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HOSTILE TAKEOVERS AND THE AGGREGATE THEORY OF THE CORPORATION

Griselda Muhametaj and Artan Broci

[1]Part-time Lecturer at University of Tirana, Faculty of Law.

[2]Judge at Supreme Court of Albania

ABSTRACT: *With the public controversy generated by the explosion of hostile takeover activity during the 1980s, we again are witnessing debate about theories of the corporation. Responding to widespread concerns about the harsh impact of hostile takeovers on target company employees and others, state legislatures, courts, and commentators have focused on the notion of the corporation as aggregation, defined broadly to include not just shareholders and management but also other participants in the corporate enterprise. This broader conception serves to justify corporate law reforms responsive to the interests of these various non-shareholder, non-management constituencies. Opponents of regulation that impinges on shareholders' financial interest in unimpeded access to takeover bids (regardless of impact on non-shareholders) have responded with argument based on their nexus-of-contracts interpretation of the corporate aggregation, but their efforts have proved to be unpersuasive in the legislatures and courts.*

KEYWORDS: Hostile Takeovers, Aggregate Theory, Corporation.

INTRODUCTION

The Debate Over Hostile Takeovers

Over the past decade, the pace of hostile takeover activity has accelerated sharply. In the typical hostile takeover, those seeking to seize control of a target corporation offer generous premiums over market prices to target company shareholders willing to tender their stock. In contrast to a friendly merger, the tender offer or (or bidder) appeals directly to the target's shareholders. In this manner, bidders seek to obtain voting control without first obtaining the blessing of the target's management. The typical objective of recent takeover activity is the so-called "bust-up" takeover.[1] Rather than continuing target company operations under new and more efficient management, the "bust-up" takeover seeks to realize gains through large-scale asset liquidations or financial restructurings. Takeovers motivated by such objectives are widely perceived to result in employee lay-offs, plant closings, or out-of-state removal of existing operations. Even successful efforts to defend against unwelcome bids have resulted in significant employ merit cuts as a consequence of radical restructuring. Thus, despite the obvious attractiveness

of windfall premiums to target company shareholders, public concern about hostile takeovers has centered on lost jobs and other less direct ripple effects such as disruption of established

[1] Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REv. 1, 2-7 (1986) ("bust-up" motivation dominant). This development is related in part to the ready availability of so-called "junk bond" financing. *See* Lipton, *Corporate Governance in the Age of Finance Capitalism,* 136 U. PA. L. REv. 1, 11 (1987).

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customer and supplier relationships, lost tax revenues and corporate charitable contributions, and destruction of other less tangible economic and social benefits.[2] State legislators have responded to these concerns by enacting increasingly bold legislation designed to curb hostile takeovers.[3]Some have suggested that the legislators who pass these laws are acting as toadies to locally influential corporate managers who stand to lose their positions if their companies are taken over.[4] The statutes themselves, however, reveal clearly that they address a quite different set of concerns. For example, a recent amendment to North Carolina's corporate statute refers expressly to a broad range of issues, including lost employment, tax revenues, and community service activities.[5] Similarly, Wisconsin's anti-takeover statute candidly declares that Wisconsin corporations "encompass, represent and affect, through their ongoing business operations, a variety of constituencies including shareholders, employs, customers, suppliers and local communities and their economies," and the statute states further that it is intended "to promote the welfare of these constituencies" and "should allow for the stable, long-term growth of resident domestic corporations."[6] Most notably, several states have adopted provisions that, in effect, redefine the role of a corporate board of directors confronted with a hostile takeover. Rejecting the standard idea that the board's fiduciary duty requires it to get the best deal possible for the shareholders, regardless of effects on non-shareholders, these new statutes provide expressly that the board may consider such effects in deciding how to respond. A representative example begins by restating the conventional principle that a director shall discharge his or her duties in a manner reasonably believed to be in the best interests of the corporation. The statute then proceeds to redefine "the best interests of the corporation" in a radically innovative manner: A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the

[2] For a discussion of public opinion regarding hostile takeovers, see Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion,* 57 U. CIN. L. REv. 457, 490-503 (1988).

[3] *See generally* Johnson & Millon, *Missing the Point About State Takeover Statutes,* 87 MICH. L. REv. 846, 848 (1989) (arguing that the purpose of state antitakeover laws is to protect nonshareholders);

[4] *See, e.g.,* Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REv. 111 (1987).

[5] The amendment reads:
Whereas, takeovers and takeover attempts of North Carolina corporations have been occurring with increasing frequency; and
Whereas, such activity can be highly disruptive to communities within North Carolina by causing, among other things, high unemployment and erosion of the State and local economy and tax base; and
Whereas, many of these corporations are not presently subject to the North Carolina Shareholder Protection Act since while substantially present in North Carolina they are chartered elsewhere; and
Whereas, these corporations offer employment to a large number of North Carolina citizens who pay income taxes, property and other taxes; and
Whereas, these corporations pay significant amounts of income taxes to North Carolina; and
Whereas, these corporations pay substantial State and local property taxes; and
Whereas, these corporations pay substantial sales and use taxes in North Carolina;
and
Whereas, these corporations provide their North Carolina employees with health, retirement and other benefits;
and
Whereas, these corporations and their employees contribute greatly to community projects in North Carolina;
and
Whereas, many unrelated businesses rely on these corporations to purchase goods and services; and
Whereas, North Carolina has a vital interest in providing to these corporations the benefits of the provisions of the North Carolina Shareholder Protection Act; ....

[6] Act of June 9, 1987, ch. 13, 1987 Wis. Laws 45.

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corporation are located, and any other factors the director considers pertinent.[7] Arizona's similar statute appears to go even further, making consideration of non-shareholder interests mandatory rather than merely permissive.[8] Developments in state common law governing target management resistance to hostile bids also evidence a willingness to restrict takeover activity for the sake of non-shareholders. In the important *Unocal* decision, the influential Delaware Supreme Court referred to the board's duty to evaluate the threat to "the corporate enterprise" that a takeover presents.[9] Besides considering such factors as adequacy of the tender offer price and other issues of concern to shareholders, the court stated that the board also may weigh the effects on various non-shareholder constituencies.[10] Another court has stated that a board of directors confronted with a bust-up takeover threat must balance shareholder interests, on one hand, "and the legitimate concerns and interests of employees and management.., who service the interests of investors, on the other."[11]Nevertheless, the extent of courts' willingness to allow management to take non-shareholder interests into account has been unclear.[12]Common law decisions therefore have lagged behind statutory developments in this regard.[13] In response to concerns about the disruptive effects of hostile takeovers, a number of corporate law scholars argue forcefully against state or federal regulation, emphasizing the benefits to shareholders and to the general public of an unregulated, robust "market for corporate control." [14]Most notably, of course, hostile tender offers present opportunities for shareholders to realize substantial premiums over the market price of their stock. Shareholders, who have risked their capital by investing in stock, are simply earning their just rewards. In addition, the credible threat of a takeover is said to encourage corporate management diligently to maximize corporate profits and asset values in order to remove any incentives (in the form of depressed stock prices) to hostile bidders. Whereas these shareholder-welfare claims are at the center of arguments in favor of takeover activity, proponents also claim that society as a whole benefits from takeovers. Because successful takeovers reallocate corporate assets to higher valued uses, takeover activity is said to enhance efficiency. Further, it is assumed that denial of access to takeover premiums would discourage participation in the stock market, thereby increasing the costs of capital and leaving the American public worse off.

[7] IND. CODE § 23-1-35-1(d) (1989) (amendment effective January 31, 1989). Note that this provision is not limited to director action in hostile takeover situations.
[8] ARiz. REV. STAT. ANN. § 10-1202 (Supp. 1989) (amendment effective July 22, 1987).
[9] Unocal v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985).
[10] *Id* The Delaware Supreme Court has since reiterated its adherence to this principle. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1985). In the only case in which management has sought explicitly to justify its decision to prefer non-shareholder over shareholder interests under *Unocal,* the Delaware Supreme Court held that under the circumstances the board's duty was to the shareholders. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986) (once sale of the company appears inevitable, board's duty is to auction the company to the highest bidder).
[11] GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985); *see also* Gearhart Indus. v. Smith Int'l, 741 F.2d 707, 726 (5th Cir. 1984); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); Herald Co. v. Seawell, 472 F.2d 1081, 1094-97 (10th Cir. 1972); Enterra Corp. v. SGS Assocs., 600 F. Supp. 678, 684-87 (E.D. Pa. 1985); Berman v. Gerber Prod., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978).
[12] *Ibid*
[13] For discussion of recent statutory and common law developments, see Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct,* 14 J. CORP. L. 35 (1988).
[14] Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers,* 57 Tax. L. RyV. 1 (1978); Gilson, *A StructuralApproach to Corporations: The Case Against Defensive Tactics in Tender Offers* 33 STAN. L. REv. 819 (1981).

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Hostile Takeovers and Conventional Corporate Theory.

Opposition to anti-takeover regulation starts from the proposition that shareholders occupy a privileged position within the network of relationships constituting the corporation. As the owners (or, at least, the residual risk bearers) who have entrusted management responsibilities to agents, it is their financial interests that deserve priority over conflicting claims. If shareholders occupy this privileged position, on what basis can one claim to restrict their right to maximize the value of their investments? Property notions imply that shareholders should be free to realize the premiums that takeover bidders are willing to pay for their stock. Contract and agency theory suggest that target company management should be forbidden to stand in the way of shareholder access to such .premiums. In the two-party, principal-agent, shareholder-manager world of conventional corporate law, it strikes many commentators as obvious that restrictions on takeover activity, as infringements on shareholder welfare to which shareholders have not consented, are illegitimate. Although they might disagree over which legal rules best protect shareholder interests in hostile takeovers, there is no disagreement about the underlying premise- that shareholder welfare is the fundamental criterion. Taking for granted that shareholder welfare is the touchstone against which all corporate law rules are to be assessed, these scholars largely ignore concerns about the harmful impact on non-shareholders. Under the conventional conception of corporate law such concerns are doctrinally irrelevant as well as politically uncongenial. To the extent

welfare of non-shareholders is acknowledged, it is asserted that losses caused by takeovers are likely to be offset by creation of new employment opportunities elsewhere.[15] Further, the aggregate benefits to society as a whole that flow from more efficient use of productive resources outweigh the localized costs of job losses and other temporary dislocations. To try to address these concerns through corporate law not only would threaten its doctrinal coherence,[16] but it also would assign to corporate law public law functions that are inconsistent with its private law character. Yet, while one notion of the corporation as an aggregation of individual actors implies a shareholder-centered, anti-regulation policy toward hostile takeovers, the dominant conception of the corporation as an aggregation rather than an entity also has contrary implications. Thinking about the corporation in terms of the collection of all the individuals who contribute to production suggests a potentially broad conception of the corporation, including management and lower level employees, as well as holders of equity and debt securities. After all, to describe the corporation as a nexus of contracts is to suggest far more than the vision of the corporation as simply shareholders and their agent-managers. Recent commentators have drawn on this broader conception of the corporate aggregation to support several normative claims. Clyde Summers, for example, has revived arguments in favor of broader participation in corporate governance, describing the corporation as "an operating institution combining all factors of production to conduct an ongoing business" in which employees "are as much members of that enterprise as shareholders."[17]Similarly, a broad notion of the corporate aggrega- tion underlies Joseph Singer's argument in favor of according

[15] Macey, *State Anti-Takeover Legislation and the National Economy,* 1988 Wis. L. REV. 467, 479.
[16] Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?,* 44 Bus. LAW. 247, 267 n.65 (1989).
[17] Summers, *Codetermination in the United States: A Projection of Problems and Potentials, 4* COMP. CORP. L. & SEc. REG. 155, 170 (1982). Other recent examples include M. AOKI, THE Coop- ERATIVE GAME THEORY OF THE FIRM 56-57 (1984); R. NADER, J. SELIGMAN & M. GREEN, *supra* note 108, at 124-28; C. STONE, WHERE THE LAW ENDS 174-83 (1975). For an earlier version of the same argument, see *supra* text accompanying notes 103-07.

legal recognition to non-shareholder efforts to prevent corporate relocations.[18] In Singer's view, detrimental reliance by employees and local communities on a corporation's implicit promise to provide employment and other benefits is a basis for a structure of property rights in the corporate enterprise that embraces more people than simply the shareholders. A broader interpretation of the aggregate theory of the corporation also has been used to support anti-takeover regulation. Recent state laws modify existing corporate law doctrines in order to take better account of the losses non-shareholders are likely to suffer as a result of hostile takeovers.[19] Conceding that target company shareholders benefit from hostile takeovers, some commentators focus on the losses that non shareholders suffer as a by-product of these benefits.[20] Their arguments rest on a conception of the corporation that extends beyond the interests of shareholders alone. In a similar vein, some economic theorists suggest that shareholder premiums derive, in part at least, from appropriation of the value of implicit promises of long-term job security.[21] Shareholder gains, in effect, are paid for by middle management and lower-level employees whose compensation has reflected their expectation of continued employment. To the extent lay-offs result, the takeover frustrates these expectations and allows the bidder to reap their value instead. Furthermore, although shareholders can protect themselves from losses on particular investments by diversifying their stock portfolios, corporate employees invest all of their "human capital" with a single employer and thus are unable to diversify. They therefore stand to suffer losses in the event of a hostile takeover that cannot be hedged against in, advance. For some commensalism tutors, these findings may justify corporate law reforms that take these non-shareholder interests into account.[22] Needless to say, such arguments are premised on the notion that, at least under some circumstances, non-shareholders have a legitimate claim to corporate law's attention, an idea that in turn is based on a broad conception of the corporate aggregation. Although advocates of shareholder primacy in hostile takeovers have tended simply to take their normative premise for granted, it is getting harder to ignore their opponents' arguments. As we have seen, the argument that hostile takeovers are different from other corporate activity and therefore warrant special legal treatment is winning the day in state legislatures[23] and perhaps in the courts, too.[24] Accordingly, ant regulation scholars recently have begun to offer express justification for shareholder priority over non-shareholder interests in hostile takeovers. [25] Jonathan Macey, in a recent article criticizing legal regulation designed to protect non-shareholders, does not dispute that non-shareholders suffer from hostile takeovers.[26] He acknowledges that, On the surface, few issues of corporate law present as appealing a case for regulatory intervention as the effect of fundamental corporate changes on non-shareholder constituencies. These changes can profoundly disrupt the lives of everyone connected to the firms that experience them; indeed, corporate change seems a paradigm of corporate exploitation of innocent third parties.[27]

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[18] *See* Singer, *The Reliance Interest in Property,* 40 STAN. L. REv. 611, 701 (1988).
[19] *Ibid*
[20] *See Coffee, The Uncertain Case for Takeover Reform: An Essay on Stockholders; Stakeholders and Bust-Ups,* 1988 Wis. L. REv. 435, 440
[21] *See* A. SCHLIEFER & L. SUMMERS, BREACH OF TRUST IN HOSTILE TAKEOVERS (Nat'l Bureau of Economic Research Working Paper No. 2342, 1987)
[22] Ibid
[23] *Ibid*
[24] *Ibid*
[25] Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of FundamentalCorporate Changes,* 1989 DUKE L.. 173, 197; Ribstein, *Takeover Defenses and the Corporate Contract,* 78 GEo. L.J. 71, 140 (1989).
[26] Ibid
[27] Idem.

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Macey accepts the argument that target company shareholders in effect appropriate "firm-specific capital investments" when they tender their shares to a hostile bidder.[28] His conclusion, however, is that non-shareholders are fully capable of protecting their interests through contracting, including collective bargaining in the case of rank-and-file employees. Even in cases in which the party who has made a firm-specific investment that is adversely affected by a takeover is not in contractual privity with the target corporation (for example, a charitable organization that has built a hospital or a local government that has built roads and sewers), the relationship between the investor and the corporation can be structured so that the investor will receive adequate compensation. In any event, public law responses are unsuitable because they cannot address with sufficient particularity the unique relationships between specific constituencies and firms. Further, Macey argues that protective legislation will do more harm than good because it will discourage investment and ultimately result in fewer jobs as firms seek incorporation in locations that lack such laws. The conclusion is the familiar one: Private

ordering better serves society's interest in efficient resource allocation than does legislative intervention that claims to serve the public interest.[29] Much of the political controversy surrounding the appropriate legal response to hostile takeovers can be understood in terms of differing notions of the composition of corporate aggregation. Advocates and critics of anti-takeover regulation alike have continued to talk about corporations in aggregate terms. -By focusing solely on the interests of shareholders, some opponents of regulation seem to imply that the corporation is nothing but an aggregation of shareholders and managers. Proponents of regulation think about the aggregation more broadly to include all participants in the corporate enterprise. Their objective is to define the corporation in a way that supports reform of corporate law governing takeovers so as to protect the interests of non-shareholders, even at the expense of shareholders. Thus, depending on how expansively one draws the boundaries of the corporate aggregation, non-shareholder losses caused by takeovers are either an appropriate concern for corporate law or an irrelevant "externality.". More sophisticated defenders of shareholder primacy do not dispute the broader notion of the aggregation on which support for takeover regulation rests. The theory of the corporation that underlies Macey's position is an aggregate theory that depicts the corporation as nothing more than a web of contractual relationships among real people. He frankly acknowledges the relevance of claims by non-shareholders heard in the policy debate and is unwilling simply to say that shareholders, whether as property owners or as residual risk-bearers, should be entitled to takeover premiums regardless of their impact on non-shareholders.[30] Where Macey differs from the advocates of regulation is in his strongly diver- gent vision of the relationship among the participants in corporate activity. Macey's claim that non-shareholders can protect themselves by contract implies that present contracts lacking such protection amount to an acceptance of the risk of adverse effects, a risk for which they have already received compensation. If shareholders and non-shareholders together have constructed this web in a manner that allows shareholders to sell their stock to a hostile bidder regardless of the consequences for non shareholders, they

[28] *Idem*
[29] While attempting to address directly the claims of non-shareholders for legislative protection from the effects of takeovers, Macey makes no effort to defend his underlying normative assumption- that allocative efficiency is the basic value against which social policy should be assessed. Ribstein's analysis of non-shareholder interests in hostile takeover has a focus that differs from Macey's. Ribstein accepts Macey's normative assumption, but then argues that neither existing law nor the "standard form contract" defining the relationship between shareholders and management allows the target board of directors to disregard shareholder interests in order to protect non-shareholders.
[30] Macey, *Idem*

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must have done so for self-interested reasons that are entitled to respect. Advocates of regulation implicitly reject the assumptions about human relationships upon which this vision of the corporation rests. They deny that the various markets in which shareholders and non-shareholders interact with each other function according to the assumptions of the neoclassical model. Thus, opponents and advocates of takeover regulation are able to draw different normative implications from an expansive conception of the corporate aggregation. Although these differences are significant, even the advocates of legal restrictions on takeovers seem implicitly to share with their adversaries a private conception of corporate activity. The primary justification for intervention is the interests of the participants in the corporate enterprise who are believed to suffer from unregulated takeover activity. The claim that members of the general public (local communities or consumers, for example) also suffer is secondary to the focus on employees and creditors. The opponents of regulation also treat public interest concerns only secondarily. While focusing their primary attention on the claims of shareholders, they also have argued that the market for corporate control increases efficiency-a broader justification for takeovers that supposedly appeals to all Americans. This argument has remained secondary, however. One reason is that it is too abstract: The theoretical efficiency benefits seem too remote and speculative when laid next to actual, observable job losses and the like. A deeper reason also may explain the tendency to downplay the efficiency justification. Once one concedes that the public dimension is relevant to takeover policy, one implicitly seems to acknowledge the relevance of public interest-based arguments that might trump shareholder primacy. Thus, until recently, neither side in the controversy surrounding hostile takeovers has chosen to base its position explicitly and primarily on a conception of the public interest and a theory of corporate law as public law.

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