocks, or where there is no stock, from among the members of the corporation, who shall hold office of one (1) year and until their successors are elected and qualified."

Thus, it is provided that directors shall hold office for one year and until their successors are elected and qualified. The fact that the tenor of the statement is mandatory would seem to imply that directors are limited to one year terms. This interpretation is further supported by Section 47(7) which enumerates the contents that may be included in the by laws, one of which may include "the manner of election or appointment and the term of office and all officers *other than directors or trustees.*"[116] (emphasis supplied) This therefore implies that the terms of office of directors may not be altered since as provided for by Sec. 23, they are allowed only one year terms. Consequently, on the basis of this textual analysis, a staggered board provision would not be feasible because such a provision necessarily contemplates the allowance of fixing variable terms of office for each class of directors (typically it would be provided that a set of three directors would hold office for three years, the next set for two years, and the last for one year).

Another management entrenchment provision ancilliary to the staggered board provision is a provision permitting removal of directors but only for cause. Under the Philippine Corporation Code, such a provision would not be feasible in view of Section 28[117] which provides for removal with

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[116] Section 47 reads:

> SEC. 47. Contents of by-laws. — Subject to the provisions of the Constitution, the Code, other special laws, and the articles of incorporation, a private corporation may provide in its by-laws for:
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> 1. The time, place and manner of calling and conducting regular or special meetings of the directors or trustees;
>
> 2. The time and manner of calling and conducting regular or special meetings of the stockholders or members;
>
> 3. The required quorum in meetings of stockholders or members and the manner of voting therein;
>
> 4. The form for provies of stockholders and members and the manner of voting them;
>
> 5. The qualifications, duties and compensation of directors or trustees, officers and employees;
>
> 6. The time for holding the annual election of directors or trustees and the mode or manner of giving notice thereof;
>
> 7. The manner of election or appointment and the term of office of all officers *other than director or trustees;* (Italics supplied).
>
> 8. The penalties for violation of the by-laws;
>
> 9. In the case of stock corporations, the manner of issuing stock certificates; and
>
> 10. Such other matters as may be necessary for the proper or convenient transaction of its corporate business and affairs. (21a)

[117] Section 28 reads:

> "SEC. 28. Removal of directors or trustees. — Any director or trustee of a corporation may be removed from office by a vote of the stockholders holding or representing at least two-thirds (2/3) of the outstanding capital stock or if the corporation be a non-stock corporation, by a vote of at least two-thirds (2/3) of the members entitled to vote: Provided, That such

or without cause. Two conditions are attached to removal without cause, however, and they are 1) that "at least two thirds" majority of the outstanding capital stock approved of the removal action, and 2) that the removal of such a director will not derive the minority shareholder of the right of representation which is impliedly guaranteed for by Section 24.[118] This particular provision would therefore enable a raider to acquire control of the board quite easily; the two thirds vote would not be difficult to obtain, either by further acquisition of shares or an active campaign to gain support from shareholders, and likewise the removal of a director representing the minority shareholder need not even be considered since it will be the directors representing the incumbent management who will be removed. More important, under this same provision, a change in the board could be effected immediately because it is also provided that an election may be held in the very same meeting where removal was voted upon, without further notice required.

No doubt, Section 24 serves as a boon for any bidder in quest for control. A defensive measure which may somewhat lessen the benefits of Section 24 would be to provide that a supermajority vote would be required to remove a director without cause. The language in said provision would seem to allow such an amendment since the words "at least" imply that a greater majority vote may be provided for.

An amendment increasing the required vote for removal for directors may be adopted either in the by laws or the articles of incorporation. If the

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removal shall take place either at a regular meeting of the corporation or a special meeting called for the purpose, and in either case, after previous notice to stockholders or members of the corporation of the intention to propose such removal at the meeting. A special meeting of the stockholders or members of a corporation for the purpose of removal of directors or trustees, or any of them, must be called by the secretary on order of the president or on the written demand of the stockholders representing or holding at least a majority of the members entitled to vote. Should the secretary fail or refuse to give the notice, or if there is no secretary, the call for the meeting may be addressed directly to the stockholders or members by any stockholder or member of the corporation signing the demand. Notice of the time and place of such meeting, as well as of the intention to propose such removal, must be given by publication or by written notice as prescribed in this Code. The vacancy resulting from removal pursuant to this section may be filled by election at the same meeting without further notice, or at any regular or at any special meeting called for the purpose after giving notice as prescribed in this Code. Removal may be with or without cause: Provided, That removal without cause may not be sued to deprive minority stockholders or members of the right of representation to which they may be entitled under section 24 of this Code. (n)

[118] Section 24 provides:

SEC. 24. Election of directors or trustees. — At all elections of directors or trustees, there must be present, either in person or by representative authorized to act by written proxy, the owners of the majority of the outstanding capital stock, or if there be no capital stock, a majority of the members entitled to vote. The election must be by ballot if requested by any voting stockholder or member. In stock corporations, every stockholder entitled to vote shall have the right to vote in person or by proxy the number of shares of stock standing, at the time fixed in the by-laws,

foregoing amendment is to be adopted in the by laws, Section 48[119] requires approval of the majority by the board and the shareholders. More interesting, the same provision also allows the shareholders to delegate to the board the power to amend, repeal, or adopt by laws by two-thirds majority vote. As such, the incumbent management could utilize this provision in their favor and could obtain the power to amend by laws, it is also provided that such power may be revoked by only a majority vote at a regular or special meeting. In this particular instance, a supermajority requisite for revocation may not be allowed considering that this is the only provision in the Code which does not qualify the percentage with the words "at least."

If any amendment is to be made which would protect management, it should be adopted through the articles of incorporation. Section 16[120]

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in his own name on the stock books of the corporation, or where the by-laws are silent, at the time of the election; and said stockholder may vote such number of shares for as many persons as there are directors to be elected multiplied by the number of his shares shall equal, or he may distribute them to the same principle among as many candidates as he shall see fit: Provided, That the total number of votes cast by him shall not exceed the number of shares owned by him as shown in the books of the corporation multiplied by the whole number of directors to be elected: Provided, however, That no delinquent stock shall be voted. Unless otherwise provided in the articles of incorporation or in the by-laws, members of corporations which have no capital stock may cast as many votes as there are trustees to be elected but may not cast more than one vote for one candidate. Candidates receiving the hgihest number of votes shall be declared elected. Any meeting of the stockholders or members called for an election may adjourn from day to day or from time to time but not sine die or indefinitely if, for any reason, no election is held, or if there are not present or represented by proxy, at the meeting, the owners of a majority of the outstanding capital stock, or if there be no capital stock, a majority of the members entitled to vote. (31a)

[119] Sec. 48 provides:

SEC. 48. Amendments to by-laws. — The board of directors or trustees, by a majority vote thereof, and the owners of at least a majority of the members of capital stock, or at least a majority of the members of a non-stock corporation, at a regular or special meeting duly called for the purpose, may amend or repeal any by-laws or adopt new by-laws. The owners of two-thirds (2/3) of the outstanding capital stock or two-thirds (2/3) of the members in a non-stock corporation may delegate to the board of directors or trustees the power to amend or repeal any by-laws or adopt new by-laws: Provided, That any power delegated to the board of directors or trustees to amend or repeal any by-laws or adopt new by-laws shall be considered as revoked whenever stockholders owning or representing a majority of the outstanding capital stock or a majority of the members in non-stock corporations, shall so vote at a regular or special meeting. . .

The amended or new by-laws shall only be effective upon the issuance by the Securities and Exchange Commission of a certification that the same are not inconsistent with this Code. (22a and 23a)

[120] Sec. 16 provides:

SEC. 16. Amendment of Articles of Incorporation. — Unless otherwise prescribed by this Code or by special law, and for legitimate purposes, any provision or matter stated in the articles of incorporation may be amended by a majority vote of the board of directors or trustees and the vote or written assent of the stockholders representing at least two-thirds (2/3) of the outstanding capital stock, without prejudice to the appraisal right of dissenting stockholders in accordance with the provisions of this Code, or the vote or written assent of two-thirds (2/3) of the members if it be a non-stock corporation. . . .

requires a majority approval of the board and "at least" two thirds majority shareholder vote. Although two thirds majority shareholder vote may be slightly higher, the advantage in imposing a supermajority requisite or lock up amendment is well worth the difficulty. Under these rules, therefore, if a supermajority percentage for removal of directors without cause is adopted in the articles and a corresponding lock-up provision is incorporated, the bidder will definitely not have such an easy time in implementing an immediate change in corporate policy.

The crucial factor of disallowing a classification of directors and providing for a mandatory annual election has the effect of dulling the sting of management entrenchment provisions. At best, the delay that may result will last for one year but then again, such a delay may possibly deter a raider, especially in instances where immediate control (ergo timing) is a primary consideration. Within this framework, the possible provisions, aside from the ones previously discussed, which maximize delay are few, much less that effective in repelling a raider. At any rate, another provision which should be adopted in conjunction with the previous provision is one which would limit the number of directors in a corporation. Section 10 prescribes that the board of directors may be comprised of at least five but not more than fifteen natural persons. If an amendment limiting the number of directors is adopted in the charter, the effects of Section 29[121] which allows or a simultaneous shareholder approval of an increase in the number of directors and the corresponding election of the new directors to fill said vacancies in the very same meeting if so stated in the notice of the meeting, may be avoided. The limitation of the directors would therefore effectively prevent the raider from packing the board and gaining immediate control thereof.

Another suggested provision with regards to the filling of vacancies in the board involves the granting of the power to fill vacancies to the board. Under Philippine law, such a provision is effectively precluded by Section 29[122] which provides that the board may only fill vacancies which occur

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The amendment shall take effect upon its approval by the Securities and Exchange Commission or from the date of filing with the said Commission if not acted upon within six (6) months from the date of filing for a cause not attributable to the corporation.

[121] Sec. 29 reads:

SEC. 29. Vacancies in the office of director or trustee. — Any vacancy occurring in the board of directors or trustees other than by removal by the stockholders or members or by expiration of term, may be filled by the vote of at least a majority of the remaining directors or trustees, if still constituting a quorum; otherwise, said vacancies must be filed by the stockholders in a regular or special meeting called for that purpose. A director or trustee so elected to fill a vacancy shall be elected only for the unexpired term of his predecessor in office.

Any directorship or trusteeship to be filled by reason of an increase in the number of directors or trustees shall be filled only by an election at a regular or at a special meeting of stockholders or members duly called for the purpose, or in the same meeting authorizing the increase of directors or trustees if so stated in the notice of the meeting. (n)

[122] *Id.*

other than by reason of removal or expiration of term (i.e., resignation, illness, or death) provided that a majority of the remaining directors still constitute a quorum. In the absence thereof, the shareholders shall have the right to elect the director(s).

The institution of a by law amendment limiting the shareholder's right to call special meetings by requiring a supermajority vote might prove to be cumbersome to a potential raider. The legality of such a provision as pointed out in the previous section may however be subject to question, more so under the Philippine law in that the prevailing tendency of the new Code was to acknowledge and give effect to the right of the shareholders to participate in corporate affairs. This tendency is especially evident in Section 6 which grants the holder of shares, regardless of whether these are voting or not, the right to vote on matter such as those involving amendment of the articles of incorporation, adoption and amendments of by laws, sale, lease, exchange, or disposition of corporate property, etc.[123] It is therefore unlikely that the SEC which reviews all amendments would approve of this amendment.[124]

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[123] The relevant portion of Sec. 6 raeds:

> SEC. 6. x x x
>
> Except as otherwise provided by the articles of incorporation and stated in the certificate of stock, each share shall be equal in all respects to every other share.
>
> Where the articles of incorporation provide for non-voting shares in the cases allowed by this Code, the holders of such shares shall nevertheless be entitled to vote on the following matters:
>
> 1. Amendment of the article of incororation;
> 2. Adoption and amendment of by-laws;
> 3. Sale, lease, exchange, mortgage, pledge or other disposition of all or substantially all of the corporate property;
> 4. Incurring, creating or increasing bonded indebtedness;
> 5. Increase or decrease of capital stock;
> 6. Merger or consolidation of the corporation with another corporation or other corporations;
> 7. Investment of corporate funds in another corporation or business in accordance with this Code; and
>
> Dissolution of the corporation.
>
> Except as provided in the immediate preceding paragraph, the vote necessary to aprove a particular corporate act as provided in this code shall be deemed to refer only to stocks with voting rights. (5a)

[124] Aside from reviewing amendments, the SEC has been granted more functions by Presidential Decree No. 902-a (March 11, 1976). Sec. 5 of that decree provides:

> SEC. 5. In addition to the regulatory and adjudicative functions of the Securities and Exchange Commission over corporations, partnerships and other forms of associations registered with it as expressly granted under existing laws and decrees, it shall have original and exclusive jurisdiction to hear and decide cases involving.
>
> a) Devices or schemes employed by or acts of the board of directors, business associates, its officers or partners, amounting to fraud and misrepresentation which may be detrimental to the interest of the public and/or of the stockholder, partners, members of associations or organizations registered with the Commission.
>
> b) Controveries arising out of intracorporate or partnership relations, between and among stockholders, members, or associates; between any of all of them and the corporation; partnership or association of which they are stockholders, members or associates, respectively: and between such

The only measure which is certain to be approved by the SEC is the lock up amendment requiring a higher percentage than two thirds to repeal, amend or adopt amendments either in the articles of incorporation or in the by laws. Under the relevant sections, Section 16 and Section 48, the phrase "least two thirds" clearly implies the allowance thereof.

B. *Shareholder Protection Provisions*

The defensive measure of shareholder protection is more suitable to be adopted under Philippine law. The philosophy of affording protection to minority shareholders is complementary to the policy of affording shareholders the corporate right to self-determination.[125] Thus, it is provided in the Code that the approval of "at least two thirds" of the outstanding capital stock is necessary for vital corporate actions. Interestingly enough, the corporate action referred to in Section 6 encompasses all the possible transaction for the second step acquisition. The only major difference in these actions is that in mergers a more detailed procedure is provided for.[126]

Basic Supermajority Provision

There appears to be no prohibition in the Code as to tying a higher supermajority percentage vote to a substantial shareholder. Neither is there a prohibition against imposing a floating percentage requirement. However, regarding the proviso providing that the substantial shareholder's vote shall not be counted, such cannot be incorporated in view of Section 6.

Provisions qualifying for exceptions to the higher than two thirds supermajority requisite are likewise allowed and as such, qualifications could be made regarding board approval (i.e., unanimous board approval) or the time of approval (i.e., prior to the acquisition of the substantial shareholder). Nonetheless, if the exception as provided for were to apply, it is important to note that the two thirds percentage would still apply and in certain cases, that in itself would also be difficult to obtain.

Fair Price Provision

The variation of the supermajority vote as embodied in the fair price provision is equally applicable in the Philippine context in that there exists no express prohibition against it. Likewise, there exists more than sufficient reason for these provisions to be approved by the SEC because of the protection they afford to minority shareholders. It has been the case that shareholders of Philippine corporations have been caught in the short end

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corporation, partnership or association and the state insofar as it concerns their individual franchise or right to exist as such entity.

c) Controversies in the election or appointments of directors, trustees, officers or managers of such corporations, partnership or associations.

125 See Sec. 6 of the Corporate Code of the Philippines.

126 See Title IX, Mergers and Consolidation of Corporate Code of the Philippines.

of deals partially due to the lax and comparatively minimal disclosure obligations provided by the New Securities Law.[127]

Right of Redemption Provision

The same considerations would also hold true for the right of redemption provisions. The Corporation Code is more explicit in the allowance thereof under Section 41 which provides:

> "SEC. 41. Power to acquire own shares. A stock corporation shall have the power to purchase or acquire its own shares for a legitimate corporate purpose or purposes including but not limited to the following cases: Provided, That the corporate has unrestricted retained earnings in its books to cover the shares to be purchased or acquired:
>
> 1. To eliminate fractional shares arising out of stock dividends;
>
> 2. To collect or compromise an indebtedness to the corporation, arising out of unpaid subscription, in a delinquency sale, and to purchase delinquent shares sold during said sale; and
>
> 3. To pay dissenting or withdrawing stockholders entitled to payment for their shares under the provisions of this Code. (n)

However, as most American state corporate statutes likewise provide, the redemption is subject to the condition that the corporation has "unrestricted retained earnings"[128] in its books to cover the shares to be purchased. Moreover, if a corporation decides to decrease its capital in order to create unrestricted retained earnings, such a decrease will have to be first approved by majority of the directors and at least two thirds majority of shareholders. Likewise it is further provided that such a decrease in capital stock shall not be approved by the SEC should it prejudice the rights of corporate creditors.[129]

C. *Other Pre-Offer Defensive Measures*

Dilution of Bidder's Stock

The convenient defensive measure of issuing stock to dilute a raider's stock ownership and subsequently transfer them to a friendly party is also permissible under Philippine law However, if a corporation does not have at its disposal shares for issuance, as in the case when its capitalization is adequate, the target corporation will have to increase its capital stock subject to majority board approval and at least two third majority shareholder approval.[130] The possibility of implementing this measure may be uncertain however, depending on the raider's stock ownership since at the inception of such an increase, the raider could block such a plan if he holds more than one third of the target's outstanding capital. Thus, the only situation where

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127 Batas Pambansa Blg. 178. The disclosure requirement mostly refers to registration of securities. For a discussion of the Securities Act, see Ricalde, *Towards a New Securities Act*, 56 Phil. L.J. 306 (1981).

128 Although this term is mentioned in the Code, no precise definition is offered in the Code.

129 See Sec. 39 of Corp. Code of the Phil.

130 See Sec. 38 of Corp. Code of the Phil.

such a measure would prove effective is if the target corporation has in its reserve, treasury or unissued shares which may be sold. The suggested action of granting the board a "blank check" authority to issue preferred shares with disproportionate voting rights or with class voting rights on issues of mergers or similar transactions would not be possible however in view of Section 6.

Consideration of Social and Economic Provision

Another provision which may be adopted under Philippine law is the provision which authorizes the board to consider non-financial factors in its evaluation of a tender offer. Adoption of this provision would afford the board sufficient basis for rejecting an offer and would also serve as a feasible defense should a shareholder file a derivative action alleging breach of fiduciary duties. Because there are no obligations upon the board to disclose their reasons for accepting or rejecting a tender offer, the necessity of adopting such provision would not be as urgent as in the American setting where federal disclosure obligations exist. Moreover, the Philippine courts, in constantly acknowledging and applying the business judgment rule,[131] have in effect accorded directors greater leeway in exercising their discretion subject of course to the exceptions of bad faith, fraud, or gross negligence.

Regulatory Considerations

The defensive measure of acquiring a business which would subject the transaction to governmental regulation may be adopted and prove to be a most effective deterrent to a raider whose prime consideration is time in that a delay could result, possibly lasting for more than one year. Section 79 specifically enumerates the kinds of business requiring approval from the appropriate government agencies. These would include "banks or banking institutions, building and loan associations, trust companies, insurance companies, public utilities, educational institutions, and other special corporations governed by special laws." A potential difficulty lies in adopting this measure because an acquisition of such a nature would have to comply with Section 42, which requires prior majority approval of the board and two thirds shareholder approval. A potential raider owning more than one third of the shares could easily thwart this plan unless, as provided by the same section, the intended investment is "reasonably necessary to accomplish its (the target corporation) primary purpose as stated in the articles of incorporation," in which case the approval of the shareholders shall not be required. In order to maximize the utility of this section, it would be advisable to draft the corporation's general

[131] *The Board of Liquidators v. Heirs of Maximo M. Kalaw*, 20 SCRA 987 (1967); *Montelibano v. Bacolod Murcia Milling*, 5 SCRA 36 (1962); *Steinberg v. Velasco*, 52 Phil. 953 (1929).

[132] Commonwealth Act No. 108 as amended by Rep. Act 42, Rep. Act 134, Rep. Act 6084 and P.D. 715. See Campos, *Regulation of Transnational Corporations Under Philippine Law*, 53 Phil. L.J. 54 (1978).

purpose statement in a very general manner so as to include future acquisitions of a broad nature.

If a bidder is a foreigner, it would be important to note that there are inherent restrictions provided by the Philippine Constitution of 1973, which definitely have to be considered. Under Section 9 of Article XIV, foreign equity participation is limted to forty percent in business engaged in "the disposition, exploration, development, exploitation, and utilization of material resources." Likewise, Section 7(2) of Art. XIV provides that business involved in mass media and education shall be reserved solely for Filipino citizens. In consonance with these restrictions, a target corporation with information as to the identity of a foreign raider, could adopt an amendment increasing the constitutional restriction and could derive basis for its decision to do so from the Constitution itself.

Availing of Antitrust Defense

The defensive measure of acquiring a business that could create an antitrust impediment for a potential raider could equally be applicable in the Philippine setting although the instances wherein an antitrust problem have arisen are not as varied as in American law This is largely due to the lack of extensive and strict antitrust or antimonopoly application within the Philippines.[133] Notwithstanding, a target's acquisition of a business which would place a bidder in a position to create a monopoly should still deserve serious consideration in light of the *Gokongwei* case where the Supreme Court utilized as partial basis for its decision, the antitrust provision in the Philippine Constitution of 1973.[134] The same consideration underlying an acquisition which would subject the transaction to governmental regulation would also apply.

Due to the scarcity of case law and relevant legislation, the validity of defensive measures can only proceed from a textual analysis of the provisions of the Corporation Code. Unlike in American law, there are no extensive disclosure obligations imposed on the board with regards to the adoption of a defensive measure. Consequently, disclosure of motive is not an issue to be reckoned with. The shareholder therefore may only arrive at a decision on the basis of whatever information is disclosed by the corporation. The absence of a disclosure obligation does not mean

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133 Philippine courts have not had the occasion on deal with antitrust cases very often. Anti-trust cases have been sparse; in my research, I had only found five cases, namely, *Filipinas Cia de Seguros v. Mandana,* 17 SCRA 391 (1966); *Ferrazin v. Gsell,* 34 Phil. 697 (1916), *Ollendorf v. Abrahamson,* 39 Phil. 585 (1915). *Red Line Transportation Co. v. Bachrach Co.,* 67 Phil. 77 (1939); *Del Castillo v. Richmond,* 45 Phil. 679 (1924).

134 Section 2 of Article XIV of the 1973 Constitution provides: "The State shall regulate or prohibit private monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed." In line with this policy, the other relevant legislation enacted art Art. 186 of the Revised Penal Code of the Philippines; Art. 28 of the Phil. Civil Code; Sec. 4, par. 5 of Rep. Act No. 5455, and Section 7(g) of Rep. Act No. 6173.

however that the shareholder does not have any recourse to question the validity of a specific amendment. Charter and by law amendments, even if approved by the required two thirds majority, are still subject to SEC approval.[135] Accordingly, a shareholder who is extremely wary of a charter amendment may invoke Section 17 which enumerates the grounds for rejection as follows:

> Section 17: x x x
>
> 1. That the articles of incorporation or any amendment thereto is not substantially in accordance with the form prescribed herein;
>
> 1. That the purpose or purposes of the corporation are patently unconstitutional, illegal, immoral, or contrary to government rules and regulations;
>
> 3. That the Treasurer's Affidavit concerning the amount of capital stock subscribed and/or paid is false;
>
> 4. That the required percentage of ownership of the capital stock to be owned by citizens of the Philippines has not been complied with as required by existing laws or the Constitution.

Thus, if a shareholder action is filed invoking these grounds, the necessary information, it is to be hoped, may be disclosed. And in the event it is disclosed, it would only be proper to hold another election. Notwithstanding, the fact remains that before he can invoke these grounds, a shareholder must necessarily be privy to relevant information.

Gokongwei Case: Application of Business Judgment Rule

Although there are no Philippine cases which specifically deal with the validity and/or impropriety of a defensive measure within the context of a takeover situation, there does exist one case which may give a clue as to how courts will construe such a measure. The previously cited case of *Gokongwei v. San Miguel Corporation* comes to mind, where the particular measure adopted by the incumbent management was a by law amendment.

Decided in 1979, this case involved a substantial shareholder (four percent) in the person of Mr. Gokongwei who had made public his intention of becoming a director at the corporation. The reason underlying Gokongwei's desire to become a director was allegedly due to his disagreement over the incumbent management's corporate policy; he felt that "his and other stockholders' investment were not effectively deployed and that the accounting of foreign operators was not at all thorough, especially with regards to foreign purchases and investments."[136] The incumbent management, on the other hand, emphasized the fact that Mr. Gokongwei was also a majority stockholder of various companies which competed with San Miguel Corporation (SMC) and that, in view thereof, his presence on the board would represent a conflict in interests and thus expose SMC to possible risks.

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[135] Cf. sec. 16 and 48 of the Corp. Code of the Phil.
[136] *Annot.*, 89 SCRA 413 (1979).

Incumbent management then decided to take concrete action to prevent his election by adopting a by law amendment which disqualified any person who was an "officer, manager or owner (either of record or beneficially) of 10% or more of any outstanding class of shares" of any corporation engaged in a similar business as SMC.[137] Gokongwei questioned the validity and reasonableness of such a by law, arguing that such a by law was unreasonable and that the doctrine of corporate opportunity accorded him a right to be elected as a director which the by law effectively denied.

The Philippine Supreme Court disagreed with Gokongwei and upheld the validity of the by law in question, anchoring its decision principally on the business judgment rule. Thus, the Court stated:

> "The validity or reasonableness of a by-law of a corporation is purely a question of law. Whether the by-law is in conflict with the law of the land, or with the charter of the corporation, or is in a legal sense unreasonable and therefore unlawful is a question of law. This rule is subject, however, to the limitation that *where the reasonableness of a by-law is more a matter of judgment, and one upon which reasonable minds must necessarily differ, a court would not be warranted in substituting its judgment instead of the judgment of those who are authorized to make by-laws and who have exercised their authority.*[138] (Italics supplied)

Moreover, the Supreme Court held that said by law amendment was adopted in consonance with Section 21 of the Corporation law which allowed corporations to prescribe in its by laws for qualification of its directors.[139] Likewise, the court made specific reference to the American case of *McKee & Co. v. First National Bank of San Diego*[140] where the same type of by law disqualifying a stockholder who was a director in a corporation which was competing with the corporation which adopted the by law, was held to be valid.

Finally, the Court bolstered its opinion by considering the law which prohibits combinations in restraint of trade or unfair competition.[141] The Court stated that the election of Gokongwei could result in a combination in restraint of trade or unfair competition and on this basis alone, the by law amendment would be valid and reasonable.

Insofar as utilizing the Court's finding that such by laws are valid, there appears to be no precedential value thereto. This is due to the fact that the requisite majority vote necessary to qualify the court's resolution as precedential was not obtained.[142] Still and all, the Court's principal reliance on the business judgment rule more than justifies the conclusion that defensive measures adopted by the target corporation, as long as they

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137 *Gokongwei*, 89 SCRA 336, at 346.
138 *Id.* at 361-362.
138 *Id.* at 365.
140 265 F. Supp. 1 (1967).
141 *Gokongwei*, at 374-382.
142 *Id.* at 397-398.

are drafted within the contextual bounds of the Corporation Code, will be held to be valid by the courts.

IV. CONCLUSIONS AND OBSERVATIONS

From the foregoing sampling of the numerous pre-offer defensive measures under American law, it is readily apparent that their evolution has been phenomenal. The two principal categories, namely management entrenchment and shareholder protection provisions, actually represent two opposing forces in the corporate power structure. The management entrenchment provisions have been shown to favor the retention of management at the price of removing, curtailing or qualifying traditional shareholders' rights such as the right to call a meeting, the right to remove a director, and the right to adopt, amend, or repeal a by law or charter provision. On the other hand, the shareholder protection provisions tend to benefit the shareholders' welfare by assuring them a fair price for their shares or granting them, albeit qualified with exception, the right to effectively thwart the second step transactions. Because of these features, it would be reasonable for a board to adopt these two types of provisions in conjunction. The question would arise however as to whether the benefits of the shareholder protection devices are well worth the price of having the traditional shareholders' right curtailed or qualified by management entrenchment provisions. To be sure, an effective balance should be maintained.

Under the Philippine law, it is interesting to note that the shareholder protection devices operate more feasibly than management entrenchment provisions. As a matter of fact, management entrenchment provisions are virtually of no use in that classification of directors is not allowed by the Corporation Code. Viewed from the corporate power structure, shareholders are afforded more protection in that their corporate right to self determination is effectively provided for by Sec. 6 which mandates that all shares shall be entitled to vote on basic corporate matters. Be that as it may, these provisions are still effectively balanced by the application of the business judgment rule which grants directors sufficient discretion to determine whether or not to oppose a takeover and which defensive measure to adopt.

One last oservation is that a large portion of the defensive measures under American law have really no application within the Philippine context. Granted that the Corporation Code is simpler or less sophisticated but it cannot be denied that it is unresponsive to the Philippine business environment. It must be remembered that defensive measures were formulated in reaction to the numerous takeover techniques in the same manner that law reacts and adjusts to the different situations. Perhaps, in the future, when corporate takeovers occur with more frequency will the various defensive mechanisms be more applicable in the Philippine context.

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