HARVARD JOURNAL
on
LEGISLATION

VOLUME 5 MAY, 1968 NUMBER 4

CONTENTS

ARTICLE

S.510 and the Regulation of Cash Tender Offers: Distinguishing St. George from the Dragon
Richard G. Swanson 431

BUREAU PROJECTS

An Act to Establish a Corporation for Urban Development 529

A Divorce Reform Act 563

NOTE

Building Codes: Reducing Diversity and Facilitating the Amending Process 587

CUMULATIVE INDEX — Volumes I-V 613

Published four times during the academic year (November, January, March and May) by the Harvard Student Legislative Research Bureau, Langdell Hall, Harvard Law School, Cambridge, Massachusetts 02138.

Subscriptions per year: United States, $6.00 (single copy, $1.50); United States student rate, $5.00 (single copy, $1.25); foreign, $7.00 (single copy, $1.75). Subscriptions are automatically renewed unless a request for discontinuance is received.

Notification of change of address must be received one month in advance of publication to insure prompt delivery. Notification should include both new and old addresses as well as ZIP codes.

Copyright © 1968 by the Harvard Student Legislative Research Bureau.

S. 510 AND THE REGULATION OF CASH TENDER OFFERS: DISTINGUISHING ST. GEORGE FROM THE DRAGON †

Richard G. Swanson*

An outsider who wishes to acquire control of a corporation has several courses open to him.[1] If the outsider is himself a corporation, if the management of the corporation to be acquired supports his view that a change is in the best interests of both companies, and if the acquirer is willing to forego the possible secrecy of his actions in order to cultivate such cooperation, the techniques of merger or sale of assets, through shareholder approval, are available. Of course, any such approval, requiring a vote of the shareholders, is regulated by the Securities and Exchange Commission through its proxy rules.[2] If the management is expected to oppose any acquisition attempt by the outsider, and if the outsider is lacking the funds or desire to acquire his control by capital investment, the acquirer may use the technique of the proxy contest. This too, however, is carefully regulated by the SEC under its proxy rules. His remaining course, other than private negotiations for a sale of control, is the tender offer. If the offer

† This article is based on S.510 as originally introduced by Senator Williams. S.510 as it passed the Senate on August 30, 1967, was changed in some respects from the version as introduced. For example, additional disclosure is required if there is a prior understanding that, following a successful tender offer and without a shareholder meeting, a new majority of the board of directors will be elected.

However, the article discusses S.510 as originally introduced; it is essentially an analysis of the basic justifications for and aims of the regulation of cash tender offers. Since the amended version of the bill has not yet passed the House, any comments must necessarily be tentative.

* Member of the Minnesota bar; A.B., Albion College, 1964; LL.B., Harvard Law School, 1967.

1. *See generally* A. CHOKA, BUYING, SELLING, AND MERGING BUSINESSES (1958); G. MCCARTHY, ACQUISITIONS AND MERGERS (1963); CORPORATE GROWTH THROUGH MERGER AND ACQUISITION (A.M.A. Management Report No. 75, 1963); C. DRAYTON, MERGERS AND ACQUISITIONS: PLANNING AND ACTION (1963) (a research report to the Financial Executives Research Foundation); J. HENNESSY, ACQUIRING AND MERGING BUSINESSES (1966).

2. 15 U.S.C. §78n(a) (1964); 17 C.F.R. §240.14 (1964).

is to exchange the shares of the acquiring corporation for the shares of the acquired, the shareholders accepting this offer have been viewed by the SEC as essentially purchasers of stock in the acquiring corporation as well as sellers of their presently-owned stock. They therefore fall under the protection of the Securities Act of 1933 and its prospectus requirements.[3] If, however, the outsider is not a corporation, or if he seeks to utilize secrecy as a means for avoiding management opposition or for saving costs, he may use the technique of a cash tender offer to the shareholders. This latter technique, unlike the others, is not subject to the meticulous regulations of the SEC.[4]

The phenomenon of the tender offer has become increasingly apparent in the past few years. In 1965, there were 29 cash tender offers involving companies listed on the New York Stock Exchange and 15 on the American Stock Exchange, compared with only eight in 1960 involving companies listed on both exchanges.[5] And this number is increasing.[6] The amount involved in these offers was close to one billion dollars.[7] Perhaps the most significant indication that the tender offer is becoming a major form of corporate takeover is the abandonment of the proxy contest (the most analogous substitute method for effecting a management-opposed take-

---

3. 15 U.S.C. §77e (1964). For the definition of the term "sale", see 15 U.S.C. §77b(3) (1964).

4. *See generally* Fleischer & Mundheim, *Corporate Acquisitions by Tender Offer*, 115 U. PA. L. REV. 317 (1967).

5. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149 (1966). The figures vary among the different sources used. It has been reported also that in 1965 there were 60 tender offers involving the New York Stock Exchange and 25 involving the American Stock Exchange. N.Y. Times, Jan. 17, 1966, at 110, col. 3. Another source reported an estimate of 56 offers involving the New York Stock Exchange, up from 40 in 1964, and 30 offers involving the American Stock Exchange, up from 19 in 1964. Wall Street Journal, May 16, 1966, at 5, col. 2. A more empirical study revealed that the number of cash tender offers reached its peak in 1965 of 76 cash bids and 24 stock tenders, but the level decreased in 1966 due to a tight money policy. Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135, 136-38 (1967).

6. BUS. WEEK, Feb. 26, 1966, at 38.

7. Senator Williams stated that the Wall Street Journal reported 107 different cash tender offers during 1966, which would be an increase over the 1965 data of the Hayes and Taussig study. 113 CONG. REC. [No. 6 444 at S444] (daily ed. Jan. 18, 1967). This would differ, however from the results of that study, which showed a decrease in the number of tender offers during 1966 because of the tight money policy. Hayes & Taussig, *supra* note 5, at 137-38. For an examination of several recent tender offers, see N.Y. Times, April 2, 1967, § 3, at 1, col. 4.

over) in favor of the tender offer by groups with a history of proxy battle experience[8] and the recommendation of the tender offer method in many cases by proxy contest specialists.[9] In any event, the increasing impact of the cash tender offer method on the financial community calls for a reassessment of the circumstances surrounding its use in order to provide the maximum protection of the interests of all those involved with it.

On January 18, 1967, Senator Harrison Williams of New Jersey, chairman of the Securities Subcommittee of the Senate Banking and Currency Committee, introduced a bill, S. 510, to amend the Securities Exchange Act of 1934 and to require disclosure of material information prior to an acquisition by a cash tender offer.[10] Of course, the mere fact that the cash tender offer remains the only major technique of acquisition not subject to the disclosure provisions of the securities acts and regulations does not in itself justify protection by the SEC and the disclosure rules under the proposed legislation.[11] It is the purpose of this article to analyze whether such disclosure regulation is both necessary and justifiable; and, if so, whether the proposed legislation attacks the problem in the best manner. The bill offered by Senator Williams is significant in two respects: (1) it represents the initial entry of the SEC into regulation of the market for corporate control in sales among shareholders and purchasers, and (2) it represents an extension of the Securities Exchange Act protection of sellers of securities substantially beyond dealings with insiders. Because of this significance, any step taken by Congress in authorizing such an extension must be carefully examined. In such a light, this article will

8. N.Y. Times, Jan. 17, 1966, at 110, col. 3.

9. Elias, *The Role of Professional Proxy Solicitors*, 2 MERGERS & ACQUISITIONS 79, 84 (1966) (regarding a report from Georgeson and Co., New York proxy solicitors).

10. S. 510, 90th Cong., 1st Sess. (1967), Appendix. For a brief history of the bill, see *infra*, at 483-85.

11. The unofficial statements of Manuel Cohen, chairman of the SEC, in his article, *supra* note 5, have been criticized by Professor Henry Manne as implying that the mere existence of the unregulated market area of tender offers is itself justification for regulation. Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS 91 (1966).

The article by Chairman Cohen was adapted from a speech before the American Society of Corporate Secretaries, Inc., at Colorado Springs, Colorado, on June 28, 1966. For summaries of that speech, see 204 COM. & FIN. CHRON. 145 (1966); *Proposed Regulation of Cash Tender Offers*, FINANCIAL EXECUTIVE, Aug. 1966, at 60.

seek to answer the following questions: (1) Is there a need for protection in the use of cash tender offers? (2) If so, can adequate protection be provided under the present law? (3) If legislation is desirable, what should be its scope? (4) And does the proposed legislation of Senator Williams accomplish the desired ends yet remain within the justifiable scope?

I. Is Protection Necessary?

Before beginning an analysis of the proposed legislation, it is necessary to gain some insight into the tender offer phenomenon. The procedure of an offer usually begins with the prospective purchaser, after investigating the operations of the company in which control is desired as well as the recent market trends of its stock,[12] determining an offer price

12. This investigation by the prospective purchaser of shares may reveal several factors which would make a corporation vulnerable to a takeover bid. These are: (1) Low earnings and low dividends. A corporation that has not been performing successfully within the industry will usually find the price of its stock below its potential value as an active and progressive member of that industry. The possibility of reorganizing the management to bring the company up to a par with the industry is attractive to potential offerors. This attractiveness may also be present in a generally declining industry where the management has failed to diversify in order to maintain a profitable business despite the industry. (2) Cash accumulations. A corporation which has accumulated large amounts of liquid assets or has retained too high a ratio of cash receivables and marketable securities to current liabilities as a result of a conservative investment program may provide a tempting picture to an offeror who would wish to liquidate and keep (or liquidate and reinvest) those assets. The same view might be taken of a corporation with considerably undervalued assets or excessive reserves. Also, a corporation that has achieved effective decentralization among its divisions and subsidiaries would be prone to partial liquidation by spinning off some of those parts. (3) Shareholder relations. A corporation that has recently been having trouble with dissatisfied shareholders, or one that has maintained a consistent policy of alienating the shareholders even though there has been no recent uprising, is a very vulnerable target for a tender offer. Another relevant factor is the dispersion of the shareholders. If they are widely spread, their allegiance to management may be insignificant, and the percentage of holdings required to achieve control is less. Also, the stockholder is less likely to know what is going on, except as he is informed by letter or other communication. (4) Offeror plans. Of course, a corporation might, through no fault of its own, fit into the diversification plans of the offeror. Here such factors as research developments, underdeveloped new products, patent expiration dates, geographical area, and the adaptability of the corporation to the function of supplier or sales outlet, become relevant. In this case, a well-adjusted company is just as vulnerable to a tender offer as one that faces serious problems. — Financial World, Aug. 17, 1966, lists 12 respectable candidates for takeover bids. (5) Abortive merger talks. The tender

sufficiently in excess of the present market price to induce the shareholders to tender their stock.[13] Unless he has sufficient capital to finance the purchase from his own coffers, the offeror must usually arrange a loan to cover the taking up of the tendered shares. He then will contract with a brokerage house to manage the procedural aspect of the offer and will communicate with the shareholders, either directly by mail or indirectly through newspaper advertisements and press releases.[14] The terms of an offer may vary; but they will usually describe the method for tendering shares, the offer price, the length of time available in which to take advantage of the offer, and the minimum and maximum number of shares to be tendered as a condition of the offer. Beyond these, there are some precautionary terms that have been inserted in tender offers, such as a statement that the purchaser may withdraw the offer in the event of material adverse developments in the acquired corporation,[15] and indication of possible plans for a future merger,[16] or a dis-

offer is often used as a means to gain directly from the shareholders what could not be gained from negotiations with the incumbent management. The failure of merger talks, then, may mark the corporation as a tender offer target by the interested outside party. Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take-Over Offers*, 20 BUS. LAW. 763, 764-65 (1965); Hayes & Taussig, *supra* note 5, at 142; G. MCCARTHY, *supra* note 1, at 73-102; Wheelus, *Proxy Pugilism: Proxy Battle Techniques and How They Were Used in Some of the Rougher Fights*, 2 MERGERS & ACQUISITIONS 73 (1966).

13. The rule of thumb is a premium of 20 per cent above the market price two days before the offer is to be made. Variations of this rule, according to the special circumstances of the case, have ranged from zero to 44 per cent of the market price. Hayes & Taussig, *supra* note 5, at 139-40; G. MCCARTHY, *supra* note 1, at 259-60.

14. *Compare* Offer to Purchase 350,000 Shares of Common Stock of Columbia Pictures Corporation at $33 Per Share, Sept. 30, 1966 [hereinafter cited as Offer for Columbia Shares], *with* Wall Street Journal, Oct. 3, 1966, at 25, col. 5.

15. *See* Offer to Purchase the First 65,000 Shares of Common Stock Tendered of Pacific Insurance Company of New York, Sept. 16, 1966, p. 3, which provided that the offer might be withdrawn on notice delivered to the shareholders upon the occurrence of any significant change in the corporation's capital structure or increase in the number of outstanding voting shares, a material adverse change in the financial condition of the corporation, and any other material adverse occurrence beyond the control of the offeror. Fleischer & Mundheim, *supra* note 4, at n. 77.

16. *See* Offer to Purchase Common Stock of Wagner Electric Corporation, May 31, 1966, which provided that if the tender offer was successful, the purchasing corporation might acquire the entire business of the offeree corporation, whether by purchase, merger, or otherwise. The reason for such a statement stems from the uncertainty whether merger plans are a material fact that could impose liability under 10b-5 and whether such plans are definite enough to require disclosure even if being negotiated. *Id.* at n. 95 and accompanying text.

claimer provision allowing the purchaser to buy stock of the acquired corporation on the market both during and after the offer.[17] The terms of the offer will usually also mention the method by which the purchaser will take up the shares tendered. The advantage of using the first-come-first-served method of acceptance is that the shareholders will be prone to rush immediately to tender their shares in order not to be left behind. On the other hand, the forcing of hasty action is likely to evoke cries of unfairness and fraud as a management defense; and the offeror may desire to insert a provision for the pro-rata taking up of tendered shares.[18] Furthermore, if a term is added permitting the purchaser to take up any or all of the shares in excess of the maximum desired at his option, the offeror may gain a greater foothold in the acquired corporation than is immediately apparent since the shareholders will not tend to back off from sending in their shares to the tender agent once it is known that the maximum has been reached.

There are several inherent advantages in the tender offer technique which have contributed substantially to its increased use. Compared with the proxy contest, even in the face of hostile management, it is cheaper, as the proxy contest entails expensive solicitation as well as the expense of complying with SEC disclosure requirements and the complexities of various legal and mechanical requirements. Further, the complexity of a proxy fight tends to prolong it, enabling management to defend itself better, which in turn increases the costs and risks of a proxy contest. Further, if he loses the proxy fight, the outsider may have nothing to show for his efforts, whereas with a cash tender offer, even if he does not get control, he still has the shares he has purchased, on which he may have a gain, and he also will be getting a return on his investment. In a proxy fight the outsider will find it difficult to know where he stands until the proxies are finally counted at the shareholders meeting. The tender offer eliminates this uncertainty by establishing a time limit for tenders, before which the outsider may at

17. *See* Offer to Purchase 300,000 Shares of Common Stock of the Philip Carey Manufacturing Company, Feb. 8, 1966, which disclaimer provided that the offer is not to be construed to mean that the offeror cannot purchase shares on the market at prices less than the offer price or that such purchases would "diminish" the tender offer. *Id.* at n. 108.

18. *See* Offer to Purchase Columbia Shares.

any time accurately assess his position because those shares tendered are irrevocable until the offeror has acted on them. Finally, the tender offer is less damaging to the reputation of the corporation sought to be acquired as well as to that of the outsider.[19] This is because of the relative secrecy in which an offeror may act and the speed in which the entire transaction may take place, both of which tend to prevent management from hurling public accusations at the intruder with the resulting public rebuttals and counter-accusations.

The tender offer method also provides advantages over the acquisition of assets, either with cash or an exchange of shares. The latter usually requires a two-thirds vote of shareholders to approve the transaction.[20] And if the management opposes the acquisition, the outsider is forced back into all of the problems noted above concerning proxy solicitations. But even beyond this, the purchaser may wish to avoid the extensive redrafting of legal arrangements in the acquired corporation that can accompany a merger or acquisition of assets.[21] Under the tender offer method, control is maintained through the board of directors and through the voting of shares, and the acquired corporation does not become an integral part of the acquiring corporation. Furthermore, the concept of "working control", which is possible under the tender offer method but not under an acquisition of assets or merger, as opposed to numerical or complete control, enables the outsider to gain an effective grip on the target corporation at a minimum of capital investment.[22]

---

19. The offeror will have to be cautious in taking advantage of his ability to realize his investment, particularly if he sells out after an abortive tender offer. He may become liable under §16(b) of the 1934 Act if he has obtained over ten per cent of the outstanding shares in his acquisition program and sells within six months of his last purchase of the corporation's shares. 15 U.S.C. §78p (1964). Also, if a share-for-share offer fails, he may become liable under Rule 10b-6 of the 1934 Act for participating in sales on the market before the impact of the tender offer has subsided and the market price has returned to its own level. 17 C.F.R. §240.10b-6 (1964).

20. ABA-ALI MODEL BUS. CORP. ACT §§ 67, 72 (1962). Although most states require a two-thirds consent from the shareholders to effect a merger or sale of assets, a few states vary from this. R. BAKER & W. CARY, CASES ON CORPORATIONS 96 (3d ed. 1958).

21. The United Fruit Company used a tender offer to avoid renegotiation of a number of leases incident to a merger proposal involving Winchell Donut House, Inc., Wall Street Journal, Sept. 13, 1966, at 15, col. 4.

22. Several kinds of control are possible, including (1) complete ownership of the capital stock, (2) majority ownership, (3) majority ownership with a legal

Although such control may just as easily be gained from the purchase of control from a single shareholder or a small, controlling group, there are three factors which warrant the use of a general tender offer.[23] First, the uncertainty accompanying the developing law of sale of control and fiduciary responsibility may cause the management group to hesitate. Secondly, the outsider must necessarily "tip his hand" in seeking such a sale of control, which may allow the management group to begin mounting an opposition to later attempts via the tender offer. And finally, a single controlling group would demand a greater "sweetener" in the premium offered over market price because of the certainty of the transaction, the savings in expenses of the purchaser in communicating his offer, and the higher bracket of capital gains tax applicable to a large shareholder.[24]

The tender offer method has certain advantages beyond the facilitation of a choice among specific alternatives of corporate control acquisition. Perhaps the most important of these advantages is secrecy.[25] The element of surprise will catch the management off their guard and will usually

---

device, such as pyramiding through holding companies, voting trusts, and issues of non-voting stock, (4) minority control with shareholders widely and diversely scattered, (5) management control by self-perpetuation where the majority of shareholders are too dispersed and disinterested to exert a controlling influence, (6) proxy control through committees, and (7) interlocking corporate officers and directors. *Detroit Edison Co. v. SEC*, 119 F.2d 730, 739 (6th Cir. 1941) (action under §2(a)(8) of the Public Utility Holding Company Act of 1935). *See generally* 2 L. Loss, Securities Regulation 770-83 (2d ed. 1961); Sommer, *Who's "In Control"? — S.E.C.*, 21 Bus. Law. 559 (1966).

23. For a discussion of private sales of control regarding the definitional scope of "tender offer" under S. 510, see *infra*, pp. 510-16.

24. For tax considerations concerning the offeror, see Colborn, Fleming, Katcher & Merritt, *Buying and Selling a Corporate Business: A Survey of Tax and Non-Tax Implications*, 10 W. Res. L. Rev. 123 (1959); Sogg, *Problem Areas in Buying and Selling a Corporate Business*, 17 W. Res. L. Rev. 784 (1966); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 Harv. L. Rev. 1183 (1957).

25. Hayes & Taussig, *supra* note 5, at 139. Senator Williams stated in a speech before the New York State Bar Association that "those who wish to keep their identity and their transactions secret have turned to other methods [than the proxy contest], chief of which is the cash tender offer." N.Y. Times, Feb. 4, 1966, at 42, col. 3.

Recently, a mystery group made a tender offer to purchase 250,000 shares of Metro-Goldwyn-Mayer, Inc., at $43 per share. Wall Street Journal, April 5, 1967, at 2, col. 2. *See also* N.Y. Times, April 5, 1967, at 61, col. 3.

prevent the development of serious opposition.[26] And by keeping the offeror's identity a secret, the shareholders will be less tempted to hold out for higher prices if the offeror is well-respected in the financial community or has indicated a strong interest in the company,[27] and they will be less likely to hold back tenders as a protective measure if the offeror has the reputation of a looter or liquidator.

Furthermore, there are advantages to the tender offer subsequent to the acquisition of control. Having purchased a controlling interest in stock, the offeror will be able to maintain a leverage on earnings distributions.[28] Also, the maintenance of a controlling stock interest will nearly eliminate the problem of opposition groups with substantial shareholdings arising in the future.[29]

The tender offer method is not without its shortcomings. First, the decision of the offeror to maintain secrecy in his plans to acquire control will hinder his investigation of the target corporation, for the offeror will be unable to time his offer precisely due to an unawareness of the immediate internal climate of the corporation, such as the initiation of forward-looking projects, recent dividend decisions, and other factors which might hinder the success of the offer if they were made public. He will also find it difficult to "feel out" shareholder opinion fearing to inform management of his interest and will thus be unable to get the cooperation of

---

26. The secrecy employed by Pennzoil Company enabled it to acquire 5,152,598, or 42 per cent, of the shares of United Gas Corporation, which was nine times its size. Pennzoil started buying the stock of United Gas one year before the tender offer was announced, accumulating over 275,000 shares. Pennzoil management referred to United Gas during this time as "Company X," refused to discuss the takeover in the presence of secretaries, and watched the waste baskets. Rejecting the prospect of making merger overtures, the company lined up a public relations man and six law firms in the areas where United Gas operated in order to protect its position once the offer came to the attention of the management. Of the 25 banks financing the offer, only five were informed of the actual intentions of the company. The tactics paid off when over five times the minimum shares requested in the offer were tendered and accepted by Pennzoil. Wall Street Journal, Feb. 11, 1966, at 1, col. 6. *See also* BUS. WEEK, Feb. 26, 1966, at 39. The courts later rejected an attempt by United Gas to enjoin Pennzoil from purchasing more than ten per cent of the corporation's stock, as it would require a change in its present capital structure to comply with the Public Utility Holding Company Act of 1935. *United Gas Corp.* v. *Pennzoil Co.*, 248 F. Supp. 449 (S.D.N.Y. 1965).

27. The problem of shareholders holding out for a higher price when they are aware of the identity of the offeror is discussed fully *infra* pp. 488, 491, 493.

28. G. MCCARTHY, *supra* note 1, at 28.

29. *Id.*

dissident shareholders against management.[30] In other words, the more the offeror tends toward secrecy, the less accurate his assessment of the proper premium above market price is likely to be. The consequences are that, if the offer falls short of the "desirable" mark, there is a greater probability of opposition to the offer developing, not only from the management, and perhaps the shareholders themselves, but also from outside bidders interested in the company.[31]

Second, the announcement of a tender offer above market price invariably causes a jump in the market of that stock's price.[32] Usually, that jump will seek the level of the offer price.[33] This can add greatly to the cost of an offer if the offeror is later forced to raise his price in order to insure success. For example, if the original offer was $5 above market, and this proved to be an inadequate premium, a subsequent raise of $4 to a $9 premium above the *original* market level would be even more inadequate since the shareholders would be considering the second offer against a *new* market level that has already absorbed the $5 premium. Further, if the offeror intends to make further acquisitions of stock, this rise will add to the expenses of the offeror in

---

30. The offeror is faced with a similar problem if he wishes to obtain the shareholder list of the corporation in order to contact personally some of the larger shareholders. By making his demand on management for the right as a shareholder to view the list, he will have "tipped his hand" and allowed management to begin building up defenses. Furthermore, it is often easy for management to use the withholding of the list as a delaying tactic, forcing the offeror to vindicate his right in the courts. Even though the courts will likely adjudge the seeking of control a proper purpose under most state laws, an offeror will have to weigh the disadvantage of giving warning to management against the obvious advantages of the shareholder list.

31. N.Y. Times, Dec. 5, 1965, §3, at 2, col. 3 (statement by a Lehman Brothers spokesman).

32. This sudden rise in the market price has enabled the larger securities firms to engage in arbitrage, the practice of short-term buying and selling in different markets to take advantage of slight price differentials. When a tender offer is announced, these firms will buy stock on the open market and then tender it to the offeror at the higher offer price. The firms must act quickly because profit seekers will drive the price up to the offer level almost immediately; and there is still the risk that the offeror will not accept the shares if the bid is unsuccessful as a whole. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

33. Almost immediately after Giannini Controls Corporation announced its offer for 35 per cent of the shares of Veeder-Root, Inc., the market price jumped up from $32.50 per share to near the level of the offer price of $38 per share. N.Y. Times, Dec. 5, 1965, §3, at 2, col. 3.

using later tender offers to supplement his shareholdings,[34] especially if the first offer stimulated interest in the shares of the company and they continue to rise.

Third, the costs of the tender offer may be increased by the offeror's own overeagerness. If he overplays his part in trying to induce the shareholders to tender their stock, they may see his enthusiasm as a chance to hold out, expecting higher offers to follow.[35] Once this idea has been conveyed to the shareholders, it may even hamper subsequent offers despite later attempts to correct it.

Fourth, if the offeror decides to use a pro rata provision in his offer, he may find that existing management factions may be left in the corporation even though they tried to get out. While they may remain effectually impotent because of a substantial reduction in their shareholdings, their reputation and contacts with the shareholders can prove to be an undesirable situation.

Fifth, from a tax standpoint, the sale of shares in a tender offer is a taxable transaction to the tendering shareholder. Because the larger shareholders will find themselves in a higher tax bracket than the smaller ones, the premium inducement must be high enough to entice those larger shareholders if the offer is to prove successful. This increment of the "tax premium" to entice those larger shareholders is essentially a giveaway to those with smaller holdings.[36]

---

34. Greatamerica Corporation sought to gain control of Braniff Airways, Inc., by using two separate tender offers over a period of two years. The market jump caused by the first offer at $25 per share continued to rise as the prospects of the company and of the industry in general looked brighter, so that the second offer had to be made at $75 per share. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

35. G. McCarthy, *supra* note 1, at 38.

36. This can best be illustrated by hypothesizing X Corporation, which has 21 stockholders, five of which own one per cent each of the company's outstanding shares, five owning four per cent each, five owning six per cent each, five owning seven per cent each, and one owning ten per cent. If an offeror wishes to gain 51 per cent control of the corporation, he must offer a premium above market price that will induce the tender of shares by the group most essential to his obtaining that percentage. Since the capital gains tax for each group increases as his sale constitutes a greater percentage of X Corporation's stock, the single holder of ten per cent will demand a greater premium than the holders of seven per cent, and so on. Therefore, all other factors being equal, the offeror must provide a premium that appeals to the six-per-cent holders in order to gain his requisite 51 per cent. In this case, a completely successful bid would yield him 55 per cent of the company's shares. Since the four- and one-per-cent holders would have been induced to tender at a lower premium because of their lower tax brackets, the premium costs to this segment is non-func-

Sixth, even though the offeror may employ the tender offer technique to avoid the agencies and regulations of the federal government, he may find himself faced with problems either under the antitrust laws[37] or under § 16 of the Securities Exchange Act.[38]

Finally, perhaps the greatest disadvantage, and the most prevalent cause of increased expenses to the offeror, is the defensive tactics open to a hostile management faced with a tender offer to its shareholders. Even before beginning any positive program of defense, the management has available in its arsenal two weapons that can be most detrimental to the offeror's efforts. Access to the shareholder list allows the management to cultivate shareholder support by personal communication through the mails, whereas the offeror must rely on the more impersonal methods of newspaper advertisements and the efforts of brokers if he is to maintain a desired secrecy. The list also permits management to use face-to-face persuasive techniques on the larger shareholders, where the support of management can do the most damage to a tender offer. And management has access to the corporate

---

tional expense to the offeror. Furthermore, if factors other than their tax situations enter in their decision, the offeror may have to provide a premium that would appeal to the seven-per-cent holders to compensate for non-tendering shareholders in the lower groups.

37. The Justice Department is equally concerned with violations of the antitrust laws resulting from acquisitions of control via the tender offer as resulting from mergers. BUS. WEEK, Feb. 26, 1966, at 38.

38. The offeror will usually embark on a program to purchase stock on the market in the corporation in which control is sought in order to gain a foothold prior to the actual tender offer. If he becomes the beneficial owner of more than ten per cent of a class of the company's stock during this program, he must file a report under §16(a) of the Securities Exchange Act. 15 U.S.C. §78p (a) (1964); G. MCCARTHY, *supra* note 1, at 258. It has been suggested that, if the offeror obtained a firm commitment to tender from stockholders who owned over ten per cent of the shares once the offer is made, a partnership under §3(a)(9) of the 1934 Act would be formed, requiring the filing of a report under §16(a). *See* 15 U.S.C. §78c(a)(9) (1964); Fleischer & Mundheim, *supra* note 4, at n. 68. An extension of this reasoning would be that the offeror must file a report under §16(a) at that time during his offer when he has received the minimum number of required shares tendered that would make both his offer and the shareholders' acceptance unconditional and would create an obligation to purchase shares resulting in ten per cent beneficial ownership, even though the offer is extended for an additional period of time. But the disclosure of the offeror's identity at this point would not hinder the success of the bid. And it is questionable whether a tender of over ten per cent of the shares would require filing if the bid remained conditional, since the tender is essentially a non-transferable option to purchase the shares. *See* Rule 16a-6, 17 C.F.R. §240.16a-6 (1964).

treasury to support its efforts. Furthermore, there is incentive for forming an immediate defense to the offer because, if the first attempt is unsuccessful, further attempts are often unlikely. Not only will the offeror suffer additional expenses as a result of counter tactics and market jumps, but he will also have been publicly embarrassed by the failure of his first attempt. His only measure against the latter is secrecy, although it is doubtful that he can maintain complete secrecy throughout the entire length of the tender offer. His measure against the former is speed, which ideally would not permit management to take advantage of either the stockholder list or the corporate treasury; but he must allow enough time to collect the desired number of tenders.

One of the defensive techniques used by management is to contact the shareholders and present arguments against the acceptance of the tender offer. This may be done either by letter,[39] or by newspaper advertisement,[40] or both. The arguments will vary according to the circumstances, but they will generally include notice of rejection of the offer by management and the directors; financial conditions that show the value of the stock to be worth more than the offering price; future plans of the company; a statement intimating that broker persuasiveness is due to incentive commissions paid by the offeror; the irrevocability of the tender; tax considerations; and, if there is a pro rata provision, a statement that there is nothing to be gained by tendering before the deadline.[41]

The management will also be able to engage in slight exaggeration, or "puffing", of its arguments without much fear of successful retaliation by the offeror in the courts. Except in cases of blatant misstatements or fraud, the SEC will probably not be persuaded to intervene to seek an injunction. In the past, especially in proxy contests for control, it has remained in an umpire role, rather than as an active participant, allowing greater freedom than usual in

---

39. *See* Letter to Columbia Pictures Shareholders, Oct. 5, 1966 (hereinafter cited as Columbia Letter, Oct. 5, 1966); Letter to Stockholders of Columbia Pictures Corporation, Oct. 11, 1966 (hereinafter cited as Columbia Letter, Oct. 11, 1966).

40. *See A Word of Advice to Shareholders of Columbia Pictures Corporation*, Wall Street Journal, Oct. 7, 1966, at 24, col. 5.

41. *See* Columbia Letter, Oct. 5, 1966.

making statements.[42] Apparently, this policy of protecting advocacy is shielded from abuse by the opposing party's ability to answer the statements. Furthermore, the offeror will find it difficult to seek redress for misstatements by private action under 10b-5 because the deception, if effective, would not have caused injury to the offeror in the purchase or sale of a security.[43] Rather, an effective misstatement by management would be the direct cause of a lack of a purchase or sale.[44]

---

42. Von Mehren & McCarroll, *The Proxy Rules: A Case Study in the Administrative Process*, 29 LAW & CONTEMP. PROB. 728, 735 (1964); Cohen, *The SEC and Proxy Contests*, 20 FED. B.J. 91 (1960).

43. 17 C.F.R. §240.10b-5 (1964). A private right of action under Rule 10b-5 is created only in favor of persons who have either purchased or sold securities and have been defrauded in the process. Studebaker Corp. v. Allied Products Corp., 256 F. Supp. 173, 179 (W.D.Mich 1966), citing Kardon v. National Gypsum Corp., 69 F. Supp. 512 (E.D.Pa. 1946); Birnbaum v. Newport Steel Co., 193 F.2d 461 (2d Cir. 1952); O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); and Vine v. Beneficial Finance Co., Inc., 252 F. Supp. 212 (S.D.N.Y. 1966). The case of Voege v. American Sumatra Tobacco Co., 241 F. Supp. 369 (D.Del. 1965), allowed standing to a shareholder under 10b-5 for misrepresentations in a tender offer even though she did not tender her shares. The offeror acquired over 90 per cent of the corporation's shares and then effected a short-form merger under Delaware law, in which plaintiff and the other remaining shareholders were paid $17 per share. This case is therefore distinguishable from the broad proposition that any shareholder offered a tender bid may sue for misrepresentations under 10b-5, even though he did not tender, because the plaintiff in effect "sold" her shares in that she was forced to dispose of them as a result of the merger. And the merger was made possible by the success of the deceptive tender offer.

A further problem that would be faced by the offeror in acting under 10b-5 to recover because of management's misstatements in preventing tenders would be the difficulty in proving damages. Since the offeror did not pay for the shares affected, damages would have to be based on the value of the shares had the offer been successful. This would require speculation as to the success of the corporation under new management, which would be an unacceptable measure to the court. The offeror may find it easier to secure a remedy under the state laws of intentional torts. W. PROSSER, TORTS 938 (3d ed. 1964).

44. It has been suggested that two recent decisions imply that the offeror would be successful in seeking an injunction preventing management from disseminating misleading statements.

In J.I. Case v. Borak, 377 U.S. 426 (1964), the Supreme Court required the courts to fashion an appropriate remedy to vindicate substantive rights arising from the 1934 Act. If such a right can be found, an injunction would be an appropriate remedy in the tender offer situation. And in Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966), the court gave a corporation standing to seek an injunction under §14(a) of the Securities Exchange Act because it had an interest in seeing that a contest for control was free from infractions of the proxy rules. Since the offeror has an interest in seeing that statements affecting the tender of shares under the offer be free from infractions under 10b-5, the same reasoning would apply to him. Fleischer & Mundheim, *supra* note 4, at 362-63.

A second defense is to enter into merger talks with another corporation.[45] This would have a dual effect. First, if the other corporation seeking a merger has a good reputation and a progressive record, the shareholders will be induced to keep their stock in order to take advantage of the new management. Secondly, if the offeror subsequently reveals his identity in order to compete with the merger-seeking corporation on a "popularity" basis, the merger terms can be used to force the offeror to increase his offer price until he has reached his cost limit and must withdraw. But the offeror has an advantage in forcing a tender decision within a given time limit. Management might find it difficult to attract a merger prospect in such a short time; and, when it does, concrete merger terms will take time to negotiate. It will then be forced to curry favor with the shareholders with glittering generalities, which may look pale compared with the hard cash offer of the offeror—a sort of "bird-in-the-hand" philosophy. But if headway can be made in a merger program, the offeror will find difficult competition.[46]

Another defense is management purchase with corporate funds of its outstanding shares, either on the market or

---

45. Phoenix Insurance Company successfully warded off an offer for 51 per cent of its 1.7 million shares at $75 per share by pursuing merger arrangements with Travelers Insurance Company. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

If the merger talks are genuine and attractive, the only means with which an offeror can turn the attention of the shareholders back to the tender offer is to increase the offer price. This was done by Kewanee Oil Company in its bid for Kendall Refining Company, eventually resulting in two successive increases, from $52 per share to $55 and then to $65, in order to head off the latter's merger with Witco Chemical Company. BUS. WEEK, Feb. 26, 1966 at 38.

46. Two questions have been raised as to the role of the offeror regarding tendered shares when management seeks to use the defense of merger negotiations. First, because to effect a merger the shareholders must consent by vote or proxy, any communication by the offeror to induce acceptance of the tender offer may be "reasonably calculated to result in the procurement, withholding or revocation of a proxy" under Rule 14a-1(f)(iii). 17 C.F.R. §240.14a-1(f)(iii) (1964). This is even more apparent in the case in which the offeror attacks the proposed merger as well as seeks to induce tendering. Secondly, it is possible that the offeror could vote under state law the shares tendered in the shareholder vote to approve the merger, if those shares are tendered with proxies and are coupled with an interest that supports a promise of irrevocability. The SEC, however, has taken the position that the offeror cannot vote the shares until he is firmly obligated to purchase them, since he is not a "beneficial owner" under Rule 14a-2(c). 17 C.F.R. § 240.14a-2(c) (1964). *See* Fleischer & Mundheim, *supra* note 4, at 368-70.

with a counter offer.[47] The result of this would be to attract tenders away from the original offer in the case of a counter offer, and to cause an increase in the market price level in the case of market purchases. Both would force the offeror to increase his offer price to make a successful bid.[48] And if the purchasing is extensive, management can "dry up" the market.[49]

Market purchases can give rise to shareholder derivative suits under state law for waste of corporate assets, but a series of Delaware cases seems to have established the principle that management is justified in using corporate funds to thwart a bid for control if it believes the contest is one of policy that involves possible major changes in the form or conduct of the business as it exists at the time.[50] The propriety of this line of thinking has been the subject of some criticism;[51] and the fact that there has been a dearth of supportive cases since the series implies that the criticism might be valid. Also, speed will again aid the offeror, since management repurchase of stock with corporate funds is not justified if begun before it was determined that there was a genuine threat to corporate policy.[52]

Because the "waste of assets" attack by the offeror is after the fact and consequently of no benefit to the tender offer itself, the offeror would do better to seek a preliminary

---

47. American Steel and Pump Corporation, controlled by the Defiance Industries-BSF group, made a tender offer to purchase 51 per cent of the outstanding shares of Standard Products Company at $13.50 per share. Standard management resisted, driving the offer price up to $15 per share, and finally forced American Steel and Pump to retreat empty-handed with a counter-offer at $17.25 per share. N.Y. Times, Jan. 17, 1966, at 110, col. 3.

48. For a discussion of the role of management's use of corporate funds to outbid the offeror under the proposed legislation, see note 171, and accompanying text *infra.*

49. If management purchases shares on the market to force out the offeror, either by raising the market level or by buying up available shares, it should be required under Rule 10b-5 to disclose the reasons for its purchases, including whether it is for the preservation of corporate offices, since that information would affect the market level at which the shareholders would sell in order to aid in that purpose. *See generally* 3 L. LOSS, *supra* note 22, at 1453-54.

50. Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962), and Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964).

51. Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966); Note, 1965 DUKE L.J. 412.

52. Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962).

injunction by persuading the SEC[53] to intervene under § 9 (a) (2) and Rule 10b-5 of the 1934 Act.[54] A violation of § 9 (a) (2) occurs whenever purchases are made with a manipulative intent to raise the market price level (and such actually occurs) even though the purchaser acted in what he believed was a bona fide purpose and even though his self-serving intent was never fully realized.[55] This is true in the case of placing bids or offers, directly or indirectly, on the market as well as in the case of actual purchases on the market.[56] This would then cover the counter offer of management. The only uncertainty is that the usual case involves market purchases to raise artificially the market level in order to *sell* a block of stock at the higher price. No case has held that it is equally damaging to raise the level artificially to out-*purchase* another party. But this would seem a logical extension of the law because purchasers at the higher market level after the defeat of the tender offer would be injured by the market collapse when the battle was over.

A fourth defense is to begin litigation against the offeror. In some cases, this tactic is legitimate, such as for protecting the present operating condition of the corporation from federal or state intervention resulting from a violation of a statute that would occur if the offeror were to gain control.[57] But in other cases, a suit may be equally effective as purely a harassment tactic.[58] Other than the filing of

53. The offeror here faces the same problem of a lack of a purchase or sale by himself when proceeding under 10b-5 to require management to disclose its intentions when purchasing on the market or making a counter offer as when proceeding under 10b-5 for misstatements in communications to shareholders. *See supra*, note 42.

54. 15 U.S.C. §78i(a)(2) (1964). Both §9(a)(2) and Rule 10b-5 are often cited together in a suit to enjoin false and deceptive practices in manipulating the level of the market. *E.g.*, Studebaker Corp. v. Allied Products Corp., 256 F. Supp. 173, 179 (W.D.Mich 1966). For a general discussion of illegal market manipulation, see 3 L. Loss, *supra* note 22, at 1529-71.

55. SEC Securities Exchange Act Release No. 3055, (Oct. 27, 1941).

56. *Cf.* Kidder Peabody & Co., 18 S.E.C. 559, 570 (1945).

57. The complaint of Columbia Pictures Corp. v. Clairmont, Civil No. 3581 (S.D.N.Y. 1966) alleges that the offeror and its associates violated the Federal Communications Act of 1934 and the rules thereunder by seeking control.

58. This tactic may also be used by the offeror and his associates. Although it is not clear whether the dissident shareholder group of Columbia Pictures Corporation was directly involved with the tender offer of the Banque de Paris, that group filed suit while the offer was pending to force Columbia to separate the earnings statement of the motion picture company and that of its subsidiary, Screen Gems, Inc., which sold movie rights to television. Alliston Corp. v. Columbia Pictures Corp., Civil No. 3279 (S.D.N.Y. 1966).

counter suits, there is really very little that the offeror can do to retaliate. But again, speed and secrecy are potent weapons for delaying use of these defenses by a hostile management.

There are several potential defenses available to management that would provide effective opposition if certain circumstances exist. If the company has plans for new developments, such as plant expansion, research programs, product improvements, or the like, announcement of these plans can be accelerated in order to influence the tender offer. And along the same line, an increase in dividends would help paint a pro-management picture, if such action is warranted by the corporation's earned surplus situation.[59] Also, wealthy friends of management can be induced to purchase stock on the market in order to buoy the price level above that of the tender offer.[60] However, if part of this inducement is the promise that the friendly purchasers would later be able to sell out at a profit because of the buoyed market level, they run the risk of violating the anti-manipulative provisions of the 1934 Act.[61] Influential friends might also prove helpful if they can persuade the banks or other loan sources to withdraw the financing of the tender offer.[62]

Despite the defenses open to an entrenched management because of its corporate powers and access to corporate facilities, three distinct advantages of the tender offer method for gaining corporate control emerge from the above analysis. First, the method is relatively cheaper than the proxy contest because expenditures result in an investment as well as the

---

59. When Allied Products Corporation made a tender offer for 854,000 shares of Dayco Corporation at $26 per share, the Dayco management issued a stock split of five new shares for four old shares and announced a dividend increase of 300 per cent, which forced the market level of the shares above the offer price. N.Y. Times, Nov. 1, 1966, at 53, col. 6.

60. Dorchester Gas Producing Company made an unsuccessful bid to purchase 290,000 shares of Louisiana Gas Service Company at $20 per share, due to the efforts of New Orleans interests friendly to Louisiana Gas in purchasing on the open market to push the market level above $21 per share. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

61. *See* notes 53-55 *supra*.

62. When Glen Alden Corporation sought control of McKesson & Robbins, Inc., it is said that the chairman of McKesson persuaded the chairman of the Chase Manhattan Bank during a golf game to abandon its tentative plans to finance the Glen Alden purchase. When this move became known, the other banks grew doubtful; and Glen Alden was pressured to sell its one million McKesson shares to Foremost Dairies, Inc., which had been approved by McKesson management. Wall Street Journal, Feb. 11, 1966, at 1, col. 6.

purchase of control. And it is less complex than the proxy contest because of the lack of federal regulation in this area. Secondly, the offer can be limited to a fixed period of time. The resultant speed with which the entire transaction can take place is an influential factor in both preventing the build-up of management defenses and curbing the expenses of acquiring control. And finally, if the offeror is confident of management opposition and does not wish to seek their co-operation,[63] secrecy enables him to catch the management by surprise. In the confusion of the moment, management will be less likely to build effective defenses against the offer than if it were notified in advance.

To illustrate the generalities analyzed above, and to provide exemplary material for the discussion to follow on the proposed legislation, consider a recent tender offer made for the shares of Columbia Pictures Corporation. This is an appropriate example in that it involves neither a case of outrageous fraud and looting by a corporate Genghis Khan[64] nor a case of a "friendly" change of control in which protection of the interests involved would be less necessary. It is rather the in-between case—the case that is most likely to reveal whether protection of interests is needed in the general area of tender offers.

Columbia's trouble began in mid-September of 1966, when a shareholder committee representing over 200,000 of Columbia's 1,967,000 outstanding shares was formed.[65] In the wake

---

63. It would seem the rare case in which the offeror would not seek management cooperation before the announcement of the tender offer. Although the element of surprise is a high card against a recalcitrant management group, there would be an even greater savings of costs and headaches if management could be persuaded to approve the offer. Unless management has given the offeror some prior indication of its unwillingness to cooperate, an offeror is foolish not to try to gain the favor of his only source of opposition, at least briefly before the offer is made.

64. Senator Williams points out recent "industrial sabotage," in which "we have seen proud old companies reduced to corporate shells after white-collar pirates have seized control with funds from sources which are unknown in many cases, then sold or traded away the best assets, later to split up most of the loot among themselves." 111 CONG. REC. 28257-28258 (daily ed. OCT. 22, 1965).

65. The members of this committee included Maurice Clairmont, president of Alliston Corporation and former chairman of Lee National Corporation, representing over 30,000 shares; Sylvia Martin, investor and former chairman of Windsor Industries, Mojud Company, Bates Manufacturing Company, and other concerns of the late Lester Martin, representing over 135,000 shares; and Gerald Rivlin, member of Rodman & Renshaw, Chicago brokers, representing over 75,000 shares. Wall Street Journal, Oct. 3, 1966, at 32, col. 2.

of two other shareholder uprisings in the motion picture industry, involving Paramount Pictures and MGM, the Columbia shareholder group submitted a list of grievances to the management.[66] It stated dissatisfaction with the earnings record, the executive compensation, and the use of the television licensing profits of Screen Gems, a subsidiary of Columbia, to bolster Columbia's profits by combining the earnings reports.[67]

On September 30, Columbia shareholders received a tender offer from an undisclosed principal through a Swiss Branch of the Banque de Paris et des Pays Bas.[68] It offered to purchase all shares tendered up to 350,000 shares at $33 per share, about $3 over market, expiring two weeks later on October 14. The offer stated that, if less than 200,000 shares were tendered, the offeror could refuse to accept the shares but reserved the right to accept any or all of those shares tendered if it desired. If more than 350,000 shares were tendered, the offeror reserved the right to purchase all or some of the excess or to assign it to others. If it did not exert that right, the offeror would take up those shares tendered on a pro rata basis.

It is obvious that the Columbia management was taken by surprise, not knowing whether the offer was a bid for control or merely a means for supplementing an investment, or whether it was from the dissident shareholder committee, the Banque de Paris, or some completely unknown party.[69] The best management could do was to send a letter to the shareholders, arguing that if the offer was for $33 per share the offeror must think that the actual value is greater than $33, and urging the shareholders to "go slow" in tendering

66. Wall Street Journal, Sept. 14, 1966, at 32, col. 2.

67. An unidentified member of the shareholder committee stated that the Columbia board refused its request for three of the nine seats on the board of directors and that "now we're going for all the marbles." He would not comment on whether a proxy contest was planned. Wall Street Journal, Sept. 15, 1966, at 6, col. 2.

68. *See* Offer for Columbia Shares.

69. Seymour H. Malamed, vice-president and treasurer, stated that "at this stage, there is nothing we know about it [the offer] or can comment on." As to the question of the unknown source of the offer, Morton Gould, attorney for the shareholder committee, denied that the dissident group had any connection with it. Wall Street Journal, Oct. 3, 1966, at 32, col. 2. Abraham Schneider, president of Columbia, issued a statement that "we don't know who is behind the Swiss bank offer, but we are trying to find out not only who they are, but what their plans and intentions are; and we will inform the stockholders immediately of anything we learn." Wall Street Journal, Oct. 4, 1966, at 8, col. 2.

the shares because the pro rata provision made immediate tender unnecessary and because a tender would tie up the stock for two weeks, even if the market went above the $33 level.[70]

On the sixth day of the offer, October 5, the management was able to send out a more comprehensive letter of opposition to the tender offer.[71] This was substantially the only defense used against the bid prior to October 14. It argued that the directors recommended refusal of the offer, that none of the directors would accept, that the Swiss bank representatives had not disclosed their intentions but that it was apparent that the Swiss bank thought the value of the stock was greater than $33, that no attempt at cooperation with or prior notice to management was made, that Columbia's interest in Screen Gems alone was worth $31.75 per share and that to this must be added real estate interests and first-run movie releases owned by Columbia, that brokers would encourage tenders because the bank was giving a 50 cents per share incentive commission, and that there was nothing to be gained by hasty action.

On the same day, the representatives in the United States of the Swiss bank, Paribas Corporation, a subsidiary of the Banque, and Kuhn, Loeb & Co., a New York broker, stated that the Banque de Paris was the sole principal and that it was not seeking control but only investment. They added that a Swiss bank was used for "purely technical reasons."[72] On the basis of this statement, and because of the reputations of the Banque de Paris and Kuhn, Loeb & Co., the Columbia management accepted the declaration of investment intent only and so informed the shareholders in a letter dated October 11.[73]

In this atmosphere, around 675,000 shares, or 34 per cent of Columbia's outstanding stock, were tendered; and the Banque announced that it would purchase the bulk of the ex-

70. Wall Street Journal, Oct. 4, 1966, at 8, col. 2.

71. Columbia Letter, Oct. 5, 1966.

72. Wall Street Journal, Oct. 6, 1966, at 24, col. 3. Serge Varangot, manager of the stock exchange department of the Banque de Paris, communicated with the Columbia management, assuring them that the purchase was for investment. This was not unusual for the Banque, which had acquired a ten per cent interest in Libby, McNeil & Libby through a tender offer in 1963 for investment purposes, which was supported by the Libby management. Wall Street Journal, Oct. 7, 1966, at 12, col. 3.

73. Columbia Letter, Oct. 11, 1966.

cess for its own account and would assign the remainder to unidentified persons.[74] None of the members of the shareholder committee tendered their shares.[75]

It is at this point that several things should be noted. This is because, if protection is necessary, the interests concerned would most likely be injured prior to the culmination of the tender offer. Regardless of the Columbia management's selfish interest in retaining control of the corporation, the management has a fiduciary interest in protecting the operating condition of the corporation. This would seem particularly true in the case of Columbia, since the television interests owned by its Screen Gems subsidiary are severely regulated by the Federal Communications Commission.[76] It was not until the sixth day of the offer that Columbia became aware that the offeror was a foreign concern rather than a United States interest and that the offeror was seeking investment and not control. Had a foreign concern been seeking control, the television interests of Screen Gems might have been in jeopardy under the FCC regulations. Even at this point management's fiduciary interests had not been fully protected. In the first place, the statement of investment intent was nothing more than just that; and, as we shall see, the events following the offer tended to cast doubts on the validity of that statement. Secondly, the management was still in the dark as to the identity and intentions of the assignees of the excess shares tendered.

As to the shareholders, they were unaware whether there was an attempt to oust the present management until the management letter of October 11 told them that the bid was for investment only and that management would remain. Until that time, a shareholder could not have made his tender decision to sell because of his dissatisfaction with the present management or to take a chance on new management, whoever it may be, since they did not know whether the directors would remain despite the offer. Furthermore, uncertainty as to management's ability to protect the operating condition of Columbia under the FCC rules might affect the shareholder's decision as to the tender offer, since the latter's investment is best served by the assurance that man-

74. Wall Street Journal, Oct. 18, 1966, at 5, col. 2.

75. *Id.*

76. *See* the litigation of Columbia Pictures against the Banque de Paris and its associates, *infra*, pp. 454-55.

agement's fiduciary obligations are protecting the corporate enterprise whenever there is a change in control. Finally, shareholders accepting the bid could not be assured that they were receiving the best possible price for their shares. They could not be certain of the reasons for the "toned-down" opposition in the letter of October 11 compared with the fervent opposition in the letter of October 5, whether it was an honest belief that the offeror was only seeking a capital investment or was the result of private arrangements between management and the offeror.

Of course it is all speculation, but the general uncertainty prevailing during this tender offer, coupled with the downward trend in Columbia earnings in the past few years, may have been the cause of the overwhelming response to the tender offer on October 14.

The role of the dissident shareholder committee in the tender offer was, and still is, an unanswered question. Throughout the offer and after, committee spokesmen repeatedly denied any connection with the Banque's bid.[77] However, none of the members of the shareholder committee tendered their shares. Further, on October 7, during the bid, Alliston Corporation, controlled by Maurice Clairmont, who was a member of the dissident committee, filed suit against Columbia to compel the latter to report its earnings separately from those of Screen Gems.[78] It is uncertain whether this was done solely in the interest of the shareholder committee or whether it was a harassment tactic and publicity measure to aid acceptance of the tender offer.

In any event, on October 20, the opposing forces met. The shareholder committee represented over 200,000 shares. The Banque de Paris and its assignees represented 675,000 shares. Spokesman for the Banque group, Edward Merkle, president of the Madison Fund investment company, assignee of 100,000 of the tendered shares (the Dreyfus Fund had been assigned about 190,000 shares), stated that the two major groups had joined forces in seeking control of the board and estimated that they controlled 1,100,000 of Columbia's 1,967,-

---

77. *See* Wall Street Journal, Oct. 3, 1966, at 32, col. 2; Wall Street Journal, Oct. 10, 1966, at 2, col. 3; Wall Street Journal, Oct. 18, 1966, at 5, col. 2; Wall Street Journal, Nov. 1, 1966, at 9, col. 3; Wall Street Journal, Nov. 7, 1966, at 32, col. 2.

78. Note 58 *supra*.

000 outstanding shares.[79] Apparently, the Banque de Paris had decided to seek control after all, or at least was willing to go along with the shareholder committee to see what would materialize. Columbia management refused the request of the two groups for a controlling position on the board of directors, and the lines were drawn for a proxy battle at the December 21 annual meeting.[80]

The Banque's change in attitude from investment to control, and the entrance of two mutual funds into the picture, posed a threat to the interests of Screen Gems in several television stations, as well as a threat to the management's offices. Columbia filed suit against the Banque de Paris and the Madison and Dreyfus Funds.[81] The complaint alleged that the Banque violated §§ 310(A) and 310(B) of the Communications Act of 1934 by failing to apply for approval of the FCC where a transfer of control would result in substantial control of a communications enterprise by aliens.[82] This allegation was later vindicated in a letter from the FCC to representatives of the coalition group seeking control.[83] It also alleged that the two mutual funds violated an FCC rule prohibiting a single company from owning a greater than one per cent interest in more than five VHF stations, since both Madison and Dreyfus owned over one per cent interests in Metromedia, Inc., which controlled four stations, and since Madison owned an interest of over one per cent in Wometco Enterprises, which controlled three stations.[84] Now under

79. Wall Street Journal, Oct. 25, 1966, at 3, col. 2.

80. Wall Street Journal, Oct. 26, 1966, at 32, col. 2.

81. Columbia Pictures Corp. v. Clairmont, Civil No. 3581 (S.D.N.Y. 1966). *See also* Wall Street Journal, Oct. 28, 1966, at 7, col. 1.

82. 47 U.S.C. §310(A)(5) (1964); 47 U.S.C. §310(B) (1964).

83. In a letter dated November 2, 1966, to Gould, the FCC stated that ". . .An agreement among stockholders whose holdings total more than 50% of voting stock to act in concert through specified representatives to exercise control of the company would prima facie constitute a change in control of broadcast licenses issued pursuant to the Communications Act of 1934. Such control may not, under Section 310B of the Communications Act, be transferred [sic] without the prior written consent of the commission, obtained pursuant to an application therefor." Wall Street Journal, Nov. 7, 1966, at 32, col. 2.

84. 47 C.F.R. §73.636 (1966). The complaint contained further allegations that (1) there were material omissions in the tender offer, (2) the Madison and Dreyfus Funds violated §17 of the Investment Company Act of 1940 and Rule 17d-1 thereunder by failing to get SEC approval for the plan to gain control of the company with the other parties, and (3) the sale of shares by the Banque to the Madison Fund violated §17(a)(1) of the Investment Company Act because Merkle and Varangot were affiliated parties of both concerns. Columbia Pic-

pressure, the Banque and both mutual funds withdrew from the coalition and restated their interests as being solely for investment.[85] Negotiations were begun with management to cement the new relationship; the Columbia suit was dropped; and the Banque started taking the necessary measures with the FCC to safeguard the Screen Gems licenses.[86]

The Columbia experience indicates that the three tender offer advantages to the offeror of cheapness, speed, and secrecy may seriously jeopardize the interests of the corporation and the shareholders. Threats to the operating condition of the corporation, such as the television licenses of Screen Gems, are of great importance to the shareholder who wants to reject the tender offer. Because he is in a sense casting a vote for the existing management, he must know that any transfers of control will not unduly hamper his investment; otherwise he might tender his stock. The protection of this interest can come either from his own analysis of potential takeovers or from his assurance that management is adequately able to analyze the situation in order to perform its fiduciary duty in keeping the corporate enterprise from unlawful dangers. In the latter case he must know of any arrangements that would cause self-interest to overshadow fiduciary responsibility. Neither of these can be accomplished under a cloak of secrecy. Furthermore, both tendering and non-tendering shareholders have an investment interest in determining the adequacy of the price offered them. This interest can best be protected by a sufficiency of information, either from a regulated source or from the arguments and counter-arguments of the parties involved and of the financial press. But the speed of the tender transaction will often hamper a full realization of

tures Corp. v. Clairmont, Civil No. 3581 (S.D.N.Y. 1966). *See* 15 U.S.C. §80a-17 (1964); 17 C.F.R. §270.17d-1 (1964).

85. Wall Street Journal, Nov. 15, 1966, at 2, col. 3.

86. Later, the FCC approved an additional purchase of 350,000 shares of Columbia stock by the Banque, boosting its holdings to 35 per cent of the outstanding shares. The FCC imposed the following conditions: (1) that the bank not acquire further stock in Columbia that would increase its percentage holdings, (2) that the bank take no action looking to control of the company, by itself or with others, (3) that the bank make no agreements concerning the voting of the stock, and (4) that it report annually to the FCC on any agreements or actions concerning the Columbia stock. Wall Street Journal, Dec. 30, 1966, at 18, col. 2. Even though the stock is restricted in the hands of the Banque, it offers a tempting control package that would not be so restricted in the hands of the purchaser. *See* BUS. WEEK, Feb. 18, 1967, at 78.

this objective. Only the cheapness is an advantage that does not directly interfere with the interests of the corporation and the shareholders, but that advantage is directly related to speed and secrecy. Among the offeror, the shareholders, and the corporation, a balance must be struck.

Since Senator Williams has introduced his proposed legislation to regulate this complex area of tender offers, the SEC has expressed its interest in approval of the entrance of the Commission into this field.[87] This in itself raises serious problems. No one can doubt that the SEC has been rapidly expanding its sphere of influence to the point at which it is becoming a major governmental agency.[88] The result is inevitably a "continuous drain upon its skilled manpower."[89] Nevertheless, if the SEC regulation of tender offers is the most adequate remedy for the protection of all the interests involved, this would seem the appropriate course of action.[90] But first one must determine that present laws are inadequate in providing this protection.

---

87. SEC, MEMORANDUM TO THE SENATE COMMITTEE ON BANKING AND CURRENCY on S. 2731, 89th CONG., 2d SESS. (1966) (hereinafter cited as SEC Memorandum on S. 2731). *See also* N.Y. Times, May 13, 1966, at 38, col. 3. In fact, it has been reported that one official of the SEC foresees that, if the bill does not pass eventually, the Commission will make its own rules similar to those offered in the proposed legislation. Wall Street Journal, May 16, 1966, at 5, col. 2. However, the source of this authority is not likely to be Rule 10b-5, whose general grant of power confines the SEC to defining fraudulent practices under that section and which does not contain the broad kind of authorization given by Congress to the SEC regarding §5 of the 1933 Act. Effective regulation of all tender offers must come from express congressional authorization. Note, *The Regulation of Corporate Tender Offers Under Federal Securities Law: A New Challenge for Rule 10b-5*, 33 U. CHI. L. REV. 359, 384-85 (1966).

88. Loomis, *Where Manny Cohen Is Leading the SEC*, 74 FORTUNE, at 163 (1966).

89. Cary, Book Review, 75 HARV. L. REV. 857, 858-59, (1962). *See also* Douglas, *Foreword*, 28 GEO. WASH. L. REV. 1, 2-3 (1959). (Note that both articles were written before the major expansion of SEC activities under the 1964 amendments).

90. The SEC has said that the proposed legislation of Senator Williams would be significant in providing the necessary protection of shareholders in situations similar to that of the Columbia Pictures Corporation. MEMORANDUM OF THE OFFICE OF THE GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION, WITH RESPECT TO LETTER OF NOVEMBER 10, 1966 FROM SENATOR THOMAS H. KUCHEL, 113 CONG. REC. S448 (daily ed. Jan. 18, 1967).

II. Can Adequate Protection Be Provided Under Present Law?

If the offeror is to be required to disclose material facts in connection with his tender offer, the duty is most likely to arise from Rule 10b-5 under the Securities Exchange Act of 1934.[91] For 10b-5 to achieve similar results as S.510 would, then the information required to be disclosed under S.510 would have to be both material and definite enough to require 10b-5 disclosure. Further, 10b-5 would have to cover omissions in the tender offer market for control as well as misrepresentations.

It is true that the offeror possesses information that may have a direct bearing on the interests of the shareholders involved, for example, his identity and intentions. Even before the offer was made, a shareholder selling on the exchange to the offeror, as a part of the latter's program to build up an initial block of stock, would like to know of the offeror's plans to make a tender bid at a price higher than the one at which he is selling. Granting shareholder interest in acquiring some of this information, he has no "right" to it under 10b-5 unless it can be deemed "material." Materiality is defined as the nature of information which would "materially affect the judgment of the other party to the transaction"[92] and would affect the value of the stock.[93] But several questions arise in the tender offer situation. While the disclosure of the information possessed by the offeror prior to the tender offer would undoubtedly affect the value of the stock on the market, disclosure during the tender offer would not since that value is fixed by the terms of the offer. This disclosure would aid the shareholder in determining whether to accept the bid; but the "value," if it is anything different from the offer price, is affected only by corporate information possessed not by the offeror but by the management.[94] The result is a capricious coverage of

---

91. For a thorough discussion of tender offers under the present law, see Fleischer & Mundheim, 115 U. Pa. L. Rev. 317 (1967).

92. Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D.Pa. 1947).

93. Speed v. Transamerica Corp., 99 F. Supp. 808 (D.Del. 1951).

94. To explain this more fully, suppose A makes an offer for X stock at $10 per share, and the market value at that time was $8. Before the offer was made, disclosure of a possible offer at $10 per share would undoubtedly cause

10b-5 to pre-tender-offer purchases but not to the tender offer itself. There is no reason for distinguishing bids by shareholders and bids by complete outsiders without one share, at least as a matter of disclosure. But even relying solely on the shareholder judgment aspect of materiality, it still is uncertain whether a purchaser covered by 10b-5 must disclose his identity as such.[95] Furthermore, it is questionable whether the offeror's intentions can be held material, especially if they are a part of a profit-making scheme that might have been deduced by any of the shareholders selling under the tender offer from the available corporate information.[96] It is clear that 10b-5 does not require the disclosure of superior financial analysis.[97]

In a similar respect, the question whether the offeror is seeking investment or control may be material to the shareholder judgment but not sufficient enough a "plan" to require disclosure. No one speculating on the tender offer for Columbia shares can fail to note the possibility that the Banque de Paris may have had no thoughts of control until the completion of the transaction when approached by the dissident shareholder committee for support. Yet, such information would have an impact on a shareholder's decision to tender his stock.

The information withheld by an offeror is usually a complete omission rather than a misrepresentation or misstatement. The recent case of *SEC* v. *Texas Gulf Sulphur*,[98] however, indicates an extension of liability for non-disclosure to

---

the market level to rise to around $10. But A is not an insider at this point. If one makes the assumption that the announcement of an offer places A in the position of an insider, the effect on the market that brings 10b-5 into play no longer exists because A has already established a steady market level of $10 by publicly offering to pay any shareholder that amount for his stock. The only way that the market can be affected after the offer announcement is for B, or possibly C, an outsider, to consider the worth of the stock above $10 per share and to begin purchases on the open market at a higher price or to make a counter offer. But the information that would prompt such a decision is not the fact that A was to make an offer or the reasons why A made that offer, but that the stock has certain inherent values belonging to the corporation not under A's management. This is essentially corporate information that is possessed by B, if anyone, and not A.

95. L. Loss, *supra* note 22, at 1463-65. *But see* Ward La France Truck Corp., 13 S.E.C. 373, 380-81 (1943).

96. *See infra*, pp. 492-98.

97. L. Loss, *supra* note 22, at 1463. *See also* Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1148 (1950).

98. 258 F. Supp. 262 (S.D.N.Y. 1966).

complete omissions involving transactions on the stock exchange or over-the-counter market. The principle would seem equally applicable to the tender offer situation, where a mechanical procedure for tendering the shares to brokers or representatives of the principal prevents any knowledge of the offeror's intentions. In the market for control, the atmosphere created is much the same as in the anonymous exchange or over-the-counter markets and rather unlike that of an arm's length transaction. The disclosure should then be made generally to all the shareholders at the time of the offer.

Even if 10b-5 applied to the information and omissions discussed above under the present law, it is unlikely that 10b-5 as such can be used to provide adequate protection because of the "insider" hurdle.[99] Despite the broad language of the rule, 10b-5 has been held not to apply to all cases involving a purchase or a sale of securities. The duty to disclose material information rests on an insider relationship arising out of the circumstances of the transaction and the fiduciary or quasi-fiduciary relation of the parties.[100] It does not apply to the ordinary investor since he, by definition, has no sources of corporate information different from those of the other party.[101] It is certain that an offeror is not an "ordinary" investor because he does possess information unavailable to the tendering shareholders. If labeled an "insider" he would be forced to disclose his firm plans for future action after a successful bid,[102] or to disclose his intent to make a tender offer to sellers on the market prior to the bid.[103] But it is uncertain whether possession of this information makes him an "insider" because it is essentially personal information, and he has no fiduciary ties to the shareholders.

The most expansive definition of an insider was given in *In the Matter of Cady, Roberts and Co.*:[104]

---

99. *See* Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1399 (1966).

100. Connelly v. Balkwill, 174 F. Supp. 49, 59 (N.D. Ohio 1959). *See also* Note, 59 HARV. L. REV. 769, 774 (1946).

101. Comment, 59 YALE L.J. 1120, 1155 (1950).

102. Note, 33 U. CHI. L. REV. 359, 375 (1966).

103. *Cf.* Hughes & Treat, 22 S.E.C. 623, 626 (1946) (dictum).

104. 40 S.E.C. 907 (1961).

> Analytically, the obligation [to disclose material information] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone; and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[105]

Certainly, if the offeror were to base his decision to make a tender offer on information received from a corporate insider that was otherwise unavailable, there is a likelihood of liability under 10b-5.[106] But beyond that, he can hardly be classified an insider. His information is self-deduced and not information intended solely for corporate use. Furthermore, there is no element of unfairness related to "corporate" information because the facts available to the offeror are equally available to the tendering shareholders. And if this concept of fairness were applied on a broad scale, the result would be administratively impossible and contrary to the policies inherent in the securities market.[107]

Even if the scope of 10b-5 could be judicially expanded to encompass the tender offer situation, there is strong argument against its direct application. The broad terms of 10b-5, which would require solutions to the myriad problems by individual court analysis, and the resort to state law whenever 10b-5 proved to be inadequate, would result in a hodgepodge of judicial decisions in an already complex area. However, the fact that tender offers often involve numerous and scattered shareholders, and that each of them is placed in identical decision-making situations by the tender offer, would indicate that their interests should be uniformly protected. Because disclosure of material information is involved, some guidelines should be provided through SEC rule-making if one is to proceed under the present law.[108]

105. *Id.* at 912.

106. *See id;* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, (S.D.N.Y. 1966).

107. Fleischer & Mundheim, *supra* note 4, at 331.

108. Note, *The Regulation of Corporate Tender Offers Under Federal Securities Law: A New Challenge for Rule 10b-5*, 33 U. CHI. L. REV. 359, 383-86 (1966).

It has been suggested that disclosure of information known to the offeror might

Furthermore, the delicate balancing in this area between the importance of a vigorous business community and shareholder protection by disclosure would seem to call for a more considered approach to the problem through legislation rather than rule-making.[109]

Another possible source of protection that cannot be overlooked is § 14 of the Securities Exchange Act and the proxy rules thereunder. Here are explicit guidelines for disclosure that would be lacking under 10b-5. In fact, the SEC relied heavily on these rules when framing the recommendations regarding the proposed legislation of Senator Williams.[110] However, the direct application of the proxy rules to tender offers is an even more tenuous proposition than 10b-5.

---

be required under 10b-5 by implying that the failure to disclose such information in the light of the statement made in the offer that the offeror is willing to pay $X per share makes that statement a misrepresentation. For example, the expectations of the shareholders reading the offer might be that the value of the stock is worth no more than $X. Therefore, the offeror must disclose information known to him that would make the value of the stock over $X, such as liquidation plans or other intentions. Furthermore, that statement might imply that $X is the highest that the offeror is willing to pay for the shares during the tender offer, preventing him from negotiating with management groups to sell out at a higher price, or increasing the offer price without paying those who have already tendered the higher price. But this method of finding liability has two disadvantages: (1) the effect of the implications giving rise to liability under 10b-5 can be nullified with an appropriate disclaimer that rejects such implications, and (2) the theory would place an emphasis on disclosing the least possible information so that fewer implications can be made. Because of these disadvantages, the matter could better be handled by SEC rule-making. Fleischer & Mundheim, *supra* note 4, at 335-49.

Another suggestion is that whenever additional compensation is paid to brokers in order to persuade them to actively participate in effecting the transaction, extra disclosure precautions are necessary. Such bonus commissions are common in the tender offer situation. But this method must also be supplemented by SEC rules. *See* Heller, *Integration of the Dissemination of Information Under the Securities Act of* 1933 *and the Securities Exchange Act of* 1934, 29 LAW & CONTEMP. PROB. 749, 763-65 (1964).

Professor Cohen suggests that, if the offeror is a continuous registrant under the 1934 Act, the making of an offer may be material to the investors in the offeror and require more immediate filing of that information in the offeror's continuous disclosure file than is now required by Form 8-K. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, at n. 176 (1966).

109. This opinion has been supported regarding any extension of 10b-5 into what is now state law or corporation law. *See* Kaplan, *Corporation Law and Securities Regulation*, 18 BUS. LAW. 868, 872-73 (1963); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication through Rule 10b-5*, 59 NW. U.L. REV. 185, 190 (1964).

110. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 153 (1966).

The recent case of *Studebaker Corp.* v. *Gittlin*[111] poses some problems to the pre-offer stage if the offeror seeks to obtain the shareholder list to aid in making his offer. A shareholder had obtained an authorization from forty-two other shareholders, representing over five per cent of the corporation's outstanding stock, entitling him under New York law to inspect the stockholder list.[112] Studebaker refused the request, charging a violation of Rules 14a-3 and 14a-6.[113] The SEC argued in an amicus brief that the scope of § 14(a) literally includes all authorizations, not just one conferring powers to vote, and that the proxy rules should apply therefore to a solicitation of authorizations from shareholders to inspect the stockholder list.[114] The court, however, found it unnecessary to go that far. Relying on *SEC* v. *Okin*,[115] the court held that since Gittlin's purpose in seeking to inspect the list was to use it as an aid in soliciting proxies to oppose management on certain policies, the authorization was part of a "continuous plan" ending in the solicitation of proxies and was calculated to "prepare the way for its success."[116] The failure of the court to consider the SEC's expansive interpretation of the proxy rules has led one commentator to assert that its practical effect will be to affirm the SEC position.[117] If this is true, the proxy rules would apply to the solicitation of an authorization to inspect the stockholder list in order to effect a tender offer. The disclosure that an offer is to be made, and its terms, would destroy the element of surprise and perhaps the effectiveness of the offer. Premature disclosure would probably force the offeror to elicit management support to save his offer and there would be no need to inspect the stockholder list. The offeror would probably forego the stockholder list inspection and the SEC's expan-

111. 360 F.2d 692 (2d Cir. 1966).

112. N.Y. Bus. Corp. Law § 1315 (McKinney, 1962).

113. 17 C.F.R. §240.14a-3 (1964); 17 C.F.R. §240.14a-6 (1964).

114. The SEC wrote to the court, explaining its position that "section 14(a) of the Securities Exchange Act of 1934 and the Commission's rules thereunder apply to any proxies, consents, and authorizations in situations involving elections to office; there is no reason to suppose that Congress intended that the protective provisions of the proxy rules should not reach other situations in which a shareholder is requested to permit another to act for him, whatever may be the purpose of the authorization." Studebaker Corp. v. Gittlin, 360 F.2d 692, at n. 2 (2d Cir. 1966).

115. 132 F.2d 784 (2d Cir. 1943).

116. *Id.* at 786.

117. 65 Mich. L. Rev. 582, 589 (1967).

sive view of § 14(a) would not protect the shareholder.

Regarding the tender offer itself, application of the proxy disclosure rules seems most doubtful. It has been argued that in enacting § 14(a) Congress intended to remedy the need for disclosure of information in all situations where "either the corporate management or outside groups bargained with security holders to affect the latter's rights."[118] This need is particularly evident when such bargaining would result in the affected shareholder remaining in the corporation with his rights substantially changed in some way, as in the case of a vote to effect a major change in the corporate structure or a consent to tender securities in exchange for a different security.[119] But to apply the proxy rules in a case where the shareholder is being asked to sell his stock in a substantially arm's-length transaction would require technical manipulation of the terms of the rules. If such a manipulation were possible, it would undoubtedly come through the "continuous plan" concept of *Okin,* now embodied in Rule 14a-1(f)(1) (iii), which defines "solicitation" as any communication that, among other things, is issued under "circumstances reasonably calculated, to result in the procurement, withholding or revocation of a proxy."[120] Under this section, it is generally thought that there is a two-fold test.[121] First, the communication itself must be reasonably calculated to result in a proxy being procured, withheld, or revoked. This covers a broad range of communications; for example, a letter to shareholders of a Swiss bank during a proxy contest for the election of directors of a company whose shares are owned by the bank opposing the bank's policy of supporting management regardless of the opposition.[122] Secondly, the sender of the communication must be shown to have intended to

118. Bernstein & Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy,* 7 U. CHI. L. REV. 226, 231 (1939).

119. *Id.* at 232.

120. 17 C.F.R. §240.14a-1(f)(2)(iii) (1967). *See also* SEC Securities Exchange Act Release No. 5276 (Jan. 17, 1956).

121. *See* 42 NOTRE DAME LAW. 84, 91 (1966).

122. Gaudiosi v. Mellon, 269 F.2d 873 (3d Cir. 1959). However, certain communications are clearly not within the scope of a solicitation under §14(a), including semi-annual and quarterly reports, communications containing information and comments concerning business matters that are usually sent by management to the shareholders during the fiscal year, proxy forms furnished at the shareholder's unsolicited request, and newspaper stories quoting contending parties in an election and furnishing editorial comment. 42 NOTRE DAME LAW. 84, 91 (1966), citing L. LOSS, *supra* note 22, at 872-73, n. 5.

solicit proxies. The difficulty in applying this test to the offeror in a tender offer situation is that it is doubtful whether he has any specific intentions to solicit proxies; if he does, it would seem an entirely different matter than the solicitation of tenders, since the success of the latter would be a prerequisite to the mere intention to solicit proxies. For example, an intent, defined in terms of a reasonable calculation of the effect of the communication, to solicit proxies to effect a liquidation of the acquired corporation would depend entirely upon the number of shares tendered under the offer. And the result of a tender offer is most often pure speculation. The two situations are too independent to be termed a "continuous plan." Unless the definition of "solicitation" can be made to rest on the mere possibility of a solicitation of proxies that could be related to the original offer, the proxy rules have no direct or consistent application to the tender offer situation.[123]

To state that the proxy rules have no direct application to tender offers is not to state that the rules offer no insight into the problems of the tender offer. The proxy rules were an attempt to attack the disenfranchisement of the shareholder from the corporation caused by the intense concentration of power in management. They did this by a regulatory rearrangement of the powers of the shareholder regarding fundamental corporate actions, providing him the information to make a reasoned decision whenever his vote was asked for or required.

From this highly successful experiment, several observations must be noted as equally applicable to the tender offer problem. First, whenever a contest develops between opposing parties in a proxy solicitation, where the decision rests with the shareholders, the SEC and the courts have chosen to play

123. This result might be implied from SEC v. Topping, 85 F. Supp. 63 (S.D. N.Y. 1949). There the court applied the *Okin* rationale of a "continuous plan" to a letter sent by a shareholder, even though the shareholder had expressed that he would not solicit proxies unless the annual meeting was postponed for one month; and the meeting was held as scheduled. The case is somewhat ineffectual, however, since the statements of the court from which the implication must be made were mere dicta, the case being rendered moot upon the occurrence of the annual meeting.

the role of umpire and not of participant.[124] As with a proxy contest, the interest involved in a tender offer belongs to the corporation, the shareholders, and the offeror, not to the general public. The SEC should, therefore, limit itself solely to refereeing the actions of the interested parties. Its tools are full disclosure requirements. Beyond that, it should have no interest in whether the offeror's effort is successful, or whether it be looting or not.

Secondly, the SEC has sought a balance in regulating the many communications to shareholders that accompany a proxy contest. On the one hand, it seeks to promote advocacy by permitting greater-than-usual freedom in statements and opinions, on the theory that in weighing the arguments of both sides the shareholder will gain a comprehensive picture of the election or policy decision facing him.[125] On the other hand, it will not liken the corporate contest to the comparatively unrestrained political contest on the theory that the investing public deserves some protection against obviously misleading statements and unfounded accusations.[126] This same balancing can be applied to the tender offer situation. The shareholder deciding whether to tender his stock can best assess the value of those shares against the price of the offer if he is able to weigh the arguments and counter arguments of the opposing parties. But because the valuation of stock is often complex and dependent upon the accuracy of the information used in the weighing process, he should be guarded against misleading statements using information not based on fact.

Finally, the proxy contest is often complex and greatly influenced by the peculiar facts of the individual case. Much of the success of the proxy rules in this area has been the result of the SEC's ability to use the raw material of its administrative experience in handling each individual case on its facts, under the aegis of broad and flexible regulatory

---

124. The SEC: *see* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL XVIII (1957) (introduction by J. Sinclair Armstrong, former chairman of the SEC); Cohen, *The SEC and Proxy Contests*, 20 FED. B.J. 91 (1960). (1960).

The courts: *see* Levin v. Metro-Goldwyn-Mayer, Inc., CCH Fed. 1961 Sec. L. Rep. P91891 (S.D.N.Y. 1967).

125. Von Mehren & McCarroll, *The Proxy Rules: A Case Study in the Administrative Process*, 29 LAW & CONTEMP. PROB. 728, *supra* note 42, at 734-35 (1964).

126. SEC v. May, 229 F.2d 123, 124 (2d Cir. 1956).

guidelines.[127] In considering legislation to regulate tender offers, one must take note of the successful application of the proxy system. Tender offers are usually quite simple in form and can be legislatively regulated to that extent, such as the information that must be disclosed, to whom it must be disclosed, the amount of time needed to create an informed market, and the basic mechanical outline of an offer. However, the complexity of the tender offer arises in the refinements and variations possible in this kind of scheme. To deny administrative powers to deal with these variations as they are used would be to build a mountain of loopholes.

The present law provides one with guides, not answers, to the problems that arise in the use of tender offers. It is in this light that we now turn to prospective legislation to provide the answers. But before the legislative structure can be built, a foundation must be poured. This is the task of determining the justifiable scope of tender offer legislation.

III. What Should Be the Scope of Protective Legislation?

The legislation growing out of the problems involved in the use of tender offers represents a recognition of and a reaction to the market for corporate control. It is something separate from the investment market as the values of the "securities" traded are determined by premiums above the investment values of the traditional market. Yet it is tied to the investment market. Tradition permits the transfer of control only as an adjunct to investment shares. The values of both investment and control are superimposed in our traditional system of value communication, the stock exchange and the over-the-counter market quotations.[128] The law has allowed the control

127. Von Mehren & McCarroll, *supra* note 42, at 744-46.

128. I have appropriated from Professor Manne the concept of a market for corporate control as an economically functioning market separate from the traditional investment market. This division is particularly apparent in the tender offer situation, in which the premium above market represents the value of that control factor, assuming that the regular market adequately represents the value of the investment factor at that time. But because the vote of a share is tied to the capital interest represented by that stock, complete separation of the two markets is impossible. As to Professor Manne's theory that the control market should be completely divorced from the traditional market, enabling votes to be bought and sold alone through market quotations, and in which inside information should be a valuable economic commodity, I shall let him speak for himself. *See* Manne, *Some Theoretical Aspects of Share Voting*, 64 Colum. L. Rev. 1427 (1964); H. Manne, Trading and the Stock Market (1966).

market substantial entrepreneurial freedom, because of these traditional ties to the investment market, provided the curbs of the investment market are satisfied. It may be noted that the merger laws and proxy rules regulate part of the control market, the control premium being determined by the cost of convincing a shareholder to vote affirmatively for the change.[129]

While this may be true in the broadest sense of a control market, the kind of market for control created by a tender offer is much less unilateral and much more analagous to the investment market. When announcing an offer price, the offeror will have considered all of the factors necessary to arrive at a premium sufficient to induce the shareholders to tender.[130] The shareholders will have a chance to assess the value of the premium in terms of the factors creating a premium sufficient to result in a decision to tender their shares. Because these factors may differ, there will be created a sort of bid-asked situation. This is the market for corporate control.

The investment market prior to the tender offer can be presumed an accurate picture of the investment portion of the stock that must be tendered with the control portion, because of the registration and fraud provisions of the Securities Act of 1933, and the reporting and fraud provisions of the Securities Exchange Act of 1934. If one omits from consideration that part of the stock's value which represents control sought, the offeror would be in the position of any purchaser in the securities market and subject, as an outsider, only to those rules presently existing which regulate non-insider conduct. Any legislation that seeks to impose an insider's duty to disclose on the offeror must deal solely with that unique part of the tender offer that distinguishes such a purchase from all other purchases—the premium for control. It should regulate only the market for corporate control.

---

129. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1432 (1964).

130. The premium should not include the prospective profits that a corporate offeror intends to make by his own efforts after the combination or control arrangement is effected but rather only the increased value of the shares resulting from the present compatibility of the two corporations. However, the factors in this area are most easily subject to price compromise to obtain an attractive premium. G. MCCARTHY, ACQUISITIONS AND MERGERS 85 (1963).

From this analysis, it would seem to follow that there should be an exemption from regulation in the case in which the offeror indicates an intent to purchase for investment purposes only, as in the Columbia Pictures bid. One's immediate reaction would be the exact opposite of that result, since there would seem to be little apparent distinction between the premium paid for control and the premium paid to acquire a substantial investment block. In a sense, both approaches are correct if one observes the dual purpose of legislation in this area. In the first place, regulation of tender offers attempts to provide protection against the "corporate raider,"[131] that individual or corporation whose takeover of the reins of the acquired corporation would prove detrimental to the profitable, operating existence of the corporation.[132] Regulations pertaining to this aspect of the legislative purpose have no bearing on the offeror seeking only investment since, without control, the purchaser cannot "raid" the corporation. Therefore, disclosure of facts solely related to protection against "raiders," *i.e.*, the identity of the offeror, the background of the offeror, and the intentions of the offeror (other than the initial investment or control intent), would have no place in this instance. On the other hand, the nature of the control market is not entirely absent. The acquisition of a large block of stock gives the purchaser an opportunity to pass this block to another party, who does desire control, at a substantial premium. Of course, if such an arrangement were made prior to the tender offer, the situation would be the same as a single tender offer for control. Furthermore, although an investment intent will forestall the possibility of active control immediately after the acquisition, the controlling shareholder may change his mind at some later date when there is no presumption that the intent existed at the time of the tender offer. This change may not even result in active control, but may merely be an influence on the policies of management. While both of these cases can effectively be dealt

131. The term "raiders", as used throughout this paper, includes not only corporate looters but also those persons whose control would injure the operating conditions of the corporation in a manner that would make the corporation less profitable, as in the case of the violation of FCC rules by Columbia Pictures had the Banque de Paris acquired control of the corporation, which would have caused several TV licenses not to have been renewed.

132. 111 CONG. REC. 28257-60 (1965) (statement of Senator Williams). *See also* N.Y. Times, Oct. 25, 1965, at 57, col. 1.

with under the emerging law of fiduciary responsibilities of controlling shareholders,[133] the important point is that the offeror is in essence paying a premium not only for the right to acquire a substantial investment block but also for the potentialities of the control portion of the stock.

The element of a large investment block represents merely a compression of time. If the offeror were to purchase a substantially similar block of stock on the market over a period of time, the force of his interest would cause a general rise in the market price of the stock. What he offers the shareholder in a tender offer is an investment increment representing the value to him of avoiding the cost of a gradual market rise. The control premium is that amount he is willing to pay for the control potentialities of a large block of stock, whether it is in the form of later active control, influence of corporate policies, or sale of control. The mere existence of these potentialities acts as an influence on management, since it is unlikely that even an "investing" shareholder of sufficient strength will permit management to take a haphazard or laggard course because of the effect on the former's capital gains and dividend interests. Both of these elements—an investment block premium and a control premium—must be valued by both the offeror and the shareholders in the tender offer situation. Therefore, those elements of legislation that are geared to the functioning of the tender offer market and the valuation of premiums, rather than for the protection from corporate "raiders," remain essential in the case of investment tender offers as in the case of control tender offers.

To elaborate more fully on the scope of regulation of the market created by tender offers, one must consider the interests of those parties involved. Those parties are the management (as representatives of the interests of the corporation), the tendering shareholder, the remaining shareholder, and the offeror. The Congress, in enacting legislation, and the SEC, in administering and supplementing it, must perform the delicate task of balancing among these interests.[134] The concerns of the SEC and Congress are threefold: (1) The market created by the tender offer must function

133. See *infra*, note 266.

134. The task of balancing the interests of both the management and the offeror when protecting the shareholders was recognized during the time that proposals for the regulation of takeover bids were being made in Great Britain. *See* 193 THE ECONOMIST 270 (1959).

smoothly in that no one interest should be able to effectively block any of the other interests. Examples of this would be the ability of the offeror to embark on a tender offer without adequate financing to assure payment of the shareholders, the ability of management to use corporate funds to out-bid the offeror at every turn, and the ability of shareholders to utilize knowledge of the offeror's intentions to hold out until the profitability of the transaction is minimal to the offeror. (2) The market created by the tender offer must be "honest" and free from collusion. An example of this would be the ability of the offeror and management to arrange a profitable truce and thereby induce unwitting shareholders to tender at the lowest possible price. (3) The market created by the tender offer must be accurately informed so that each party has the maximum information possible to vindicate his interests without undue detriment to the other interests involved. The actual balancing process is the primary concern of the next section concerning the proposed legislation of Senator Williams. But first one must define those interests which must be balanced.

A. The Shareholders

In assessing the proposed legislation of Senator Williams, Manuel F. Cohen, chairman of the SEC, placed his disclosure emphasis on informing the shareholders of the "identity, background, and future plans" of the offeror in order to place the former on an "equal footing" with the latter in the assessing of the future of the corporation and the value of the shares.[135] This would seem to place the shareholder in a position to make a choice of management—if the future looked brighter under the offeror, he would remain; but if it looked dimmer under his present situation, he would tender. Indeed, this is the basic philosophy behind the proxy rules. By giving the shareholder the most complete picture possible of each of the contending parties, he could choose that management team he felt would provide the best future for his investment.[136]

135. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 Bus. Law. 149, 150 (1966).

136. E. Aranow & N. Einhorn, *supra* note 124, at 82; Armstrong, *The Role of the Securities and Exchange Commission in Proxy Contests of Listed Companies*, 11 Bus. Law. 110, 115-16 (1955).

This philosophy cannot be applied to the tender offer situation. If a shareholder decides to tender, and eventually sell, his shares, he in effect is saying that he has no interest in the future of the corporation and would rather realize his investment or put his money to work in other corporations.[137] If he decides not to tender, he may be saying that he likes things the way they are and prefers to remain under the present management. If this is the case, the identity, background, and future plans of the offeror would have no bearing whatsoever on his decision. To counter this, it can be argued that a shareholder *may* wish to make a choice of management and therefore should have the opportunity to do so. Here the other interests come into play. The offeror, and perhaps even the management, *may not* wish to submit to such a choice, and would therefore desire to withhold the identity and other factors. That part of the market created by tender offers which remains open to negotiation and evaluation by the parties would permit this on a voluntary basis for both sides. If a choice of management is the primary interest of the shareholder, he can withhold his tender until the relevant information is forthcoming. If it is the primary interest of the offeror, he may voluntarily submit the information to the shareholders. But to require such information by regulatory legislation is to presuppose a choice-of-management function. And this is both undesirable and impossible.

It is undesirable because it shifts from management to the shareholders collectively the burden of protecting the corporation from "raiders." It is presumed that management has both the facilities and the ingenuity to protect the shareholders from becoming the victims of a corporate looter. But if that burden were shifted, one would doubt whether the small shareholders would have the wherewithal or the concern that management would have, even with the knowledge of the identity, background, and intentions of the offeror. Even assuming that he would, his impulse might be to "git while the gittin's good" rather than to protect the corporate enterprise. Yet it would seem ludicrous to hold the small holder responsible as a fiduciary to those victims that were left in the corporation. A better solution would seem to leave the fiduciary responsibility to oppose a "raider" with the management, so

137. Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS 94 (1966).

that its recommendation to refuse the tender because of the danger of a "raid" would present a unified course of action to the shareholders rather than the quandary noted above.

Furthermore, the presupposed choice-of-management function is impossible because a certain choice is equally likely to result in tendering as withholding. For instance, if the shareholder wished to cast a vote for the offeror, he might tender his shares, or at least some of them, realizing that each stockholder must forego a portion of his present holdings as the price for bringing the new management into the corporation on its terms; but he might also withhold his stock, thinking that the others will tender enough to bring in the new management and his investment will be undiminished. If the shareholder wished to cast a vote against the offeror, he might tender his shares in order to get out in case the new undesired management might get in by others tendering, thinking that he could "wait in the wings" and reinvest without much loss if the bid was unsuccessful; but he might also withhold his stock, thinking that if everyone else did the same, the undesired management would be frozen out. It is apparent, then, that unless the impossible task of informing each shareholder what all the others were doing could be performed,[138] the choice-of-management function is not susceptible to regulation in the tender offer situation. If this is the case, what functions do the shareholders perform?

1. The Tendering Shareholder

The first bundle of interests of a tendering shareholder arises out of his "valuation" function. Faced with the premium above market price, he must determine whether that premium is sufficient compensation for those things appurtenant to the investment he would be giving up.[139] Some of

138. An attempt to inform the shareholders of what the other shareholders were going to do with the tender offer creates a circular impossibility. Each shareholder would not be able to act unless he knew how the others would act. But the others cannot act because they do not know what each shareholder would do were he to act.

139. If one assumes that the market gives an accurate picture of the investment value of the shares, those things which must be valued by the shareholder represent rights or obligations arising outside a mere return on investment at that particular time. In other words, if the offer price represents only a return on investment at that particular time (not including the right to retain the investment), he would have sold his stock on the market. However, because a share-

the factors utilized by the shareholder are personal and therefore not in need of protection by disclosure requirements. Among these would be the proper inducement to exchange investment for cash at that particular moment, the effect of the taxable nature of the transaction on his tax picture, and his personal allegiances to the present management. To this Professor Manne would add the price necessary to induce the shareholder to forego the alternative of participation in the new management.[140] Chairman Cohen would carry this to its logical end and say that the value of this factor cannot be adequately assessed unless the shareholder has enough information with which to value that alternative.[141] But, as we have seen, this implies a choice-of-management function, the result of which cannot be predictably controlled by regulation.[142] The decision remains a personal one—whether to retain an investment in *that* company with its inherent possibilities within the industry, or to change investments to another company, or to realize its value. The value of a successful premium is that which would induce either of the latter two.

Beyond the personal, there are several factors utilized by a shareholder to value the premium which is derived from his being a member of the group to whom the tender offer is made. These are the interests that affect the balancing of disclosure regulation. The number of shares sought by the offeror is important. If the percentage is substantial, say 95-100 per cent, the shareholder will be able to wield a greater power with his holdings since he can cause a greater degree of failure in the bid by withholding.[143] He will then place a greater value on the premium needed to cause him to tender. The shareholder will also value the premium according to his assurance that the offeror is financially able to back his bid, since any failure

holder also has the right to retain his investment, part of his "valuation" function will be to reassess the value of that right in the light of the information about the corporation's past performance that is provided him, as compared with the premium offered.

140. When the offeror is determining the premium necessary to induce tendering, this factor would be discounted by the value of the possibility that the offer would be unsuccessful if the shareholder did not participate. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1435 (1964).

141. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 151-52 (1966).

142. *Supra*, pp. 464-65, 470-72.

143. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1434 (1964).

to pay would decrease the over-all profit and perhaps cause litigation expense. The shareholder, further, will value the bid according to his awareness of arrangements made with the management, since these might lead to the suspicion that the management is recommending tender for its personal profit. Therefore, he will demand a higher premium to relieve him of the suspicion that he may not be getting his maximum price. The number of shares already owned by the offeror will also affect the shareholder's judgment of the value of the premium, since this indicates the seriousness of the offeror. He is then likely to demand a higher premium. Of course, these are only examples of the many factors which enter the picture. If the shareholder's interest in placing an accurate value on the premium were to be fully protected, all such relevant information would have to be disclosed. It is the role of balancing, however, that determines which are necessary and which unduly conflict with other interests.

The second bundle of interests of a tendering shareholder arises out of his "judicial" function. When presented with a tender offer, the shareholder, as a member of the entire group of shareholders acting under the offer, is given the opportunity to pass judgment on the present management. Ideally, he should be able to hear the arguments of both sides, before exercising his ultimate check on management—the sale of his shares.[144] Some elaboration is necessary to clarify this function. From the work of Adolf Berle and Gardiner Means[145] comes the characterization of the modern shareholder in a public corporation as an ineffectual element in corporate control. His power decreases as ownership is dispersed; and the power of management and single minority shareholders increases in inverse proportion. The proxy rules were an

144. When a shareholder sells his stock, he registers a vote against the management and its present policies. Sales by shareholders as a group then operate as an effective check on management policies. J. LIVINGSTON, THE AMERICAN STOCKHOLDER 60 (1958); Tucker, *Stockholder Remedies, Corporate Democracy*, 4 VA. L. WEEKLY DICTA COMP. 31, 32 (1952-53); Grimes, *The Right to Sell His Stock, Corporate Democracy*, 4 VA. L. WEEKLY DICTA COMP. 34 (1952-53). The effectiveness of this check can best provide shareholder protection by the use of disclosure to provide free exit from investment and transfer of shares. Manning, Book Review, 67 YALE L.J. 1477, 1493 (1958). But it has been suggested that the ability of a shareholder to sell his stock does not encourage "corporate democracy," particularly for those who are "locked in" with large capital gains. D. BAUM & N. STILES, THE SILENT PARTNERS 11 (1965).

145. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

effort to revest some of this power in the shareholders under the guise of "shareholder democracy."[146] It was thought that an investor obviously had no right to handle the day-to-day affairs of the corporation, but that he should be kept fully informed of the corporation's activities and be called upon at various intervals to approve or disapprove management's record.[147] The key to this was informed participation caused by disclosure, and the valuable check on management was the proxy contest for control of the corporation.[148] By providing the shareholder with sufficient information to make effective use of his vote, management would be held in check by the competitive force of other management teams that the shareholders could vote in.[149] And it has been suggested that the same disclosure technique would provide the protection of "shareholder democracy" in the tender offer situation.[150] Such a rationalization, however, would seem sheer fantasy, since "shareholder democracy" has as its purpose more active participation in the corporate enterprise while the tendering of shares amounts to nothing more than bailing out.

Despite the good intentions of the "corporate democrats," the experience of the proxy rules has cast some doubt on the entire philosophy. Although the rules have been generally successful, the shareholder has often been stubborn in wielding his check in a proxy contest, and opposition effort must be substantially greater than that of management in inducing votes. The reasons for this are varied, from the fact that by not selling his shares before the contest the shareholder has

---

146. For an extensive list of articles on "corporate democracy," written before 1960, *see* Cohen, *The SEC and Proxy Contests*, 20 FED. B.J. 91, at n. 1 (1960).

147. E. ARANOW & H. EINHORN, *supra* note 124, at 81-82. The proxy rules were intended to reestablish the effectiveness of the role of the shareholder in the corporation and to protect his interests by disclosure. "In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings." S. Rep. No. 1455, 73d Cong., 2d Sess. 74 (1934), quoted in Bernstein & Fischer, *supra* note 118, at 227-28. See also E. EMERSON AND F. LATCHAM, SHAREHOLDER DEMOCRACY 8 (1954). For a more tempered view of the proxy rules, that they seek not to restore the shareholders to their former position of control influence but rather to make more effective their residual sphere of influence, see Gower, Book Review, 68 HARV. L. REV. 922, 926 (1955).

148. Note, 60 NW. U.L. REV. 349, 353 (1965).

149. F. EMERSON & F. LATCHAM, *supra* note 147, at 143.

150. BUS. WEEK, FEB. 26, 1966, at 39.

already voted for management[151] to the fact that shareholders lack cohesiveness and are often in the management class themselves.[152] The efforts of the "corporate democrats" have been termed "fundamentally misplaced, misdirected and romantic."[153] The most effective solution to take its place has been a system of checks and balances to keep management in tow.[154] To the traditional forces of the market and labor have been added the effective check of SEC controls.[155] An informed public opinion, particularly that of the financial community, provides an executive conscience.[156] In fact, disclosure in itself can have a healthy effect on the conduct of management.[157] While these checks are somewhat amorphous, a substantial theory is developing that the professional investors, mutual and pension funds, insurance companies, and the like, have a duty to hold management in line.[158] To this group of checks can be added the tender offer. However, it possesses the same tendency toward lethargy as the proxy contest. Yet, its potentialities are greater. In both, information is the key to effectiveness, provided the shareholder is given sufficient time in which to digest that information. And in both, the greatest sources of information are the arguments and counter arguments of the parties, tempered by a regulatory guarantee of accuracy and minimal information. But, whereas the shareholder vote presumes a continued investment and therefore a lesser tendency to depart from the present course, the tender of shares is an all-or-nothing act and will give the truest picture of dissatisfaction with management. The possibility of being cut off in this manner with one stroke of the axe would tend to keep management on friendly terms with the shareholders and to give shareholder requests more importance.

---

151. Glenn, *A Study and a Suggestion, Corporate Democracy*, 4 VA. L. WEEKLY DICTA COMP. 124, 125 (1952-53).

152. *See* J. LIVINGSTON, *supra* note 144, at 26-38.

153. Manning, *supra* note 144, at 1490.

154. Loss, *An Ex-Bureaucrat's Views, Corporate Democracy*, VA. L. WEEKLY DICTA COMP. 78, 79 (1952-53).

155. *Id.*

156. J. LIVINGSTON, *supra* note 144, at 20-21.

157. Manning, *supra* note 144, at 1487.

158. *See* J. LIVINGSTON, *supra* note 144, at 239; D. BAUM & N. STILES, *supra* note 144, at 13-14; Ritter, *Reflections on the Corporate Exercise of Proxies*, FIN. ANALYSTS J., Sept.-Oct. 1966 at 89.

The effectiveness of this "judicial" function of the shareholders, then, lies in the assurance that whenever a tender offer situation arises, the shareholders will be informed of the arguments of both sides, if there is a contest, and will have time in which to make an informed decision. Of course, if the management wishes to remain silent in the face of a dissatisfied group of shareholders, it will be taking a chance on cutting its own throat, insuring the effectiveness of the check with its own inaction. If, however, it decides to take a stand, the shareholders should have access to information relevant to the state of the corporation. For a large part, this is available in the continuous reporting requirements of § 13 of the 1934 Act and the annual reports. But it should also include recent developments in the corporate picture. Time is also an element in providing full disclosure so that the arguments of both sides can be developed and so that the financial press and the financial community can comment upon the merits of either side.[159] It is only in this manner that the shareholder can effectively utilize his "judicial" check against management.

2. The Non-Tendering Shareholder

In a sense the non-tendering shareholder represents the opposite conclusion from the tendering shareholder in performing both the "valuation" function and the "judicial" function. To that extent his interests are identical to those described above in arriving at his conclusion. But his position differs in that he has chosen to remain with the corporation. This gives him an additional interest—to be protected from the corporate "raider." Here his interests are identical with the fiduciary responsibilities of the management and he must be assured that the management has had the opportunity to investigate the offeror to determine that he is not a "raider."[160] It is in his best interests, as with the management, that the identity and background of the offeror

159. Another corollary of adequate time in which to allow the arguments of both sides to develop is the fact that advisory members of the financial community will be able to form an opinion on the tender offer. When shareholders seek impartial guidance from investment advisers, advisory services, security-analyst groups, and the like, they will be given informed and capable advice. See F. Emerson & F. Latcham, *supra* note 147, at vi (introduction by Benjamin Graham).

160. *Infra*, pp. 478-81.

have been disclosed and, if management has determined that the offeror is a "raider," that he has been informed of this when being called upon to make his tender decision. His best assurance of this would seem to be adequate disclosure requirements to the management. But his interests would also include a safety valve. Assuming that management has made the determination that the offeror is a "raider," that the matter has been disclosed by management to the shareholders, and that management has recommended the withholding of tenders, a shareholder following this suggestion, thinking that the shareholders as a group would present a unified front against the offeror, would be seriously damaged if the others sold out from under him. It would seem in his best interests that at some median point in the bid he be given a progress report. But such a requirement would be certainly detrimental to the interests of the offeror, and perhaps to the interests of the shareholders themselves.[161]

B. The Management

It is certain that the directors of a corporation are bound by the fiduciary duty to use reasonable care in determining the policies and operations of their company and that failure to fulfill that duty will, under certain circumstances, result in liability.[162] What is unclear is whether this fiduciary duty extends beyond the operational functions of the corporation. It has been held that, if an outsider seeks to take control of the corporation, those presently in control have a duty to the corporation to reasonably investigate the outsider; and if it is found that there are circumstances that would have been sufficient to put a reasonable, prudent man on his guard, those in control have a duty to refrain from

161. It is detrimental to the interests of the offeror because the offeror may be placed in a situation in which his announcement might cause withdrawals on a bid that might otherwise be successful. This would be true if the tendering shareholders acted to leave the corporation under present management and, realizing that the bid would be successful without their tenders, decided to retain the shares in order to be a part of the corporation under the new management. Beyond the adverse effects on the offeror, amateur shareholders may even find this announcement detrimental to their interests. Professional investors would be able to more accurately assess the results of the bid and then over-tender so that all of their shares would be purchased when a pro rata provision is applied. *See infra*, pp. 503-05.

162. *See* Litwin v. Allen, 25 N.Y.S.2d 667 (S.Ct. 1940); Barnes v. Andrews, 298 Fed. 614 (S.D.N.Y. 1924).

transferring their control to the outsider, thereby causing harm to the corporation.[163] If one seeks to apply the same concept to the management, problems arise. For one thing, the duty imposed would necessarily be the active prevention of a takeover rather than the passive withholding of a transfer of control. The problem can be seen by extending the *Cheff* v. *Mathes* line of cases[164] from acquiescence in managerial action to prevent a takeover by an outsider to the affirmative duty to take such action. The management is put in a bind. If it does too little, it may be liable for failure to fulfill its duty of care. If it does too much, it may be liable for wasting corporate assets or using the corporate treasury to advance personal interests.[165] Yet it has been urged that management should not only have the right but also the responsibility to oppose an outside group seeking control.[166] The tender offer situation is a case in which this responsibility both should and can come in to play, at least to the extent that management investigates the offeror and reports to the shareholders any determination that the offeror is a "raider." Because it is undesirable to place the burden of protecting the corporation from "raiders" on the shareholders,[167] the interests of the non-tendering sharehold-

163. Insuranshares Corp. of Delaware v. Northern Fiscal Corp., 35 F. Supp. 22, 25 (E.D.Pa. 1940). *See also* Gerdes v. Reynolds, 28 N.Y.S.2d 622 (S.Ct. 1941).

164. *See supra*, note 59. The reasoning in *Cheff* has been held to encompass the use of corporate funds even when the protection of control is the primary motive. Lawrence v. Decca Records, Inc., 195 N.Y.S.2d 431 (S.Ct. 1959).

165. Even though the management decides that the outsider seeking control is a "raider", it would be difficult to tell to what extent this was in good faith determined for the protection of the corporation and to what extent it was done for self-interest, since the motivation for the decision lies within the minds of the management group. *See* Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35, 62 (1966).

An example of a shareholder suit against management for using corporate assets for the protection of offices and self-interests is the complaint of Gartzman against Schneider and the management of Columbia Pictures Corporation. *See* Wall Street Journal, Nov. 1, 1966, at 9, col. 3.

166. By requiring management to oppose the offeror's bid for control, there is not only the maximum protection against "raiders" that can be provided by management but also an increase in the amount of information that is disseminated to the shareholders. Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take Over Offers*, 20 BUS. LAW. 763, 780 (1965). A flat requirement of opposition, however, might frustrate economically beneficial changes in control because of the inherent advantages of an incumbent management. The duty would better be that of investigation, relying on fiduciary responsibilities, perhaps even supplemented by the motivation of self-interest, to determine the nature of the opposition and its tenor.

167. *Supra*, pp. 474-77.

ers can be vindicated only by management in performing its "protective" function adequately. It is essential, then, that management be informed of the identity and background of the offeror and be burdened with the responsibility to use that information to protect the non-tendering shareholders. In this respect, the fiduciary responsibility and the personal interests of management operate together for the protection of the corporation and the interests of the shareholders.

The problem is to delineate where management's personal interest in holding on to their corporate offices becomes paramount and therefore against the best interests of the corporation and the shareholders. This problem can be solved by confining the area of management responsibility to the tender offer itself. First, management should, ideally, be confined to responsive communications. If these communications to shareholders must be submitted to the SEC for approval, the element of disinterested judgment within that administrative body would be able to determine whether the management decision that the offeror was a "raider" was based on a reasonable analysis of the facts or whether it was a purely unsupported rationalization to cover self-interest.[168] This would not, I think, be giving too much power to the SEC. Instead, it would operate as a check on management's tendency to act selfishly in the more flagrant cases; yet it would not enable the SEC itself to screen potential "raiders" because the initial decision must be made by management before it ever reaches the Commission. Secondly, the use of corporate funds by management to purchase stock on the market or to out-bid the offeror would seem prone to permitting the emphasis of personal interests over fiduciary responsibility. There is no need for this in the tender offer situation, provided management is given enough time to build a verbal defense, since management has a much greater advantage than the offeror in knit-

---

168. Professor Marsh has proposed a legislative enactment that would accomplish very nearly the same thing in all areas. *See* Marsh, *supra* note 165, at 73-76. In the specific case of tender offers, the fraud provision of S. 510 would put the stigma of misrepresentation on communications by management that would label an outsider a "raider" without substantial support. This would most likely occur in the case in which management had let its self-interests prevail. The approval of the SEC would be a supplementary check in that unsupported statements would be weeded out of the communication.

ting cohesive stockholder opposition.[169] While the *Cheff* line of cases would seem to deny such a limitation under the present law,[170] the proposed legislation to allow the SEC to regulate corporate repurchases of stock could make it a possibility.[171] The use of corporate funds to buy shares on the market or with a counter bid might be justifiable to protect unsuspecting shareholders from being duped into surrendering control of the corporation to an unknown party. But the tender offer situation that would be created by the proposed legislation would produce an informed group of shareholders. The proper defense of management should therefore be to persuade those shareholders to act according to management's position regarding the tender offer by supplying them with arguments and information supporting that position. The use of the corporate treasury should be limited solely to communicating this information to the shareholders. The opportunity to permit an informed decision by the stockholder that would accompany the regulation of tender offers belies any argument of management that the funds must be used to buy up shares to protect the corporation from the shareholders' own naivete. The shareholder is then able to perform his "judicial" function to the extent that it will operate as a meaningful check on management, rather than becoming a pawn in a struggle for control between management and the offeror.

---

169. Other than the corporate treasury, management has possession of such defensive weapons as the shareholder list, information regarding the future plans to increase the profits of the corporation, and the natural hesitancy to make sweeping changes in the control of a corporation.

170. It has been suggested that, since the present law seems to make it impossible to deny management access to the corporate treasury, particularly in opposing proxy contests for control, an interim solution (or mitigation of management advantages) would be to permit the outside opposition also to have access to those funds by reimbursement. Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 285 (1966).

171. S. 510, 90th Cong., 1st Sess., § 1(5) (1967) (hereinafter cited as S. 510), Appendix. The rules and regulations under this section could provide that a corporation or its affiliates could not repurchase its shares, either on the market or through a tender offer, while a tender offer is pending by another group. Of course, there would have to be an exception for corporate repurchases definitely planned prior to the announcement of the bid that are otherwise legitimate corporate repurchases. Furthermore, such a rule should not prevent a management group from buying shares with their personal funds.

C. The Offeror

The limiting of management's "protective" function brings one naturally into the interests of the offeror. His sole interest, of course, is the success of the bid. To this end, he seeks to utilize his weapons of secrecy and speed to minimize the defenses of management. But if his secrecy is limited to the pre-tender-offer period and then revealed to management to assure the latter's "protective" function, and if his speed is crippled by extending the time in which the tendering must take place to assure the shareholders' "judicial" and "valuation" functions, the offeror is severely hampered. There may also be a rise in the cost of the tender offer because of this protection. Of course, he is not entirely hampered. The secrecy of the offeror before the tender offer announcement is still a potent weapon in that it takes management by surprise. And time, being a continuum, can be limited to some middle ground that is neither too short nor too long. The limitations on management's "protective" function noted above also serve to hold down management defenses, such as the SEC's approval of shareholder communications and the prohibition of management use of corporate funds to bid up the market. While it would be in the offeror's best interests for the myriad management defenses to be regulated by the SEC, this would seem undesirable in that it would put management in a strait jacket and would be administratively burdensome, if not impossible in cases of management appeals to friendly interests. The task then becomes a balancing of interests, and perhaps the creation of advantages to the offeror to equalize the advantages of management.[172]

172. One such advantage might be to require seriatim resignation of the present board of directors, after a successful bid, proportionate to the degree of control acquired by the offeror. While it might be argued that most directors would probably face the inevitable and make such arrangements anyway, the tenacity of the Columbia management in the face of the majority shareholdings of the Banque de Paris—dissident shareholder committee coalition indicates that this might not always be the case. Furthermore, in order to protect the shareholders from such an arrangement taking place without their knowledge, the SEC has recommended that information regarding voluntary seriatim resignations be sent to the shareholders under a provision in the proposed legislation similar to § 14(c) of the 1934 Act. See SEC, SECURITIES AND EXCHANGE COMMISSION RECOMMENDED AMENDMENTS TO S. 510, 90th Cong., 1st Sess. (1967) (hereinafter cited as SEC MEMORANDUM on S. 510). The advantage to offeror in making seriatim resignation required would be the avoidance of possible expenses in wresting control from a

IV. Is S. 510 the Proper Solution?

In October, 1965, Senator Williams introduced a bill, S. 2731, to provide for the regulation of tender offers.[173] The bill essentially provided for disclosure legislation that would serve the dual purpose of preventing damage to the shareholders before the tender offer was acted upon so that they would not be forced to shoulder the expense of burdensome litigation and of opening the offeror's "cloak of secrecy" to the light of publicity to prevent the kind of "industrial sabotage" that causes "proud old companies" to be "reduced to corporate shells."[174] S. 2731 provided that no per-

recalcitrant management in a proxy contest (this assumes that the offeror has either acquired only working control or would not want to allow the development of adverse sentiments in the minority toward the new management) and the avoidance of a waiting period until a meeting can be held to change control. But there are disadvantages to such a requirement in that (1) it would usurp the state law now governing seriatim resignations in tender offer situations, (2) complications might develop in determining the correct proportion that should resign, either under a cumulative or straight voting procedure, and (3) it would present an easy way in which to "buy" a directorship if the principle were applied to situations in which there was a change in control of less than a majority.

Another advantage that might be created for the offeror is a provision similar to Rule 14a-7 which would require management to either provide a shareholder list or distribute the offeror's tender offer materials at the latter's expense, whichever management chose. Since an outsider seeking control usually purchases stock as a foothold, the requirement of 14a-7 that the person making the request be a shareholder could also be carried over. This provision would enable the offeror to achieve a more thorough dissemination of his information. And the danger to him of "tipping his hand" would be inconsequential, since management would know his identity under the regulation of tender offers anyway. But it would also have the disadvantage of giving management advance notice of the offeror's arguments. And in the case of the offer itself, the offeror would probably avoid this technique since the placing of a newspaper ad would provide the initial element of surprise; and if that is successful, personal solicitation of the offer would only add to the expenses. Finally, the short time in which a tender offer is usually open would make small delays in sending the material unduly detrimental to the offeror.

173. S. 2731, 89th Cong., 1st Sess. (1965) [hereinafter cited as S. 2731].

174. *Supra*, note 73.

It should be noted at this point that the disclosure philosophy adapted by the proposed legislation goes beyond the function of informing the shareholders sufficiently to enable them to protect their personal interests in deciding whether to tender their shares. Some provisions, such as those requiring the disclosure of the offeror's identity and background and his intentions, are calculated also to prevent undesirable offerors from even beginning a tender offer program. Since the public disclosure of undesirable intentions would undoubtedly evoke public disapproval, the requirement would hopefully cause persons with such intentions to avoid using tender offers. Furthermore, such provisions as the disclosure of funds, the identity of the offeror's associates, and his previous market activities, are calculated to aid the SEC in enforcing its rules by pin-pointing violations and by showing who the violators are likely to be. For discussions of

son could increase his beneficial ownership of shares to over five per cent, nor make a cash tender offer that would so increase his holdings, without filing certain information with the SEC 20 days in advance. Such information would include the background and identity of the offeror or purchaser, the source of funds, the purpose of the purchase or offer, the number of shares presently beneficially owned, the facts of previous market purchases, information as to short sales, and the details of any arrangement with any person regarding the shares of the corporation.

After careful scrutiny of the bill by the SEC,[175] it was substantially revised and submitted as S. 510 on January 18, 1967.[176] The information required is substantially the same, but omits facts concerning previous market purchases and short sales. The reporting provisions are made applicable to purchasers of shares resulting in holdings over ten, rather than five, per cent; and reporting is not required until seven days after the purchase, rather than twenty days before it. As to tender offers, the same information that a purchaser must report must be filed with the SEC five, rather than twenty, days before the offer; and the filing is to remain confidential with the SEC until the offer is made, instead of being sent to the issuer twenty days in advance.

S. 510 goes beyond mere disclosure, however, in attacking the problem of tender offers. It provides that a shareholder may withdraw his tender at any time within seven and after sixty days after the offer is made; that the SEC shall regulate recommendations to accept or reject the offer; that all shares tendered must be taken up pro rata, that increases in the offer price apply retroactively to shares already tendered, and that all communications regarding the tender offer are subject to a fraud provision.

Since the revised bill was introduced to the Senate, the SEC has published further recommendations.[177] The SEC would change the bill to provide that shareholders may with-

---

this three-pronged protection in the use of disclosure legislation, see Note, *Disclosure as a Legislative Device*, 76 HARV. L. REV. 1273 (1963); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964); Heller, *Disclosure Requirements under Federal Securities Legislation*, 16 BUS. LAW, 300 (1961).

175. SEC MEMORANDUM on S. 2731. The SEC noted its general approval of the proposed legislation, at 5.

176. S. 510, Appendix.

177. SEC MEMORANDUM on S. 510.

draw their tenders before the expiration of seven days after the offer or at any time until the shares have been taken up by the offeror; that the pro-rata provision of the bill should extend regulatory powers to the SEC in order to cope with unanticipated problems; that if arrangements are made between the offeror and management for an immediate seriatim resignation without a special meeting, the shareholders would be given information equivalent to the proxy requirements of § 14(c) of the 1934 Act; and that the exemption for acquisitions covered by the 1933 Act be eliminated from the bill. This brief historical sketch of the progress of tender offer legislation in the United States indicates a process that has to some degree already culminated in other countries, notably Great Britain and Canada.[178]

178. Great Britain: Prevention of Fraud (Investments) Act, 6&7 Eliz. 2, c. 45, §14 (1958); Licensed Dealers (Conduct of Business) Rules, Stat. Instr., 1960, No. 1216; REPORT OF THE COMPANY LAW COMMITTEE, CMD. NO. 1749, c. 7 (1962) (hereinafter cited as JENKINS REPORT) (recommendations for legislation to supplement and extend the existing Licensed Dealers Rules, which apply only to those limited transactions effected by licensed dealers). *See generally* M. WEINBERG, TAKE-OVERS AND AMALGAMATIONS (1963). The rash of take-over bids following World War II in Great Britain reached its peak in 1953-54, causing such unethical practices as the wide use of non-voting shares to finance bids, the refusal of managements to communicate details of offers to the shareholders, and the transferring of corporate assets to newly-formed companies to leave only a corporate shell subject to the take-over bid (the Worcester Building Scheme). The reasons behind the increase in take-overs, and the liquidation of acquired corporations, were (1) the post-war inflation that caused the cash value of many corporate assets to be above the book values, (2) the cash accumulations in companies, caused by dividend restrictions imposed by the government to combat this inflation, (3) the low market values of shares because of the dividend restrictions, (4) the lack of progressive expansion plans and the conservative managements left behind when the government relaxed its tight controls after the war, and (5) the highly liquid assets owned by the corporations that were accumulated during the war and post-war inflation when the government taxed heavily distributions of earnings. Because the difficulties of that period have been largely settled by the British government, it has been suggested that the legislative regulation of take-over bids is not necessary, and that the recommendations of the Jenkins Committee are generally inconsequential. *See* G. Penrose, *Some Aspects of the Development, Criticism and Control of the Take-Over Bid Since 1945*, [1964] JURID. REV. 128; 212 THE ECONOMIST 1054 (1964). Beyond the differences in circumstances, the regulations of the SEC provide shareholder protection in the United States that would prevent the blatant cases of fraud experienced by the British in the height of the take-over bids. *See* JENKINS REPORT, ¶228, at 85 (quoting a memorandum submitted by the law firm of Davis, Polk, Wardwell, Sunderland and Kiendl, New York); Gower, *Corporation Law in England and America*, 11 BUS. LAW. 39, 49 (1955). It would seem, therefore, that the value of the British take-over experience lies not in direct application of principles to the United States situation but rather in its being the first major attempt to cope with the problems of tender offers. *See* MINUTES OF EVIDENCE TAKEN BEFORE THE COMPANY LAW

As the process of balancing all the interests involved in a tender offer begins, one general observation must be made. That is that the success of a tender offer is often in the best interests of the corporation, the shareholders, and the financial community and industry as a whole. It can be a convenient form of combining two companies in order to obtain diversification and economies of scale; and it may resuscitate a corporation that has been suffering from management doldrums.[179] On the other hand, the naivete of the shareholders in matters concerning the tender offer enables an offeror to take undue advantage of the lack of knowledge on the part of the shareholders.[180] The Kimber Committee in Ontario, in viewing these opposing poles, concluded that the primary objective of legislation in this area should be to protect the interests of the shareholders. However, in doing so it should not unduly impede potential bidders nor place them in a disadvantageous position against an entrenched management.[181] This view has been acknowledged in the United

---

COMMITTEE (1960-61) [hereinafter cited as MINUTES OF THE JENKINS COMMITTEE]. For further discussion of take-over bids in England and the Jenkins Report, see R. Pennington, *The Report of the Company Law Committee*, 25 MODERN L. REV. 703 (1962); D. Rice, *Take-Over Bids for Private Companies*, 1961 J. BUS. L. 260; S. Temkin, *Take-Over Bids*, 4 BUS. L. REV. 236 (1957); 209 THE ECONOMIST 511 (1963); 226 L.T. 215 (1958); 112 L.J. 468, 501, 579 (1962).

Ontario: Ontario Securities Act, 14 & 15 Eliz. 2, ch. 142 (1966) [hereinafter cited as Ontario Securities Act]; REPORT OF THE ATTORNEY GENERAL'S COMMITTEE ON SECURITIES LEGISLATION IN ONTARIO (1965) (hereinafter cited as KIMBER REPORT). The Kimber Committee recognized the differences between Ontario and the United States as to the necessity of legislation regarding tender offers, caused particularly by the extensive regulation of securities transactions by the SEC. KIMBER REPORT, ¶3.05, at 21 (quoting from a letter dated May 27, 1964, from Manuel F. Cohen to J.R. Kimber). However, the Ontario situation is much more analagous to that of the United States than that of Great Britain; and this was recognized in formulating the proposed legislation in this country. Cohen, *A Note on Take-Over Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 152 (1966).

179. *See* Manne, *Tender Offer & the Free Market*, 2 MERGERS & ACQUISITIONS 91, 92 (Fall 1966); 111 CONG. REC. 28260 (1965) (statement of Senator Williams). *See also* JENKINS REPORT, ¶265, at 98; MEMORANDUM BY THE INSTITUTE OF DIRECTORS, MINUTES OF THE JENKINS COMMITTEE, at 800-801; MEMORANDUM OF THE COUNCIL OF THE LAW SOCIETY OF SCOTLAND, MINUTES OF THE JENKINS COMMITTEE, at 1314-15.

180. MINUTES OF THE JENKINS COMMITTEE, ¶2163, at 442.

181. KIMBER REPORT, ¶3.10, at 22. Compare JENKINS REPORT, 265, at 99.

States.[182] With this in mind, we now turn to the specific provisions of S. 510.[183]

A. Disclosure of Identity and Background

Perhaps the most troublesome asepect of tender offer legislation is the identity of the offeror.[184] The Jenkins Report in Great Britain accepted the approach of the Licensed Dealers (Conduct of Business) Rules of 1960 without hesitation, recommending the identification of the offeror and his associates be provided in the offering circular.[185] The Kimber Committee considered the problem more fully and came to the opposite conclusion, stating that even though it could influence the shareholder's decision, it would unduly discourage tender bids.[186] However, it provided that the identity of the offeror could be voluntarily disclosed. The problem in the United States seems to have been assumed away, the identity disclosure provision having appeared in S. 2731 and having remained intact throughout the historical development of the legislation. The apparent thought is that the identity of the offeror is the primary means of protection against the corporate "raider."[187]

However, as has been noted previously, the regulatory requirement that the identity of the offeror be disclosed to the shareholder is undesirable and useless. It is outside the scope of justifiable tender offer legislation because, first, it would shift the fiduciary burden of protecting the corporate en-

182. M. Cohen, *A Note on Take-Over Bids and Corporate Purchases of Stock*, 22 Bus. Law. 149, 152 (1966); 113 Cong. Rec. S.443-44 (daily ed. Jan. 18, 1967) (statement of Senator Williams); N.Y. Times, Nov. 19, 1966, at 45, col. 7 (speech by Senator Williams); Loomis, Recent Activity at the Securities and Exchange Commission, 61 Nw. U. L. Rev. 677, 685 (1966).

183. It is to be noted that I am in agreement with many aspects of S.510. The provisions dealt with in this article will be those in which there is a necessity for explanation or change. The others do not require discussion.

184. The identity and the background of the offeror, which the proposed legislation requires to be discharged, are correlates. For convenience, the term "identity" will often be used alone throughout this paper; it should always be construed to imply disclosure of the background as well.

185. Jenkins Report, ¶280, at 104, following the Licensed Dealers (Conduct of Business) Rules, [1960] 1 Stat. Instr. §1(a)(ii) (No. 1216).

186. Kimber Report, ¶3.18, at 25.

187. See 111 Cong. Rec. 28258 (1965) (statement of Senator Williams).

terprise from the management to the shareholders; and, secondly, it presumes a choice-of-management function for the shareholder that cannot exist since the decision to tender, or not to tender, can mean both a vote for and a vote against the offeror, depending on the attitude of the shareholder.[188] The requirement that the identity of the offeror be disclosed to the shareholders would not produce the certain result that is necessary in protective legislation. And by leaving the fiduciary burden with management, the duty to investigate that the disclosure of identity would bring about would remain where the investigative tools are stored—with management.[189]

The problem that was most burdensome to the Kimber Committee was the argument that the name of the offeror is most material if the shareholder is considering whether to remain with the company. In such a case, the shareholder would be most likely to sell his shares at a lower price to an offeror with a bad reputation, holding on to his stock if the offeror has a good reputation in the financial community. As a result, the probability of higher costs, and perhaps the eventual frustration of the bid, is increased as the reputation of the offeror (and consequently the potential future of the company) improves.[190] At the other end of the spectrum is the problem which the American legislation seems to have con-

188. *Supra*, pp. 474-77.

189. *Supra*, pp. 478-81.

It might be argued that the purpose of securities legislation, besides protecting the smooth functioning of the securities market, is to protect the shareholders and investors, not the management. But the protection of management is not the primary concern in disclosing the identity of the offeror to management only. It is rather the proper method in which to protect the shareholders. Because the shareholders themselves do not have the tools to investigate a potential "raider," and because regulatory protection by disclosure to them would not produce uniform results, the only justifiable means of protection against "raiders" is management investigation. And the shareholders are the ultimate recipients of the protection because of management's fiduciary responsibilities to protect the stockholders from harm.

190. Letter from J.R. Kimber, March 14, 1967 [hereinafter cited as Kimber Letter]. A similar argument was made in Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS 91, 94 (1966). His solution essentially is to leave the cases of "crooks" to the criminal law, in which they are afforded the traditional safeguards of "trial by jury, presumption of innocence, no ex post facto laws and no double jeopardy." *Id.* Such a solution, however, would fail to recognize one of the important functions of tender offer legislation — to catch possible "raiders" before they have gained control of the corporation and have forced the shareholders into the courts, where the expenses of getting a remedy may greatly outweigh the value lost in small shareholdings.

sidered isolated, that if the corporation is to be protected from "raiders" before those persons could cause actual damage and if recovery is to be confined to after-the-fact litigation, the identity of the offeror is essential. To gain some insight into this conflict, one must begin with the conclusion of the preceding paragraph—that the protection of the corporate and shareholder interests in this matter must rest with the management and that they, not the shareholders, should be given the identity and background of the offeror. Now, if the offeror is determined a corporate "raider," with a bad reputation, the management would inform the shareholders of that fact both to preserve their control and to protect themselves from liability for mismanagement. But it does not follow that the management will be equally swift in disclosing the identity of the offeror with a good reputation, assuming that the offeror has not himself disclosed that information. Disclosure of the offeror with a good reputation may in fact induce tenders since the shareholders would feel that they can be assured prompt payment due to the reputable source of funds or that the reputation of the offeror indicates that the offer was preceded by a thorough investigation so that the price offered is the maximum he is willing to pay for the stock. The good reputation of the offeror might, also, indicate that the bid is serious, whereas by keeping the identity a secret, investors, especially those with a fiduciary responsibility such as mutual or pension funds, might withhold tender until they can be sure that it is not just a spurious bid for control that might easily fold before the tenders are taken up, causing inconvenience and expense.[191] Finally, management may want to preserve the secrecy of the offeror to utilize it as a defense. By pointing out that the offeror is withholding his identity from the shareholders, management could cause the would-be tendering shareholders to cast doubts on the offeror's motives—"what is he afraid of?"

---

191. A. Oakley Brooks, president of the De Vegh Mutual Fund, Inc., and vice-president of the Pine Street Fund, Inc., responded to the tender offer by an unidentified principal for shares of Columbia Pictures Corporation by stating that he would act in the best interests of the funds' shareholders in deciding whether to tender their Columbia holdings but that he would under no circumstances accept the offer until he knew who was behind it. Wall Street Journal, Oct. 6, 1966, at 24, col. 3.

The problem, thus, becomes much narrower. To begin with, there are few cases in which the offeror seeks to remain unidentified once the tender offer has been announced. In most of those situations, the offeror is a "raider" who has good reason to hide his identity. But in those cases the disclosure of his identity by management is presumably in the best interests of the corporation and the shareholders, and the withholding of tenders is desirable. If in some situations the management has an interest in allowing the offeror to keep his secrecy in order to provide management with defensive material, the cases in which the offeror is inconvenienced by the holding out by shareholders become even fewer. It is in the remaining negligible portion of the total picture of tender offers that the balancing of interests must take place. When viewed in the light, the inconvenience to the offeror seems insignificant in comparison with the damage that might result from a successful takeover by a "raider." Certainly, if we are to follow the presumption of the Kimber Committee in favor of the shareholder interests, the balance in favor of requiring disclosure of the identity of the offeror to management would seem sound.

The only question that remains is whether management would be required to disgorge the information of the offeror's identity anyway under Rule 10b-5, thereby causing a circular route to the same result as if the information were required to be disclosed to the shareholders themselves. There are several situations that must be considered. First, management might oppose the offeror on the grounds that a takeover would be detrimental to the corporate interest—the "raider" situation. In this case, it has been observed that the fiduciary responsibilities of the management would require disclosure to the shareholders for their protection. This could be supplemented, if necessary, by SEC rule-making power by requiring an opposition statement of this nature by management to include disclosure of identity. Secondly, the management could approve the offer. Here there is no advantage to the offeror in keeping his identity secret since the force of management approval would far outweigh the danger of holding out. Again, this could be supplemented by Commission rules to the effect that communication of approval by either party must include the offeror's identity. Finally, it is the case between these two extremes that is dif-

ficult.[192] Here management could oppose the offer on grounds other than corporate protection, and an insider could tender his shares as the result of a personal decision. Or management could remain silent, and an insider could decide either to tender or not to tender. In both cases, he possesses corporate information[193] unavailable to other shareholders. Assuming that 10b-5 can be extended to cover complete omissions,[194] the tendering of shares by an insider would seem to come under the rule. But the value of the information as to the identity of the offeror lies not in the ability to tender the shares but in the ability to withhold from tendering. If an insider decides to tender, he is realizing the value of his investment plus the premium and has no concern who is the incoming management. The value of this knowledge is his ability either to hold out with the expectation of an increase in the offer price or to retain his shares to be in the corporation when the new management comes in. If the insider tenders, there is lacking the "inherent unfairness" in using information to his advantage over the other shareholders that brings 10b-5 into play.[195] Yet, if the insider does seek that advantage and withholds his tender, there is lacking the transaction in shares—a purchase or sale—that brings in 10b-5.

Beyond the application of Rule 10b-5, it might be argued that it is unfair to put management in such a position of advantage in being able to withhold his tender. While this may be true, it is doubtful that the case will ever arise. In the first place, we have noted that the situations in which there is a combination of the offeror's desire to remain unidentified after announcement of the offer, a decision by the management that the offeror is not a "raider", and a decision by management to keep the offeror's identity a secret, are few in number.[196] Secondly, if the decision by management is to oppose the offer on grounds other than corporate protec-

192. It is, of course, assumed that in all such cases management has decided to keep the identity of the offeror to itself. This in itself would seem the exception rather than the rule.

193. The information would be deemed corporate information in that it would be acquired by the corporation in order to fulfill management's "protective" function through its fiduciary responsibilities.

194. *Supra*, note 98 and accompanying text.

195. On the "inherent unfairness" criterion, see *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

196. *Supra*, pp. 488-90.

tion, it could hardly be said that the director, officer, or employee, is taking advantage of information by withholding his tender, since he is merely following the management decision. Finally, in the case in which management remains silent, the director, officer or employee has good reason to hold his stock because a tender on his part only makes more certain the change in control that would most likely cost him his job. He, again, would not be "taking advantage" of the identity information.[197] In short, it is inevitable that the personal considerations of a director, officer, or employee in withholding his tender will be far more important than a knowledge of the identity of the offeror, simply because he has more at stake than mere investment. If the rare case in which the management person is motivated by the offeror's identity should arise, it would, in balance, seem a small price for avoiding the only other justifiable alternative, that is, no requirement of disclosure of the offeror's identity and hence lesser protection of the corporation and the non-tendering shareholders.

In essence, the problem of identity becomes this: (1) identity is most material in discovering the corporate "raider;" (2) in all other cases the identity may or may not be material under the circumstances; and (3) the "materiality" of the identity information lies in the power to withhold, not to give, tenders. Because required disclosure of identity to the shareholders cannot serve the purpose of protecting the corporation and the non-tendering shareholders since a decision to withhold can mean both approval and disapproval of the outsider, and because such disclosure to the management can provide this protection since it has the investigative tools and the power to recommend unified, cohesive action to the shareholders, the required disclosure of identity should be made at least to the management. But required disclosure also to the shareholders by regulation is both unjustifiable, in that it cannot produce uniform results to serve a protective function and is therefore outside the scope of proper regulation, and undesirable, in that it may serve to relieve

---

197. These arguments would not be applicable in the case in which a management person gave the identity information to outside shareholders who were his friends. Liability under 10b-5 in such a case where a holder's investment interest predominates would depend on the court's judgment of the "tippee" problem presented in *SEC* v. *Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D. N.Y. 1966). See 3 L. Loss, *supra*, note 22, at 1450-51 (2d Ed. 1961).

management of its fiduciary obligation to investigate the offeror since the shareholders would be put on notice of the need to investigate by the legislation. In all other cases where the identity is material and would result in withholding by the shareholders, management is most likely to divulge the information to protect its corporate office by frustrating the bid. If management does not divulge it, the reason for this would be to use it as a defense, in which case there would be no undue advantage to management because by opposition it neither withholds to be around when the offeror takes over nor withholds to command a higher price before capitulating—but rather seeks to keep the offeror out. In all other cases where identity is immaterial there is no advantage to management. In cases of approval or of opposition against an offeror determined by management to be a "raider," the identity should be disclosed to the shareholders by SEC regulation. Finally, in the rare case of unfairness that has threaded its way through the above observations, a balancing of interests would seem to place the protection of the corporation and the non-tendering shareholders in all cases above that one case of undue management advantage.

B. Disclosure of Intentions

The proposed legislation would require disclosure in tender offers of any "plans or proposals" that the offeror has to liquidate the corporation, sell its assets, effect a merger, or cause "any other major change in its business or corporate structure."[198] The problem of disclosure of intentions was dealt with by the Jenkins Committee which concluded that a statement of the offeror's intentions should not be required; in most cases the offeror will not be able to decide what actions to take until he has actually achieved control and it would be impossible to enforce implementation of the offeror's stated intentions.[199] The Kimber Report omitted without comment the offeror's intentions from among the

198. S. 510, 90th Cong., 1st Sess. §1(1)(A)(iii), Appendix, p. 522.

199. *Cf.* JENKINS REPORT, ¶267, at 99-100. *Compare* MINUTES OF THE JENKINS COMMITTEE, ¶7041, at 1549-50, *with* MEMORANDUM BY THE COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND, MINUTES OF THE JENKINS COMMITTEE, at 1334-35, and MINUTES OF THE JENKINS COMMITTEE, ¶1177, at 236.

items of required disclosure in a tender offer.[200] At the hearings before the Jenkins Committee in 1961, Chairman Cohen, then director of the SEC Division of Corporate Finance, explained that the SEC believed management forecasts to be inappropriate information to be included in a prospectus and that statements of opinion or forecasts, such as the prospects for future dividends, do "not fit into our notions of what the standards under a disclosure statute statement should be."[201] He went on, however, to state that under circumstances where an offeror as an insider could be said to have a duty to the shareholders, a failure to disclose an intent to change the nature of the business or to sell the physical assets would be considered a violation of the securities acts' anti-fraud provisions.[202] Assuming that the proposed legislation bridges the requirement of insider status, is there any reason for the apparent duality of standards between management and an offeror? Or is the need for disclosing intentions applicable only to insiders as such and therefore not relevant to tender offer legislation? The answers can be found by reviewing two important cases.

In *In re Ward La France Truck Corp.*,[203] the president and treasurer of the truck company caused the corporation to purchase shares from outside shareholders in order to increase their controlling proportions, at an average of $9.71 per share. The Commission found them liable under Rule 10b-5 for failing to disclose to the sellers of those shares, among other things, an intention to liquidate the corporation and realize about $25 per share and an intention to transfer the remaining assets of the corporation as a going business to Salta Corporation, which payment would realize about $45 per share. The Commission found this to be a fraud upon the shareholders because the insiders were acting upon information to which they had access but which was unavailable to the other shareholders.[204] There are two elements to

200. KIMBER REPORT, Appendix B, Div. B, at 73-74. *See* Ontario Securities Act, §90.

201. MINUTES OF THE JENKINS COMMITTEE, ¶6601, at 1463. See also *id.*, ¶5024, at 1030 (comments of F.A.O. Schwartz, partner in the law firm of Davis, Polk, Wardwell, Sunderland and Kiendl, New York).

202. *Id.*, ¶6642, at 1471.

203. 13 S.E.C. 373 (1943).

204. For some questions regarding tender offers that stem from the *Ward La France* case, see R. JENNINGS & H. MARSH, CASES ON SECURITIES REGULATION 836-37 (1963).

be considered here— (1) the transfer of assets plans and (2) the liquidation plans. First, the fact that Salta participated in the scheme to buy out the outsider interests indicates that the transfer of assets was not mere intention but a material fact. Since this was negotiated between the two managements confining the information within the corporate sphere, failure to disclose this material fact by an insider when he purchased on the market was a clear violation of 10b-5.[205] It was use of corporate information that was not available to the shareholders. Secondly, the liquidation plans also involve corporate information unavailable to shareholders. Information that could have been used in determining the liquidation value of the stock was not distributed to the shareholders and, hence, was known only by the insiders.[206] The implication is if the information for determining liquidation value were otherwise available to the shareholders there would be no liability for a complete omission of that fact, unless non-disclosure would render misleading a statement otherwise made.

The other case is *Mills* v. *Sarjem Corp.*[207] in which a syndicate purchased eighty per cent of the shares of Tacony-Palmyra Bridge Company through a tender offer. An action brought under 10b-5 alleged the failure of the syndicate to disclose a plan to sell the bridges to the Burlington County Bridge Commission in exchange for revenue bonds at substantial profit. In denying liability, the court stated:

> There seems to be no question but that the sellers and purchasers of the shares of stock dealt at arm's length, and that the selling shareholders were plainly on notice of the fact that the purchasing syndicate designed to obtain all of the capital stock of the corporation. Surely plaintiffs must have anticipated the likelihood that the defendants had a profit-making purpose in mind, especially when the price per share offered to

205. *Cf.* In re Hughes & Treat, 22 S.E.C. 623, 626 (1946) (dictum).

206. The unavailability of information with which stockholders might deduce the liquidation value of the company's shares was also present in Speed v. Transamerica Corp., 99 F. Supp. 808 (D.Del. 1951). This was an important factor in causing such knowledge of liquidation value to be considered inside information under 10b-5. *See* Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317, at note 71 (1967).

207. 133 F. Supp. 753 (D.N.J. 1955).

> them was substantially higher than the market value of the shares. The entire field of securities transactions is to some degree speculative in nature, and sales are usually motivated by a difference in opinion between vendor and purchaser regarding the future prospects of the particular security involved. Such was clearly the case here, and in the absence of any fiduciary duty it was not incumbent upon the defendants to divulge their plans with respect to a subsequent resale of the property.[208]

The court distinguished those cases in which the duty to disclose future prospects was placed on persons in a fiduciary position because in the present case the information was not obtained by virtue of an insider relationship.[209]

A cursory glance at these two cases might well seem to support the dual standard, insiders have a duty to disclose their intentions as a result of their fiduciary relationship and outsiders have no such duty. This would lead to the conclusion that, since tender offer legislation seeks to put a quasi-fiduciary burden of disclosure on offerors, offerors should have the duty to disclose their intentions. However, this would ignore the crucial element in both the above cases— in forming their intentions insiders have access to factual information that is unavailable to outside shareholders.[210] The tender offeror must investigate the corporation in which the takeover is sought as an outsider, despite any quasi-fiduciary obligations that legislation puts on him once he has made the offer. The information available to him is essentially the same as is available to the shareholders, investment advisers, and the entire financial community. A decision to merge, sell the corporation's assets, or liquidate is an investment decision based upon an analysis of those facts; and there is an SEC policy not to require disclosure of investment analysis, since the facts used are

---

208. *Id.* at 764.

209. *Id.* at 764-65, citing Speed v. Transamerica Corp., 99 F. Supp. 808, 828, 829 (D.Del. 1951).

210. Even after control is obtained, the plans regarding the corporation that were made before embarking on an acquisition program are not information that becomes available as a result of the new position of control and are not therefore inside information. Mills v. Sarjem Corp., 133 F. Supp. 753, 765 (D.N.J. 1955).

available to the general public.[211] Furthermore, it would be ludicrous to assume that such a declaration of intent could be enforced, or even should be enforced. For example, if the offeror intended to merge or sell the corporation's assets by purchasing working control and relying on his management influence to gain the support of the remaining shareholders, a one-third negative vote could make his plans impossible.[212] If he intended to liquidate the corporation, he may discover that the corporation was engaging in research that held prospects for even greater profits as a going concern. Conversely, if he intended to merge, he may discover upon taking control that it would be more profitable for both him and the remaining shareholders to liquidate and use the funds to finance a new plant and operations with more modern equipment. If he intended to replace the old management entirely, he may discover some persons he would like to keep employed with the corporation.[213] The speculations are infinite, but the conclusion is singular: the requirement that the offeror disclose his intentions is both impractical and contrary to the policy of protecting individual analysis based on public facts.[214]

It cannot be said that the failure to disclose the intentions of the offeror will enable corporate "raiders" to be more successful. It is doubtful whether a "raider" will readily disclose such information honestly or forthrightly since that would only be assuring his defeat. To have the proper influence on the shareholders, evil intentions must appear to be evil. By disclosing the identity of the offeror to the management, the facilities for investigation of the offeror and his possible intentions can be put to work.

---

211. 3 L. LOSS, *supra* note 22, at 1463.

212. *Supra*, note 20, p. 437.

213. *Compare* MEMORANDUM OF THE TRADES UNION CONGRESS, MINUTES OF THE JENKINS COMMITTEE, at 993.

214. Professor Manne reaches the same conclusion but from a slightly different approach. He objects to the provision requiring disclosure of intentions because (1) it implies wrongly that all liquidations are undesirable from the shareolder's point of view, (2) it requires the offeror to observe his stated plans and policies while there is no similar inhibition on the ability of incumbent managers to change their policies at will, and (3) such information would be of keen interest to competitors, particularly if the offeror is held to his statement. Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS, pp. 91, 95 (Fall 1966).

For another approach to the same conclusion, see Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135, at 144 (March-April 1967).

There is, therefore, no need to make the protection of the corporation and the remaining shareholders rest on the improbable assumption that by disclosing the offeror's intentions to the shareholders given the offer the "raiders" will honestly disclose themselves as such.[215]

C. Disclosure of the Source and Amount of Funds

Senate Bill 510 would require the offeror's disclosure of "the source and amount of the funds or other consideration" used in making the purchases, providing an exemption from specificity if the source was a loan made by a bank, as defined in § 3(a)(6) of the Securities Exchange Act, in the ordinary course of business.[216] A less specific approach to the problem was taken by the Kimber Committee.[217] The Jenkins Committee felt that the Licensed Dealers Rules, in requiring the dealer to disclose what steps he had taken in assuring payment of the offer if accepted, did not go far enough.[218] Although it rejected the other extreme of requiring security for the maximum possible cash consideration, the Committee recommended a definite statement by the offeror of the steps taken to assure payment, which would act as a binding representation.[219] It is certain that a tendering shareholder has an interest in being assured that arrangements for the payment of the offer price have been made adequately. In fact, the lack of such assurance, and the possibility that he might have to resort to burdensome litigation to recover his stock or to compensate for damages, might well influence a decision not to tender. To this end, any of

---

215. The offeror should be required to disclose only whether the tender offer is being made for control or investment. The necessity for this disclosure is aptly illustrated by the Columbia Pictures case, and it is essential in determining whether management's "protective" function and the shareholders' "judicial" function will even be brought to bear on the situation. S. 510 recognizes this by prefacing its requirement of disclosure of intentions with "if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities;" and to this extent, but to this extent only, such a disclosure provision should be preserved. *See* S. 510, §1(1)(A)(iii), Appendix, p. 522.

216. S. 510, § 1(1)(A)(ii), Appendix, p. 522. *See* SEC MEMORANDUM on S. 2731, at 9-10.

217. KIMBER REPORT, ¶3.19, at 25. *See* Ontario Securities Act, §90(6).

218. *See* Licensed Dealers (Conduct of Business) Rules, [1960] Stat. Instr., No. 1216, 1st Sched., Pt. II, §2(5).

219. JENKINS REPORT, ¶281, at 105.

the above methods would seem adequate to protect his interest.

One question that has been raised about the method used in the proposed legislation, however, has been from Professor Manne. He asserts that the required disclosure of the source of funds is an "innocent" cloak to cover the "ulterior motive" of the SEC, to uncover the use of funds from Swiss banks and to enhance the SEC's powers over foreign sources of funds, even though there is today no directly authorized method for acquiring this power.[220] While one cannot predict the motives of the SEC by speculation, the argument points out one problem with identifying the source of funds. The institutions supplying capital for the offer may be subject to business and political pressures, and many would be discouraged from financing a bid that would result in possible opposition and publicity. Furthermore, legal attacks from management might be directed toward these institutions as defensive measures.[221] Usually the offeror will place his funds in escrow until the bid is completed. In light of this, it would seem that the shareholder could be given adequate assurance of payment by requiring the escrow agent, or whoever holds the funds, to specify their adequacy in concrete terms, and in relation to the maximum amount necessary to complete the bid. Beyond this, any discrepancies or irregularities, as in the case where no escrow arrangement is used, can be pointed out by the shareholder's financial adviser.[222] In this way, the shareholder can be assured

220. Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS, 91, 94 (Fall 1966).

221. Hayes & Taussig, *supra* note 214, at 145.

222. It is unclear whether the proposed provision requiring that all recommendations to accept or reject the tender offer be subject to SEC rules—and perhaps thereunder prior to approval applies to financial advisers and brokers as well as to management and the offeror. *See* S. 510, §2(3), Appendix, p. . If this is the case, as is quite possible under the provision's broad language, these persons should be specifically exempt from its coverage. *See* N.Y. Times, March 23, 1967, at 47, col. 5 (comment of Ralph Saul, president of the American Stock Exchange). Brokers and advisers are the ones to whom shareholders would usually turn for advice regarding the best action to take in response to the tender offer. In some cases, a broker might be considered a biased party because of commission bonuses given by the offeror. But since such bonuses are a part of the tender offer, its terms would be disclosed to the shareholders. Knowing this, the stockholder can turn to his lawyer or some other disinterested party for advice. But unwarranted SEC regulations should not cut off or hinder these legitimate sources of advice. Anyone other than the offeror, management and their associates should remain free to express his opinions without being inhibited by SEC rules.

sufficient information to put him on notice of possible frauds that might otherwise only come out in after-the-fact litigation, without the danger of hindering the financing of offers by the institutions.

D. *Disclosure of the Number of Shares Beneficially Owned*

The proposed legislation would provide for disclosure by the offeror of the number of shares beneficially owned by him or his associates and the number of shares for which there is a right to acquire.[223] It is essential to the interests of the shareholder that he be aware to what extent the offeror has already made progress in his bid for control. If the progress is substantial, it is likely that the "valuation" of the premium over market price will become of greater importance in his weighing process than the protection of present management by withholding tender, since the likelihood that management will remain in office decreases as the foothold by the offeror increases. Furthermore, the greater the foothold by the offeror, the greater a percentage of the remaining shares will be held by each shareholder. Since his power over the success or failure of the bid corresponds to the percentage of shares he holds, the shareholder may want, indeed deserves, a higher premium than his percentage loss.[224] In order to make such a decision, it is essential that he knows where he stands vis-a-vis the offeror in order to bargain with him intelligently. And in order to stand in this position, he must know how many shares are presently under the offeror's control.[225]

---

223. S. 510, §1(1)(A)(iv), Appendix, p. 522.

224. An extreme example of this phenomenon is the case in which the offeror holds 49 per cent of the outstanding shares and makes a tender offer for the two per cent that would give him majority control. The shareholder would undoubtedly demand a much higher premium for these essential shares than in the case at the opposite extreme in which the offeror owns no shares. The value of the premium, or at least the portion of it here concerned, increases proportionately with the increase from the latter extreme to the former.

225. If a shareholder is concerned with the identity of the offeror, the disclosure of the number of shares owned by him provides a basis from which investigation of the shareholder list would reveal his identity. *See* Kimber Letter. *See also* ONTARIO SECURITIES ACT, 1966 Ont. Stats., c. 142, §90(1).

E. Disclosure of Arrangements

The bill before Congress would provide for disclosure by the offeror of any "contracts, arrangements, or understandings" with any person regarding the shares of the corporation.[226] As with the assurance of payment and the knowledge of the present holdings of the offeror, this information is essential to the interests of the shareholder in knowing where he stands before deciding whether to tender. Because his major source of information opposing the offer is from management, he must have a basis for determining whether an approval of the offer from management has been influenced by any "deals" between it and the offeror. The shareholder would also be interested in, among other things, any arrangements that might affect the payment for his shares. Furthermore, such arrangements can influence management's decision whether the offeror and his associates would be detrimental to the corporation and the shareholders. This was illustrated in the Columbia Pictures case, in which an arrangement was made between the offeror and two mutual funds to distribute the excess shares tendered, an agreement that threatened the television interests of Screen Gems, Columbia's subsidiary, under FCC regulations prohibiting a mutual fund from having a greater than one-per-cent interest in more than five stations.[227] As this arrangement was apparently made after the tender offer announcement but before the taking up of the shares, the SEC regulations under the bill should make it clear that such agreements are "material changes" that must be disclosed by amendment.[228] If this kind of material change occurs toward the end of the offer, or after the period in which a shareholder can revoke his tender, an additional period of revocability of short duration should be provided under the SEC rules.

F. Disclosure of Previous Market Activities and Short Sales

The original bill, S. 2731, provided for disclosure by the offeror of the dates and prices of purchases in the corpor-

226. S. 510, §1(1)(A)(v), Appendix, p. 523.
227. *Supra*, note 93 and accompanying text.
228. *See* S. 510, §1(1)(B), Appendix, p. 523.

ation's stock made by the offeror prior to the tender offer, with the identity of the broker or dealer; and the dates and amounts of all short sales effected in that period, also with the identity of the broker or dealer.[229] The SEC recommended that both provisions be eliminated. The former would unjustifiably make relationships between brokers and their customers public. The latter would be unnecessary because a ten-per-cent beneficial owner would be prohibited from making short sales under §16(c) of the 1934 Act and because owners of under ten per cent "appear to be rather unlikely to resort to short-sales as a technique to accomplish acquisitions or take-overs." The Commission said that if experience proved otherwise, it could use its rule-making powers to remedy the situation.[230] The provisions were omitted from S. 510. It is arguable that such information is necessary to point out market irregularities prior to the tender offer in the offeror's effort to achieve a foothold at the cheapest possible price. But it stands to reason that any person purchasing a block of stock on the market, whether seeking control via the tender offer or merely making an investment, would want to pay the cheapest possible price. For this reason, such activities as would be pointed out in these disclosure provisions are already covered by the antimanipulation sections of the securities acts.[231] To extend the bite of tender offer legislation to purchases in the market before the offer is to legislate beyond the justifiable scope of the bill. For example, the remedy of a person selling on the market at a low price due to manipulation should be governed by the price obtainable at that time without the manipulation. But by tying that manipulation into the tender offer legislation, it is arguable, especially in light of the bill's provision to extend increases in the offer price to all tendering shareholders, that the remedy would be governed by the offer price.[232] That would seem both undesirable to

229. S. 2731, §2(1)(c)(1)(v)-(vi).

230. SEC Memorandum on S. 2731, at 10-11.

231. See generally 3 L. Loss, *supra* note 22, at 1529-70.

232. Professor Manne objects to the provision requiring increases in the offer price to all tendering shareholders because it is contrary to the economic notion that identical goods may be acquired for different prices at different times and because, carried to its logical extreme, it would require all purchases for control to be made at the same price, whether bought on the market or through the tender offer. Combining this provision with the required disclosure of previous market activities under S. 2731, he asserts that a shareholder selling on the market

the offeror and unwarranted in that the premium is an inducement to shareholders being extended the offer and not to persons selling on the market, where the seller has consented to realize his investment portion only according to the market price. These two disclosure provisions were properly omitted, as they were duplicative in their protection and beyond the scope of tender offer legislation.

G. *Management Solicitations and Recommendations*

The Williams bill provides broad regulatory power in the SEC to govern the solicitations and recommendations of management to accept or reject the offer.[233] In the rules contemplated under this section, immediate management response with SEC approval would be permitted, provided a more complete and regulated response is forthcoming to the shareholders.[234] The communications would also be subject to a general fraud provision.[235] This, I believe, is the correct approach.[236]

---

would be able to sue under 10b-5 to get the higher offer price. Manne, *Tender Offers & the Free Market*, 2 MERGERS & ACQUISITIONS 91, 94-95 (Fall 1966). Although this argument is a bit extreme in some respects, it does point out the danger in extending tender offer legislation beyond the market for corporate control and into the investment market. The provision requiring the offeror to give increases in his offer price to all tendering shareholders is justifiable when limited to the tender offer only, since successive offers can be viewed as a continuous plan of tender offer acquisition. But the provision could have deleterious effects if market acquisitions were regulated under the same legislation by enabling sellers on the market to command a premium when they sold as the result of an investment decision with no thought of premium valuation.

233. S. 510, §2(3), Appendix, p. 524. The provision is worded broadly, in terms of "any solicitation or recommendation," and presumably applies to persons other than the offeror and management as well. *See supra*, note 222. The rules thereunder will be patterned after the examination procedures used in proxy contests. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 153 (1966).

234. Such a provision would be provided by an SEC rule similar to Rule 14a-12 under the proxy rules. *See* SEC MEMORANDUM ON S. 2731, at 18.

235. S. 510, §2(7), Appendix, p. 525. *See* SEC Memorandum on S. 2731, at 20-21.

236. Compare ONTARIO SECURITIES ACT, 1966 Ont. Stats., c. 142, §95 (legislatively required contents when a circular is issued by the management); JENKINS REPORT, ¶273, at 102 (recommendation circulars under the Licensed Dealers Rules need only be governed by a fraud provision if distributed through authorized channels).

The question remains whether management should be required to submit to the shareholders a statement of its approval or disapproval of the tender offer. It has been suggested that management have the responsibility to oppose a group seeking control of its company.[237] This would seem to go too far, since it is conceivable that the management would find a takeover in the best interests of the company and would therefore approve the bid.[238] Are there reasons that management might wish to remain silent? First, silence might indicate dilemma. The management could well conclude that the takeover would possibly help the company out of its problems; but if it came to a vote of the directors, the desire to retain their positions and the personal faith in their own management abilities would produce a vote of opposition. Yet, by using corporate funds to carry through that opposition, the management might open itself to liability for waste of corporate assets for personal aggrandizement and protection of office. A legitimate conclusion would be for management to remain silent. Secondly, management might be in the process of negotiating a merger, which would require disclosure under the SEC regulations as a matter influential to the shareholder decision. As merger negotiations are often delicate and easily upset by premature publication, management would desire to remain silent until the negotiations are completed.[239] Finally, the state of the corporation might be in such bad shape that disclosure of the information required by the SEC to accompany a management statement would aid the offeror rather than hinder him. The best defense would then be silence. Against these considerations must be balanced the interests of the shareholders in receiving the maximum amount of information. Realistically, the instances in which management will not oppose a tender offer will be few, and most of those will involve management approval, probably due to special arrangements with the offeror or the lack of a real threat of a change in control. In those remaining few cases, the desire to provide the shareholders with information is laudable. But the requirement that management must answer the offer

237. *Supra* note 166.

238. The management of Westec Corporation expressed the belief that the survival of the company depended upon its being taken over by some larger concern. Wall Street Journal, Nov. 25, 1966, at 28, col. 1.

239. *Cf.* MINUTES OF THE JENKINS COMMITTEE, ¶7051, at 1551.

would be an unwarranted intrusion of SEC regulation into the provinces of state corporation law, involving more complexities than can be handled by a black-and-white requirement.[240] The requirement was properly omitted, leaving management a voluntary choice of approval, disapproval, or silence, governed by their fiduciary responsibilities.

H. Procedural Time Limitations

The most delicate balancing of interests takes place in determining the procedural time limits in which tender offers must operate. The shareholder must be given ample time in which to assess the information available to him from both the offer statement and other sources, so that the "valuation" and "judicial" functions performed can obtain maximum veracity.[241] On the other hand, the value of speed in producing a successful tender offer should not be denied the offeror. Management must be given time to present its case to the shareholders, but not enough time to mobilize an impenetrable defense against the offeror.[242] In this light, the original bill presented by Senator Williams, S. 2731, required that tender offers be filed with the issuer and the Commission 20 days in advance of the public announcement to the shareholders.[243] In its recommendations to the Senate Banking and Currency Committee, the SEC rejected the 20-day advance notice provision because it would enable management to mobilize too great a defense and because it was "unnecessary for the protection of security holders to whom such offers would be directed."[244] Following the Commission's suggestions, the revised bill, S. 510, provided for a five-day advance filing with the SEC to remain confidential.[245] When

240. *See id.*, ¶6640, at 1471 (remarks of Manuel Cohen).

241. *See* KIMBER REPORT, ¶3.16, at 24; MEMORANDUM BY THE COMMITTEE OF THE ASSOCIATION OF BRITISH CHAMBERS OF COMMERCE, MINUTES OF THE JENKINS COMMITTEE, at 488; MINUTES OF THE JENKINS COMMITTEE, ¶3755, at 757-58.

242. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 153 (1966); 113 CONG. REC. S445 (daily ed. Jan. 18, 1967) (statement of Senator Williams).

243. S. 2731, §2(1)(c).

244. SEC Memorandum on S. 2731, at 17. *See also* Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 153 (1966).

245. S. 510, §2(2), Appendix, p. 524. The bill also provides that any person who acquires or obtains the right to acquire shares that would increase his beneficial holdings to over ten per cent must file a statement with the issuer, the

the offer had been approved and announced, the shareholders would be given a seven-day withdrawal period to change their minds and would also be able to revoke their tenders after sixty days.[246] The former was thought necessary to enable opponents of the offer to dissuade shareholders from tendering or to convince them to withdraw; the latter was thought necessary in order not to tie up the shareholders' stock for an inordinate length of time.[247] This approach was similar to that of the Kimber Committee in Ontario, which recommended a seven-day withdrawal period, but went on to require a minimum length of time of twenty-one days in which the offer must remain open and a maximum time limit of thirty-five days, unless the offer is for all the outstanding shares.[248] Since the submission of S. 510 to Congress, the SEC has offered further recommendations, advocating unlimited withdrawal for the seven-day period and then the privilege of withdrawing at any time until the tenders are taken up.[249]

In analyzing the proposals now before Congress, I wish to compare my own concept of the proper procedural time limits. It is therefore necessary to describe it briefly at this point. At some time prior to the announcement of the tender offer, the offeror must file confidentially with the Commission the statement proposed in S. 510. Presumably five days is sufficient time for the SEC to review it. When the announcement is made, both to management and the shareholders, there should be a three-day waiting period before any shares may be tendered. Once tendering is permitted, shareholders may unconditionally withdraw their tenders up to seven days from the beginning of the tender period. After that, the share-

exchange, and the SEC within seven days from the purchase. S. 510, §1(1), Appendix, pp. 522-23. This post-filing provision was necessary because there may be situations in which advance filing of that information would be impossible, such as acquisitions by inheritance or by gift without previous notice. SEC Memorandum on S. 2731, at 8.

246. S. 510, §2(4), Appendix, p. 524. Although it may only have been an oversight in the proposed legislation, there is no provision requiring the offeror to disclose to the shareholders that they have the right to withdraw their tenders during the first seven days and after 60 days. Such a statement should be explicitly required so that the shareholders have notice of their rights.

247. SEC Memorandum on S. 2731, at 19.

248. KIMBER REPORT, ¶¶3.14-3.15, at 24; ONTARIO SECURITIES ACT, § 81. *Compare* JENKINS REPORT, ¶¶274-78, at 102-104 (prior notice to the offeree company with no right of withdrawal during the bid).

249. SEC Memorandum on S. 510, at 1-3.

holders should have an additional seven-day period that permits withdrawal on the condition that the offeror has not taken up the shares. At the close of this period, there should be a twenty-one-day period in which shareholder tenders are irrevocable; but after that time the shareholders could revoke unconditionally, provided the SEC has not granted permission, upon application of the offeror, to extend the last period in the public interest. In short, this involves a 5-3-7-7-21 system. The theory behind it is that the things most consequential to the shareholder's decision will occur earliest in the bid, and these are the things which require unhurried assessment. As the bid progresses, there is less need for additional comments and information and more need for permitting the offeror to assess *his* position and either withdraw, accept, or change the offer price. I will now seek to explain this position more fully.

The idea of confidential advance filing is necessary for the protection of the offeror's interests. If it were made public, as the SEC pointed out, the management would be given additional time in which to cultivate defenses before the offeror is even able to present his offer, much less to state his case in support of that offer. It is arguable that five days is an insufficient length of time in which the Commission can fully review the offer statement.[250] But the SEC has expressed the belief that, in the light of its experience in proxy contests, five days is enough time and that any greater length of time would make the bill unworkable from the standpoint of the offeror.[251] Furthermore, the longer the time required for advance filing, the greater the possibility that news of the offer will leak out and cause harm to the offeror's interests. The designation of five days seems adequate.

The proposals before Congress reject any waiting period between the announcement of the offer and the beginning of actual tenders. This is unfortunate. A three-day waiting period would serve several legitimate functions. First, it would enable management to give some statement to the shareholders before they acted on the offer. Certainly three

250. *Compare* Rule 14a-6(a), 17 C.F.R. §240.14a-6(a) (1964) (requiring filing with the SEC ten days in advance of proxy solicitations); §8(a) of the 1933 Act, 15 U.S.C. §77h(a) (1964) (making the effective date of a registration statement 20 days after its filing).

251. Letter from Walter P. North, associate general counsel of the SEC, Feb. 6, 1967.

days is not sufficient time for management to build up a solid defense against the offer.[252] This was evidenced in the Columbia Pictures case, in which the first effort of management amounted only to a letter to shareholders to "go slow" in considering the offer.[253] But a waiting period of this duration would at least give the shareholder two sides to consider before acting. It can be argued that management has seven days in which to convince the shareholder to withdraw. But the purpose of this legislation is to enable the shareholder to carefully weigh the alternatives. It is not to create rules similar to those of a wrestling match to determine which party should begin in the top position. The shareholder should at least know whether his management is even going to take a position before he acts. Also, the mechanical difficulties of withdrawing one's tender from the transfer agent—the possibility of affidavits, guaranteed signatures, and the like—may deter the shareholder and promote inaction. Secondly, a three-day waiting period would enable the information regarding the tender offer to disseminate through various channels. A shareholder should be given the opportunity to consult, and to receive an informed opinion from, his investment adviser or his lawyer. For those who have or seek neither, the financial press offers an opportunity to receive disinterested opinion; and the waiting period would permit this to develop to a limited extent before action is taken.[254] Finally, the waiting period would effectively solve the problem of an offeror closing off the bid and taking up shares tendered in order to retender them to a second offeror

---

252. Upon learning of an impending contest for control, management should develop the following defensive measures: (1) accelerate plans for the future; (2) review the dividend policy; (3) make an opinion research survey; (4) contact public relations experts; (5) if it is a proxy contest, contact professional proxy solicitors; (6) personally talk with large shareholders; (7) have the accountants review the companies in which the outsider or insurgent has operated; (8) become familiar and comply with SEC regulations; (9) initiate voluntary campaign services such as stockholder committees; (10) determine how to present the management case; (11) get favorable news coverage, (12) contact local financial organizations, such as security analyst socities, and (13) if it is a proxy contest, determine management's proposed rules governing the validity of proxies. Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take Over Offers*, 20 BUS. LAW. 763, 768-76 (1965). Most of these are generally applicable to both tender offers and proxy contests. And they would take considerably longer than three days to develop.

253. *Supra*, note 79 and accompanying text.

254. *Cf.* Minutes of the Jenkins Committee, ¶5172, at 1048.

that has made an intervening offer at a higher price. The SEC seeks to rely on the shareholders' withdrawal privilege to solve this problem, and to an extent this is true.[255] However, the withdrawing of tenders takes time, particularly if it is done by mail. The offeror might just as easily close off the bid and retender the shares immediately thereafter, whether the tenders were withdrawable or irrevocable, taking his chances on the consequences. In the miasma of confusion that would follow—whether the second offer is deemed successful, whether the withdrawal dates from the sending or receipt of the letter, and whether the withdrawal came before or after the bid was closed, perhaps to the minute—the SEC might find that it had created a Frankenstein's monster that must somehow be subdued by it and the courts. On the other hand, if the original offeror were required to wait three days before accepting the second offer, there would be time for preliminary rulings on some of the major questions that may arise, and a chance to freeze the shares in the hands of the original offeror if it was determined that his action was illegal, for example, if he closed the bid and re-tendered during the period of unconditional withdrawal.

The following periods of seven days' unconditional withdrawal and seven days' conditional withdrawal work a compromise with the bill as it now stands. It operates on the theory that at least ten days is required to permit the shareholders to assimilate the necessary information and to weigh both sides. No offer should be permitted to be closed off within that period. However, it is unreasonable to force the offeror to keep his offer open beyond ten days if he has obtained his necessary quota. The element of speed may be essential if he is dealing with a highly entrenched management, and the forcing of his bid to remain open for a longer period of time might insure its defeat. Nevertheless, events may occur after that ten days that might influence the shareholder's decision. For example, a counteroffer may not take place until after that time because of the intervening five-day advance filing requirement with the SEC. It is also during this time that rebuttals or extended statements from either side may be made, as in the case of Columbia Pictures, in which the letter to the shareholders explaining the Banque's investment intent was sent out twelve days after the offer

255. *See* SEC Memorandum on S. 510, at 2.

was announced.[256] For this reason, the shareholders should have the privilege of withdrawing if they change their minds. But in keeping with the conclusion that the offeror may have an interest in closing off the bid after ten days, the offeror should also be able to take advantage of his success and take up the tenders. Therefore, the second seven-day period should permit withdrawals on the condition that the offeror has not closed his bid.

The SEC has changed its position from permitting no withdrawal until after fifty-six days from the initial seven-day unconditional withdrawal period to permitting conditional withdrawal at any time after that period. In support of this, it argues that the pro rata provision creates a tendency to delay tenders until the end of the offer time limit and that "there could be no disadvantage to the person making the tender offer if deposited shares may be withdrawn at any time until taken up."[257] This is not true. The offeror will undoubtedly gear his actions to the probability of success of the bid. If it is going well, he may arrange with his financiers to extend their commitments for an additional period in order to allow the bid to remain open longer until the requisite number of shares is tendered. If it is not going well, he may consider increasing the offer price and make further financial arrangements. By permitting the shareholders to withdraw at any time, he is given an unsettled picture of the success of his offer. And he may find it difficult to get backers in light of all the contingencies that can change the picture from one moment to the next.[258] If we assume that most of the arguments and events highly consequential to the shareholders' decisions will occur in the first seventeen days of the offer, it is only fair that the offeror be given a chance to assess his position in deciding what steps to take regarding the bid. As to the problem of the offeror closing the bid and re-tendering to a second offeror at a higher

---

256. *See* Columbia Letter, Oct. 11, 1966.

257. SEC Memorandum on S. 510, at 3.

258. Professor Manne objects to the seven-day withdrawal period of S. 510 because it gives the shareholders a seven-day "put" for no compensation, allowing them to have an option to sell if the market goes down for any reason; but if the market goes up they are not required to sell during this period. He states that the cost of this risk assumption is merely another unwarranted burden on the offeror. Manne, *Tender Offer & the Free Market*, 2 MERGERS & ACQUISITIONS 91, 95 (Fall 1966).

price, the shareholder who has waited for seventeen days without tendering will most likely wait until the last minute, at which time the chance of a counter bid at the same moment is doubtful. To be effective, a counter bid should come during the first seventeen days, when it can induce withdrawal and a conditional commitment to its side.

The provision in the present bill allowing unconditional withdrawal after sixty days was an effort to prevent a shareholder's stock from being tied up for an inordinate length of time.[259] But sixty days is too long in itself. Both the Jenkins Report and the Kimber Report recommended a maximum time limit on the offer of thirty-five days.[260] In keeping with the latter, I have recommended a maximum time of thirty-eight days, including the three-day waiting period. If it is found that some tender offers should remain open for longer periods of time in the public interest, the SEC could devise rules in which the offeror, upon application to the SEC, may be able to extend his offer.[261] In order to protect the interests of the shareholders, any such extension should probably include a short period of unconditional withdrawal so that shareholders who were feeling the harmful effects of an extended tying up of investment could get out.

I. Definition of Tender Offer

The proposed legislation conspicuously lacks a definition of tender offer, apparently leaving it to the SEC rule-making powers. This leaves open the question whether the definition should include private sales of control or tender offers to small numbers of shareholders.[262] In contrast, the Jenkins Report supported the Licensed Dealers Rules, which defined a tender offer as an offer to more than one shareholder, im-

---

259. SEC Memorandum on S. 2731, at 19.

260. JENKINS REPORT, ¶277, at 104; KIMBER REPORT, ¶3.15, at 24.

261. The SEC has rule-making power regarding the time limitations of a tender offer under the proposed legislation. S. 510, §2(4), Appendix, p. 524. *See* SEC Memorandum on S. 2731, at 19.

262. The problem of private sales of control is most prevalent in the smaller corporations. However, the 1964 Amendments extend the reach of the 1934 Act to some corporations that may find private sales of control a common method for transferring control of the corporation.

plicitly leaving out the private sale of control.[263] The Ontario law specifically exempts private sales of control and tender offers to companies with fewer than fifteen shareholders who are all Ontario residents.[264] In rejecting legislative regulation of the private sale of control, the Kimber Report recognized that the development of a law that would permit all the shareholders to participate in the opportunity to dispose of their shares at a premium above market price should be left to the judicial process.[265] A similar development, revolving about the problems caused by the use of a premium, has been taking place in the United States, although it has been more actively espoused in law review articles than in the courts.[266] The proposed legislation would in no way inhibit nor replace this development, as there is no provision that could effectively prevent the private sale of control, neither by forcing the premium to be paid over to the corporation nor by requiring an equal opportunity among the shareholders to partcipate in the sale of control under a general tender offer.[267] The only requirement of the

263. JENKINS REPORT, ¶269, at 100. For a criticism of the Jenkins Committee's failure to attack the problem of private sales of control, *see* Boyle, *The Sale of Controlling Shares: American Law and the Jenkins Committee*, 13 INT'L. & COMP. L. Q. 185 (1964).

264. Securities Act of 1966, Eliz. 2, c. 142, §80(b)(i, iii) (Ontario).

265. KIMBER REPORT, ¶3.12, at 23.

266. For a comprehensive discussion of the fiduciary responsibilities of sellers of corporate control, *see* Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 294 (1966); Bayne, *A Legitimate Transfer of Control: The Weyenberg Shoe-Florsheim Case Study*, 18 STAN. L. REV. 438 (1966); Berle, *The Price of Power: Sale of Control*, 50 CORN. L. Q. 628 (1965); Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Bayne, *The Sale of Control Quandry*, 51 CORN. L. Q. 49 (1965); Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L. J. 543 (1965); Bayne, *The Sale of Corporate Control*, 33 FORDHAM L. REV. 583 (1965); Note, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964); Note, *The Sale of Control: The Berle Theory and the Law*, 25 U. PITT. L. REV. 59 (1963); Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1962); Comment, *Sales of Corporate Control at Premiums: An Analysis and Suggested Approach*, 1961 DUKE L. J. 554; Katz, *The Sale of Corporate Control*, 38 CHI. BAR REC. 376 (1957); Hill, *Sale of Controlling Shares*, 70 HARV. L. REV. 786 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956); Weisbrod, *Trading in Business Ownership*, 1964 U. ILL. L. F. 465, 477; Comment, *Sale of Corporate Control*, 29 U. CHI. L. REV. 869 (1952).

267. Professor Andrews has suggested that any sale of corporate control should be accompanied by a general tender offer so that a private seller will give all the shareholders an opportunity to sell a proportion of their shares equal to the proportion sold by the control shareholder. The advantages of such a requirement would be (1) to reduce the incentive for a prospective looter to offer a premium

present bill that would affect the purchaser of control would be the statement to be filed with the issuer, the SEC, and the exchange under §1 of the bill.[268]

Are there any reasons for requiring the purchaser to comply with the advance-notice regulatory requirements of §2 of the bill, and its general provisions, in effecting a private sale of control? While the filing of the disclosure statement would be a mere formality because there would be only one shareholder that could respond to the offeror, one cannot overlook the deterrent effect of a publicly announced sale

---

to a single shareholder to gain control, since he cannot offer the same terms to all shareholders and still profit from his looting; (2) to give the shareholders incentive to investigate the possibility of looting; (3) to reduce such adverse effects of private sales of control as the loss of morale, the resignation of employees, and the loss of contract renewals based on personal rapport; (4) to increase the chances of a merger; and (5) to eliminate the possibility of a person who holds a large percentage of control stock to reap all of the profits on the investment portion of the stock, while holders of small percents of control reap nothing on the investment portion. In other words, the return on both the investment and control portions of a shareholder's stock would be proportionate for all stockholders. *See* Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965). *Contra*, Berle, *The Price of Power: Sale of Corporate Control*, 50 CORN. L. Q. 628 (1965); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965).

Two provisions of the proposed legislation would seem to support the suggestion of Professor Andrews. First, the provision requiring an increase in the offer price to be extended to all those tendering originally is based on the philosophy that, when there is a continuous program to acquire control through a tender offer, the value of some shares should not be greater than the value of others acquired for the same purpose in the same manner. The SEC has said that "the purpose of this provision is to remove a purely fortuitous factor from the calculation of the amount security holders should receive for their securities by assuring them of the same price for their securities regardless of when they are taken up, and to avoid the discriminatory effect of paying some holders more than others, since security holders tendering their shares pursuant to a tender offer normally assume that all tendering security holders will receive the same price." SEC Memorandum on S. 2731, at 20. The elimination of the fortuitous time factor in tender offers is arguably based on the same concept of equal treatment as Professor Andrews applies generally in eliminating the size factor in negotiated sales of control. Secondly, the pro-rata provision of the proposed legislation is also based on a concept of equal treatment and "fairness" by rejecting the fortuitous factor of when shares are tendered pursuant to a tender offer. *See* SEC Memorandum on S. 2731, at 19. Although Professor Andrews' theory and concept has been given limited recognition in S. 510, it should be noted that its extension to all sales of control might be against the interests of the offeror as new management. If the concept is carried to its extreme, the new management would not be able to buy out the old without purchasing 100 per cent of the outstanding shares, leaving the former with an undesired minority with a reputation.

268. S. 510, §1(1), Appendix, pp. 522-23.

of control.[269] If the terms of the offer are required to be disclosed, the fairness of these terms would be materially affected by the light of disclosure.[270] The incoming management would not want to alienate the minority shareholders from the beginning; and this would be particularly true if the purchaser was receiving only working control or if he planned to extend his control position in the future by soliciting sales from those shareholders. The publicity might also cause him to extend his premium offer to the entire body of shareholders in order to preserve a good reputation among members of the financial community. Furthermore, disclosure of the offeror's identity to the management could provide information to detect a corporate "raider." Aside from the developing law of fiduciary responsibility in the sale of controlling shares, the management might be able to prevent the takeover with such knowledge getting to the financial press and other elements that can create public opinion.[271] Of course, to have any effect different from the after-the-fact filing under §1 of the bill there must be a period of time between the announcement of the offer and the acceptance by the seller. A period of three days would require swift preventive action, and the forces of publicity would move much more slowly.[272] However, the psychological effect of the waiting period on the offeror, coupled with the seller's right of withdrawal for seven days thereafter, would undoubtedly cause some hesitation to consider the alternative of a general tender offer. Thus, while the legislation, by including all offers for control, would not prevent private sales of control, it would certainly encourage the use of a general tender offer.

Are there compelling reasons for providing an exemption for offers to a single or a limited number of shareholders? The

269. *Supra*, note 174.

270. It should not seem necessary that the terms of a private sale be sent to all shareholders even though the offer is made only to one. Public disclosure is enough, and the consequential publicity would bring those cases in which the interests of the shareholders are in danger to the attention of the shareholders.

271. While it is arguable that the board of directors would hesitate to release such information because they are under the control of the selling shareholder, it would seem that in most cases there are bound to be some directors who are dissatisfied with the transfer—minority directors and those who would lose their position—and would release the information. On the other hand, such an action, if it prevented the sale, might incur the wrath of the control shareholder, which would affect later director nominations.

272. For a discussion of a possible three-day waiting period, *see supra*, pp. 506, 507-09.

answer can best be found by examining the purposes of similar exemptive provisions—§4(1) of the 1933 Act and Rule 14a-2(a) under the proxy rules of the Securities Exchange Act.[273] First, under both of these exemptions lies the philosophy that there is no need for disclosure in a case where all of the offerees or persons solicited have easy access to or knowledge of the requisite information. In the proxy situation, a corporation having a small number of shareholders will be sufficiently close-knit that most of these persons will be active in the corporation's affairs and will probably be present at the meetings.[274] And if only a few persons are solicited, personal contact will make the flow of information adequate. In the issuance situation, the private offering exemption assumes circumstances in which the offerees have access to the requisite knowledge.[275] But in the tender offer situation, disclosure operates not only to inform the shareholders in making their judgments, but also to uncover or to deter a corporate "raider." This latter function is directed toward management. And management cannot be presumed to have adequate information from which to investigate the purchaser merely because the controlling shareholder knows the offeror's identity. Secondly, Rule 14a-2(a) seeks to permit the initial steps in proxy solicitation before a formal letter is sent out by enabling the solicitor to contact influential shareholders in determining his relative support without having to file with the SEC.[276] But the scope of this legislation, S. 510, does not extend to actions prior to the actual tender offer and the filing with the SEC five days before. An offeror, whether seeking to make a general or private offer, will not be prohibited from soliciting support by personal contact prior to the time of the actual offer to purchase control. Thirdly, Rule 14a-2(a) enables the solicitor to initiate support without his efforts coming to the attention of the management.[277] Here again, the bill does not extend beyond the actual offer into prior consultations. Furthermore, if the

---

273. 15 U.S.C. §77d(1) (1964); 17 C.F.R. §240.14a-2(a) (1964).

274. Note, *The Public Corporation—A New Theory for Federal Proxy Regulation,* 60 NW. U. L. REV. 349, 362 (1965).

275. SEC Securities Act Release No. 4552 (Nov. 6, 1962); SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

276. E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 96 (1957).

277. *Id.* at 97.

offeror is seeking a private sale of control, management will most likely be involved since the seller controls the management, unless the shareholder is selling out from under them. Fourthly, §4(1) of the 1933 Act is an effort to weed out those cases in which there is no need for the act to apply because the public benefits are too remote.[278] However, it can hardly be said that a change in control of a corporation of sufficient size to be covered by the 1934 Act and the proposed tender offer legislation does not somehow affect the public, whether it be shareholders, consumers, labor, or the community. Finally, it might be argued that the SEC should not be burdened with an excessive number of filings that are a mere formality. It is doubtful whether the SEC will be so burdened in that private sales of control in companies that are listed or have over 500 shareholders are few. And if the requirement of filing a statement prior to acceptance of an offer for private sale of control can aid in the protection from "raiders," and inform the shareholders through publicity when there is a change in control, and as a byproduct encourage the use of general tender offers, the formality would seem consequential.

J. Pro Rata Provision

The proposed legislation would require the offeror to take up tendered shares in an offer for less than all the outstanding shares on a pro-rata basis.[279] By assuring shareholders of equal and fair treatment in the acceptance of tenders, the provision puts a damper on hasty action in a rush to be first in line and consequently allows the shareholders to come to a reasoned and intelligent decision regarding their tender actions.[280] But this slowing down of the tempo of the offer is not without disadavantage to the offeror. For example, the shareholders presently in control of the corporation may be left with a minority number of shares but still be able to exert a disturbing influence because of their reputation. And if they do not want this minority position,

278. H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933), at 5.

279. S. 510, §2(5), Appendix, p. 525.

280. SEC Memorandum on S. 2731, at 19; Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 153-54 (1966).

the purchase of their shares by the offeror would increase the costs of the takeover. Furthermore, the offeror may be discouraged from making a bid under a pro rata provision because of the fact that it induces shareholders to wait until the last minute. This tends to create a hold-out atmosphere over the bid in comparison with the "bandwagon" effect of shareholders rushing to accept the offer. A pro rata provision is black and white; therefore, the task of those considering the legislation is to weigh the two interests rather than compromise them.[281] As to the interest of the offeror in decreasing his costs, this factor could be estimated to some extent beforehand. If he expected a successful bid, he might set his maximum of shares desired lower and supplement his purchase with a private sale with the controlling shareholders. As to the offeror's interest in the atmosphere of the bid, it would seem the ideal is when the atmosphere is created by arguments to the shareholders rather than by employing psychological phenomena. In either case, the interest of the shareholder in feeling at ease to consider the offer fully is paramount to cost saving or atmosphere creating.

It should be noted at this point that the bill properly combines its pro rata provision with a limited period of withdrawal by the shareholders. It can be argued that, if the pro rata provision encourages shareholders to wait until the last minute, a period of withdrawal in the beginning of the offer is ineffectual and unnecessary. This, however, belies the inherent differences in the two protections. The period of withdrawal of tenders marks the length of time necessary for the proper consideration of any tender offer. It, in effect, says that any person coming within that time period must obey the rules of the road in allowing the shareholder to come to a reasoned decision. On the other hand, the pro rata provision relates to the particular offer and, in effect, says that whatever the length of time provided by the offer the decision of the shareholder should be unhurried. The former, then, is supplementary to the latter. A pro rata provision by itself would permit an offer that must be answered in, say, five days. The withdrawal provision

---

281. *See* KIMBER REPORT, §3.17, at 25; KIMBER LETTER.

supplements this by saying that that is not enough time for the shareholders.[282]

A problem arising out of the pro rata provision is that some persons, particularly professional investors with sufficient risk capital, will over-tender so that all shares owned will be purchased by the offeror under the pro rata division. In essence, they tender short and make up any difference by market purchases after the shares are taken up.[283] This has caused the SEC to recommend an amendment to the pro rata provision of S. 510 to enable the Commission to use its rule-making power to deal with the problem.[284] This suggestion represents an unwarranted intrusion of the SEC into the regulation of investment analysis and investment risk. The danger of tendering short is apparent—the market price of the shares may rise above the offer price as the shareholders are forced to compete for sell orders on the market to cover tender deficiencies, with the result that gains in the premium offered above market by the offeror are diminished. But this is a risk that is open to any shareholder. The SEC argues that in some cases, "this may result in the professional unfairly competing with his own customers who have tendered their shares on his recommendation."[285] But the difference between the professional and the nonprofessional in ability to analyze investment risks is a fact of

282. The recommendation by the SEC to permit conditional withdrawal at any time after the first seven days would defeat its own purpose. Although it would reduce the haste with which tender offers are considered by the shareholders, it would force the offeror into closing off his bid at the end of seven days, which is the minimum time under the proposed legislation that bids must be open. There would be no advantage to the offeror in waiting a longer time because he could obtain no clearer picture in the future of the success of his offer. And by giving the offeror no time period in which he can determine the exact number of unqualified tenders, the SEC recommendation would inject the element of haste back into the tender offer situation, protected only by the withdrawal period, by making it unprofitable for an offeror to extend the bid beyond the absolute minimum period of shareholder consideration—seven days. *See* SEC Memorandum on S. 510, at 1-3.

283. When shareholders of the Columbia Pictures Corporation over-tendered in order to take maximum advantage of the pro-rata provision in the offer by the Banque de Paris, they were forced to bid up the market to cover their tenders because the Banque accepted all of the additional shares tendered, deciding not to employ the pro-rata provision. The rush to cover over-tenders the day after the offer was closed caused the Columbia stock to rise considerably above the offer price and to be thirteenth most active on the market that day. Wall Street Journal, Oct. 19, 1966, at 25, col. 2.

284. SEC Memorandum on S. 510, at 3-4.

285. *Id.* at 4.

life. And if the adviser has recommended tender to the shareholder without further explaining the possibilities and the risks of over-tendering, this would seem a task for the present law governing the fiduciary responsibilities of the adviser and not the task of the SEC rules under tender offer legislation.

K. The Ten-Percent Standard

Under the original bill, S. 2731, both the reporting requirement accompanying purchases of large blocks of stock and the filing requirement involving tender offers became effective when the result was to increase beneficial holdings to greater than five percent.[286] Although the SEC recommended that the former not be cast as an amendment to §16(a) of the 1934 Act and that the reporting requirement be effective after the purchase rather than before, it did not recommend a change in the standard of five percent regarding either the reporting of purchases or the filing of tender offers.[287] Without explanation, the revised bill, S. 510, changed the standard to ten percent.[288] The only reasonable conclusion to draw from this is that the draftsmen of the bill were persuaded that the tests under this legislation and §16(a) of the 1934 Act should be the same. This is a false notion. The purpose of §16 is to point out those shareholders who are in a position to receive inside information regarding the corporation and to prevent them, with all other insiders, from utilizing that information for personal profits in short-term trading.[289] The proposed tender offer legislation has quite a different purpose. The reporting and filing requirements are not designed to point out those who have access to certain bodies of information but to point out those whose buying practices indicate a potential attempt to take over control of a corporation.[290] It is understandable that the standard

286. S. 2731, §2(1)(c)(1); S. 2731, §1.

287. See SEC Memorandum on S. 2731.

288. S. 510, §§1(1), 2(2), Appendix, pp. 522-23, 524.

289. *See generally* Cook & Feldman, *Insider Trading under the Securities Exchange Act*, 66 HARV. L. REV. 385, 612 (1953).

290. Senator Homer Capehart of Indiana introduced a bill in 1957 to change the reporting requirements of §16(a) from ten per cent to five per cent, but it was never acted upon. This attempt was probably influential in supporting the original tender offer legislation of Senator Williams. *See* 111 CONG. REC. 28259 (1965) (statement of Senator Williams).

of §16 would not want to reach the fewer number of those cases in which information is available to holders of less than ten percent because of the automatic application of liability and the stringent regulation of conduct. There would be too many people in that category who would not be in an inside position. But a change in control is most important to the shareholders and the financial community; and no such compromises should be made. Ideally, the reporting provision should apply to all instances in which there is an attempt to seek control. But the variations in the meaning of control would in itself make the application of such a standard impossible.[291] But a percentile standard, particularly in the case of filing tender offers, should include those cases in which control in its effective sense can likely be accomplished. Because the 1934 Act applies to the larger companies with more widely dispersed shareholders, working control can often be obtained with percentages of less than ten percent.[292] There is consequently reason against the unexplained change in the standard of S. 510, with insubstantial reason for making such a change.

L. *Broad SEC Rule-Making Powers*

Throughout this article I have tried to create a framework for tender offer legislation by examining illustrative provisions of the proposed S. 510 and by fashioning a structure both justifiable in its scope and effective in its handling of the problems that arise when the tender offer mechanism is used to acquire control. It is the nature of the tender offer situation that such legislation should be no more than a framework. The area, beyond the simplified nature of tender offers in general, can become very complex. Because it is often a contest between an incumbent management and a seeker of control, the interests of the parties become sharply focused; and ingenuity is given free rein in order to advance those interests. It would be most difficult to anticipate the variety of tender offers that could result. Any attempt legislatively to build houses from this framework would end

291. *See* KIMBER REPORT, ¶3.11, at 23.

292. *See* Matter of Caplan (Sup. Ct. N.Y. County), in 151 N.Y.L.J. No. 24, at 14, col. 3 (Feb. 4, 1964) (three per cent working control); Carter v. Muscat, 251 N.Y.S.2d 378 (1964) (9.7 per cent working control).

in an unnecessarily complicated maze of provisions. The purposes of the proposed legislation can best be served by adopting the experience of the proxy rules in making use of broad administrative powers to create flexible rules.[293] This would enable the SEC effectively to cope with such problems in a contested situation as immediate clearance of materials, and would assure acknowledgement of the practicalities of the given case.

While I disagree with some aspects of S. 510 as a framework, I am in full agreement with the bill being no more than a well-structured framework to be supplemented under SEC rule-making powers. The modifications of the framework that have been the concern of this paper can best be viewed in the light of the purposes of legislation regulating cash tender offers: (1) To disclose relevant information to the shareholders. Here, there should be no required disclosure of the offeror's intentions, no regulatory inhibition of statements by brokers and financial advisers, but assurance of adequate funds without disclosure of the source of the funds. (2) To protect the corporation and non-tendering shareholders from "raiders." Here, there should be disclosure of the offeror's identity to management only and a return to the five-percent standard of S. 2731. (3) To provide a smoothly functioning, honest market for corporate control. Here there should be a prohibition against management use of corporate funds to outbid the offeror on the market and a change in the time limits to a 5-3-7-7-21 system. Also, the bill should define a tender offer to include private sales of control. And it should not extend to the regulation of over-tendering. With these modifications to the framework that were noted throughout the paper, I would recommend that a bill similar to S. 510 be passed by Congress to regulate cash tender offers.

293. *See* von Mehren & McCarroll, *supra*, note 42, at 728.

APPENDIX I

S. 510

IN THE SENATE OF THE UNITED STATES

JANUARY 18 (legislative day, JANUARY 12), 1967

MR. WILLIAMS of New Jersey (for himself and MR. KUCHEL) introduced the following bill; which was read twice and referred to the Committee on Banking and Currency

A BILL

Providing for full disclosure of corporate equity ownership of securities under the Securities Exchange Act of 1934.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 13 of the Securities Exchange Act of 1934 is amended by adding at the end thereof a new subsection as follows:

"(1) Every person, who by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly, acquires or obtains the right to acquire the beneficial ownership of, or increases or obtains the right to increase his beneficial ownership to, more than 10 per centum of any class of any equity security which is registered pursuant to section 12 of this title shall, within seven days after such acquisition, or the obtaining of such right to acquire, send to the issuer of the security at its principal executive office, by registered or certified mail, send to each exchange where the security is traded, and file with the Commission, a statement as herein below described:

"(A) Each such statement shall contain such of the information in subsections (i)-(v) of this section, and such additional information, as the Commission may be rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors—

"(i) the background and identity of all persons by whom or on whose behalf the purchases have been or are to be effected,

"(ii) the source and amount of the funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented or is to be represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading such security, a description of the transaction and the names of the parties thereto, except that where a source of funds is a loan made in the ordinary course of business by a bank as defined in section 3(a)(6) hereof it will be sufficient to so state,

"(iii) if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to, or merge it with any other persons, or to make any other major change in its business or corporate structure,

"(iv) the number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (a) such person, and (b) by each associate (as defined in the rules and regulations of the Commission under this Act) of such person, giving the name and address of each such associate, and

"(v) information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.

"(B) If any material change occurs in the facts set forth in the statements to the issuer and the exchange and the statement filed with the Commission, an amendment shall be transmitted to the issuer and the exchange shall be filed with the Commission in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

"(2) When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection.

"(3) In determining, for purposes of this subsection and of section 2 of this bill, whether a person is the beneficial owner, direct or indirect, of more than 10 per centum of a class of any security, such class shall be deemed to consist of the amount of the outstanding securities of such class, exclusive of any securities of such class held by or for the account of the issuer.

"(4) The provisions of this subsection and of section 2 of this bill shall not apply in respect of—

"(A) Any acquisition or offer to acquire securities made or proposed to be made by means of a registration statement under the Securities Act of 1933.

"(B) Any acquisition or proposed acquisition of a security which, together with all other acquisitions by the same person of securities of the same class during the preceding twelve months, does not exceed 2 per centum of the outstanding securities of that class at the time of the acquisition. As used herein the term 'outstanding securities' of a class shall not include securities of the class held by or for the account of the issuer.

"(C) Any acquisition of an equity security by the issuer of such security.

"(D) Any acquisition or proposed acquisition of a security which the Commission, by rules or regulations or by order, shall exempt from the provisions of this subsection as not entered into for the purpose of, and not having the effect of, changing or influencing the control of the issuer or otherwise as not comprehended within the purposes of this subsection.

"(5) It shall be unlawful for any issuer, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors or in order to prevent such acts and practices as are fraudulent, deceptive or manipulative, to purchase any equity security which it has issued. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold."

SEC. 2. That section 14 of the Securities Exchange Act of 1934 is amended by adding at the end thereof new subsections as follows:

"(1) When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for purposes of this subsection.

"(2) It shall be unlawful for any person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, to make a tender offer for, or a request or invitation for tenders of, any class of any equity security which is registered pursuant to section 12 of this title which, if consummated, would result in such person owning beneficially more than 10 per centum of such security, unless five days prior to the making of such tender offer or request or invitation for tenders, such person has filed with the Commission a statement containing such of the information specified in paragraphs (A) and (B) of subsection 1, section 1 of this bill, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. All requests or invitations for tenders or advertisements making a tender offer or requesting or inviting tenders of such a security shall be filed as a part of such statement and shall contain such of the information contained in such statement as the Commission may by rules and regulations prescribe. Preliminary copies of any additional material soliciting or requesting such tender offers subsequent to the initial solicitation or request shall contain such information as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors and shall be filed with the Commission at least two days prior to the date copies of such material are first sent or given to security holders. All copies of preliminary statements filed with the Commission hereunder shall be clearly marked 'Preliminary Copies' and shall be for the information of the Commission only, except that such statements may be disclosed to any appropriate department or agency of government and the Commission may make such inquiries or investigation in regard to such statements as may be necessary for an adequate review thereof by the Commission. Definitive copies of all statements, in the form in which such material is furnished to security holders, shall be filed with, or mailed for filing to, the Commission and shall be sent to the issuer not later than the date such material is first published or sent or given to any security holders. The time periods contained in this subsection may be shortened as the Commission may direct.

"(3) Any solicitation or recommendation to the holders of such a security to accept or reject a tender offer or request or invitation for tenders shall be made in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

"(4) Securities deposited pursuant to a tender offer or request or invitation for tenders may be withdrawn by or on behalf of the depositor at any time until the expiration of seven days after the time definitive copies of the offer or request or invitation are first published or sent or given to security holders, and at any time after sixty days from the date of the original tender offer or request or invitation except as the Commission may otherwise prescribe by rules, regulations or order as necessary or appropriate in the public interest or for the protection of investors.

"(5) Where any person makes a tender offer or request or invitation for tenders for less than all the outstanding equity securities of a class, and where a greater number of securities is deposited pursuant thereto than such person is bound or willing to take up and pay for, the securities taken up shall be taken up as nearly as may be pro rata, disregarding fractions, according to the number of securities deposited by each depositor.

"(6) Where any person varies the terms of a tender offer or request or invitation for tenders before the expiration thereof by increasing the consideration offered to holders of such securities, such person shall pay the increased consideration to each security holder whose securities are taken up and paid for pursuant to the tender offer or request or invitation for tenders whether or not such securities have been taken up by such person before the variation of the tender offer or request or invitation.

"(7) It shall be unlawful for any person making or soliciting tender offers, or management, or any person or persons who circularize or solicit security holders in opposition to or in favor of any such offer, to make in connection therewith any false, deceptive or misleading statements, or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in such acts and practices as are fraudulent, deceptive, or manipulative."

HARVARD STUDENT LEGISLATIVE RESEARCH BUREAU
1967-68

Mark A. Peters
President

Ben F. Johnson
Director of Research

Allen H. Horstman
Secretary-Treasurer

Harvard Journal on Legislation

Berndt G. Lohr-Schmidt
Editor-in-Chief

Stuart M. Warren
Articles Editor

Eugene R. Fidell
Peter A. Atkins
Note Editors

Jerry Terrill
Legislation Editor

Joseph M. Beck
Richard B. Child
Patricia A. Flynn
David H. Kirkpatrick
Daniel W. Latimore
Perry A. Lerner
Peter J. Manusack
Jeffrey C. Pond
Charles M. Stern
Ronald S. Tauber
Theodore Wilson

Phillip M. Barber
Dorothy J. Bonner
Timothy J. Dacey
Brenda S. Feigen
Earl N. Feldman
Thomas E. Gallagher
William A. Gregory
Andrew Jay Kleinfeld
Neil H. Koslowe
Philip J. Luks
Guy B. Moss
George Nagler
Charles H. Nida
Ambrose M. Richardson
Peter W. Rodman
Sheldon L. Schreiberg
Samuel A. Sherer
Frank P. Slaninger
Diane G. Van Wyck

Margaret V. Walker
Staff Assistant

AN ACT TO ESTABLISH A CORPORATION FOR URBAN DEVELOPMENT

INTRODUCTION*

"The housing problem is an inevitable feature of our modern industrial civilization and does not tend to solve itself. Supply and demand do not reach it, because the cost of new housing and the distribution of income are such that [much] of the population cannot present an effective demand for new housing. And while some of the older housing is acceptable enough, a great deal is shockingly inadequate."[1]

Though written thirty-four years ago, the statement has currency today. The plight of the urban poor on a national level, especially the non-white, in obtaining decent housing notwithstanding a long and costly federal effort[2] was most recently articulated in the Report of the National Advisory Commission on Civil Disorders.[3] In New York, despite a

---

* This introduction was prepared by Joseph M. Beck, member of the Class of 1968 of the Harvard Law School, and chairman of the committee which prepared the following statute.

1. Symposium, *Low Cost Housing and Slum Clearance*, 1 L. & CONTEMP. PROB. (March, 1934).

2. The first serious federal attempt to deal with housing for the disadvantaged was the depression inspired Home Owners' Loan Corporation of 1933, Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128. (For earlier federal programs *see Foreword*, 32 L. & CONTEMP. PROB. 371-372 (1967).) The National Housing Act of 1934 authorized the Federal Housing Administration to insure the loans of private lenders where the funds were to be used for rehabilitation of existing property. 12 U.S.C. § 1703 (1964). The Housing Act of 1949 (principally urban renewal authorization) pledged to provide a decent home... for every American family. 42 U.S.C. § 1441 (1964). For a summary of major federal housing acts from 1954 to 1965 *see* Lashbough, *Rehabilitation of Housing: Federal Programs and Private Enterprise*, 32 L. & CONTEMP. PROB. 416, at 418-22 (1967).

3. THE NATIONAL ADVISORY COMMISSION ON CIVIL DISORDERS, REPORT, at 467-482. (Bantam paperback ed., 1968); see also *Hearings on the Federal Role in Urban Affairs Before the Subcomm. on Executive Reorganization of the Senate Comm. on Government Operations*, 89th Cong., 2d Sess., pt. 1, at 147 (1966).

considerable state effort,[4] the problem of providing adequate housing remains unsolved. Public housing for low income persons has been expensive to finance[5] and slow to construct.[6] Completed projects have been criticized as transplanted ghettos managed by arbitrary authorities.[7] Nor have efforts to provide new "middle income" housing in New York been successful.[8] Consequently, "middle income" families must move into existing housing, much of which is substandard.[9]

---

4. As of August 31, 1967, New York had contracted to provide $71.7 million to enable forty-five communities to proceed with seventy-eight urban renewal projects. It had lent $92.4 million to provide for construction of 133 low income housing projects in thirty-nine communities throughout the state. In 1968-1969 the state will pay $33.5 million just to maintain the low rent nature of the projects. Under its two middle income housing programs a total of 109 projects, consisting of approximately 65,379 apartments, were completed, under construction or in planning as of August 31, 1967. These projects represented a mortage investment by the state of more than $923 million. Formal Budget Presentation by James W. Gaynor, Commissioner, New York State Division of Housing & Community Renewal, October 12, 1967, p. 2 (mimeo).

5. Burstein, *New Techniques in Public Housing*, 32 L. & CONTEMP. PROB. 528, at 534 (1967).

6. New York City, in the summer of 1966, had a backlog of 125,000 applications for public housing. *Hearings on Demonstration Cities, Housing and Urban Development Department, and Urban Mass Transit before Subcomm. on Housing of the House Comm. on Banking and Currency*, 89th Cong., 2d Sess. pt. 1, at 1003. (Statement of Rep. Ryan) [Hereinafter cited as *Model Cities Hearings*]. *See also* Burstein, *supra* note 4.

7. One of the most outspoken critics has been Mrs. Catherine Bauer, who helped draft the 1937 act. She concludes, "Public housing, after more than two decades, still drags along in a kind of limbo, continuously controversial, not dead but never more than half alive." Bauer, *The Dreary Deadlock of Public Housing*, ARCHITECTURAL FORUM 140 (1957). *See* Note, *Public Landlords and Private Tenants: The Eviction of "Undesirables" from Public Housing Projects*, 77 YALE L.J. 988 (1968).

8. The name "middle income" is deceptive. It refers to persons too "rich" to qualify for public housing. In New York City, a family of two adults and two children whose income exceeded $5,760 was middle income. *See* Note, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508-512 (1966). The failure of the state's middle income housing program was discussed by Division of Housing and Community Renewal Commissioner, James W. Gaynor, *Statement at Public Hearings of Borough Improvement Board of Manhattan*, September 27, 1967 (mimeo). Much of the blame for the plight of the "middle income" family can be charged to Congress. Fearful that publicly constructed housing would compete with the private sector's efforts, Congress established a "gap" of 20 percent between the income which enables a family to afford private housing with one-fifth of its income and the eligibility limits for public housing. 42 U.S.C. § 1415(7)(b)(ii) (1964). Though the "gap" has been eliminated and for certain cases, such as elderly and handicapped persons, public housing authorities, faced with more applications than units, have lowered the income limits necessary to maintain the "gap." Note, *Government Housing Assistance to the Poor*, *supra* at 510-511.

9. Of New York City's 2,758,000 housing units, 276,000 are in substandard condition. *Model Cities Hearings* (Statement of Mayor John Lindsay).

And while housing quality in New York has decreased, the proportion of family income allocated for rent has increased.[10]

In September, 1967, Robert Amdursky, Counsel to the New York State Joint Legislative Committee on Housing and Urban Development, requested the Harvard Student Legislative Research Bureau's assistance in drafting a bill to provide low and middle income housing in New York. The bill submitted would establish a quasi-public, non-profit Corporation for Urban Development.

As the name implies, the Corporation lies between the private and public types. It is organized for a quasi-public purpose, that is, a purpose which is recognized as related to matters in the public interest. Government participates as owner, partner or principal creditor.[11] Use of the quasi-public corporate form represents an attempt to utilize the advantages of both the public and private sectors. The effort is not revolutionary, nor even unique.[12] It stems in part from a feeling that the housing problem is too formidable for either sector alone.[13] By joining public and private efforts, talent from both sectors is made available. Greater coordination can be achieved. Financing through tax exempt bonds is possible. Other public aids such as eminent domain may be utilized.

The Corporation is also non-profit.[14] Despite the importance of the profit motive in achieving construction and re-

---

10. *Model Cities Hearings*, at 1003 (Statement of Rep. Ryan).

11. Lesher, *The Non-Profit Corporation*, 22 Bus. Law. 951, 960 (1967).

12. *See e.g.*, *The Model Cities Program*, 42 U.S.C. §§ 1453, 3301-13 (Supp. II, 1965-66), which represents, as well as a joining together of various government agencies, "a unique public-private housing development effort." Taylor & Williams, *Housing in Model Cities*, 32 L. & Contemp. Prob. 397, 403 (1967). A familiar effort utilizing the corporate form is the Communications Satellite Corporation. *But see* Friedman, *Government and Slum Housing: Some General Considerations*, 32 L. & Contemp. Prob. 357, 368 (1967) criticizing the "bewildering, baffling congeries of devices, many of them motivated by the hope that the market can somehow be galvanized cheaply into life," and calling for a predominantly public effort.

13. As noted by the Senate Banking and Currency Committee during its report on the Rent Subsidy Bill, "the committee has concluded that housing for lower income families can be produced in sufficient supply only through enlisting the experience and resources of a private enterprise." S. Rep. No. 378, 89th Cong., 1st Sess. 3, at 4 (1965), quoted in Welfield, *Rent Supplements and the Subsidy Dilemma*, 32 L. & Contemp. Prob. 465, at 472 (1967).

14. For a general discussion of non-profit corporations, see Lesher, *The Non-Profit Corporation*, 22 Bus. Law. 951 (1967).

habilitation of housing,[15] there are important arguments for restricting the Corporation to non-profit status. Apart from constitutional considerations[16] the strongest reason is the greater availability of government assistance to non-profit (or limited-dividend) corporations. For example, "221 (d)3" Below Market Interest Rate Loans are restricted to non-profit or limited dividend corporations.[17] In addition, the non-profit corporation provides a convenient legal form through which public funds may be channeled between various levels of government or to the private sector.[18]

The Corporation is governed by a board of directors selected by the Governor from the public and private sectors and includes representatives from the landlords and tenants of low and middle income housing. In addition, special directors living in neighborhoods affected by Corporation projects are to be elected. Originally, special directors were to be appointed by the Governor; however, in view of the tendency of the white establishment ineffectively to appoint persons of their own choosing with ghetto "leadership,"[19] selection has been left to the residents of the project. Even so, the provision for special directors has been characterized as merely a sop to the poor.[20] For real citizen participation is possible only if real governing power is delegated to the neighborhood level. The Corporation is thus empowered

---

15. BUS. WEEK, at 162 (December 17, 1966); Letter from Robert Amdursky, Counsel to the New York State Joint Legislative Committee on Housing and Urban Development, analyzing the profit motive in attracting private enterprise to build housing; pamphlet from Bernard E. Lashbough, Executive Director of Action Housing, Inc., *Action Housing* at 7 (June, 1967).

16. McKinney's Const. Art. 18, § 2.

17. Housing Act of 1961 § 101(a)(6), 12 U.S.C. § 17151(d)(3) (1964).

18. Lesher, *supra* note 14, at 951.

19. As noted by Daniel Watts, editor of LIBERATOR, "The Negro preacher has been the self-appointed leader of the community and the white power structure of the city would like to deal with him. But this does not get through to the 'soul brothers' who could get the idea to burn the community down." Chicago Daily News, June 7, 1967, at 9, col. 1. *Quoted in* Babcock & Bosselman, *Citizen Participation: A Suburban Suggestion for the Central City*, 32 L. & CONTEMP. PROB. 220, at 221 (1967).

20. Milton Cole, Director of the Jamaica Plain Area Planning Action Council in Boston, in an interview with the author. APAC is a non-profit neighborhood anti-poverty corporation controlled by local residents.

to turn over a project, at any stage of development,[21] to a neighborhood-controlled subsidiary corporation.

The Corporation's purposes may be summed up as fourfold: (1) to attract private investment in the low and middle income housing market; (2) to construct and rehabilitate low and middle income housing and related facilities; (3) to aid low and middle income persons in acquiring ownership; and (4) to encourage others to construct and rehabilitate housing for low and middle income persons, with strong emphasis placed on aiding the single parcel resident landlord to rehabilitate. In order to achieve these purposes, the Corporation has general powers to receive grants,[22] perform re-

---

21. The poor have been successfully brought into the decision-making process even before construction. Interview with Felix Obinani, Harvard Graduate School of Design, discussing the role of the poor in planning in New York's Bedford-Stuyvesant Restoration Corporation. *Cf.* Stokely Carmichael's assertion that "Only blacks can plan for a black community," quoted by Tom Wicker, New York Times, Feb. 15, 1968, editorial page. Wicker concluded, "Urban housing in America is primarily a concern of poor black people, and ought therefore to be designed for their needs, and who knows their needs best?" *And see* Babcock & Basselman, *supra* note 19, at 225, advocating resident involvement in design: "One only needs to look at a few typical examples of public housing... to conclude that the neighborhood would be hard put to do worse than City Hall." A remarkable example of poor persons actually constructing their own homes was reported by the Wall Street Journal, Nov. 13, 1967 at 1., col. 1. Prefabricated materials were used. The corporation contracted out for technical work such as plumbing, heating and electrical wiring. There were still substantial savings. The Journal noted that self-help so reduced costs that a downpayment was not needed. A finished home was worth $14,000, but the owner could return construction costs with a $9,500 mortgage. Thus families who could not have saved enough for a downpayment, but could make mortgage payments, found it possible to buy for no more than it costs to rent. "Front money" was provided through $200,000 in contributions from the business community. FHA insured mortgages with local banks supplied financing needs.

The idea of "self-help" has received increasing support. *See* 113 CONG. REC. S.3769 (daily ed. March 14, 1967) (The War on Poverty Message from the President); *Hearings on the Federal Role in Urban Affairs Before the Subcomm. on Executive Reorganization of the Senate Comm. on Gov't Operations*, 89th Cong., 2d Sess. pt. 1, at 38 (Statement of Senator Robert Kennedy); *Model Cities Hearings* at 228 (Statement of Mayor Lindsay).

22. The non-profit Bedford-Stuyvesant Restoration Corporation recently received a pledge of one-hundred million dollars in mortgage funds to be insured by FHA. The money may be used to "buy or rehabilitate homes or consolidate existing debts on them." New York Times, April 2, 1968, at 1, col. 2. *See also* the discussion of the availability of grants of "supplementary" funds under the Model Cities Program by Taylor & Williams, *Housing in Model Cities*, 32 L. & CONTEMP. PROB. 397, at 405-06 (1967).

search,[23] borrow,[24] and acquire and dispose of interests in real and personal property. All of its property is tax exempt. In addition the Corporation is granted the power of eminent domain.[25] The Corporation's specific powers may be briefly summarized. They include the construction of low and middle income housing, the provision of incentives to developers and landlords for the construction and rental of low and middle income housing, the facilitation of ownership of housing by low and middle income persons, the encouragement of rehabilitation of low and middle income housing, and the provision of advice concerning relevant federal programs.

A. Construction. The Corporation is authorized to construct low and middle income housing which may be sold or leased to non-profit or limited profit corporations or to individuals intending to reside therein. Preference is given to corporations controlled by prospective residents. The Corporation may rent a percentage of the units to higher income persons at a profit which will go toward subsidizing rentals for low income families. The Corporation may construct related community facilities in carrying out its housing construction powers.[26]

The Corporation's powers extend beyond the isolated proj-

---

23. The need for research was recently well put by HUD Secretary Robert Weaver in testimony before the House Appropriations Committee:

> Sophisticated research techniques and close working partnership between the Federal Government and private industries, universities, and private research foundations have yielded spectacular results in agriculture, in public health, in space exploration, and in many other areas. It is sad but true that nothing even remotely comparable exists to investigate and throw light on the problems that plague our cities and the people who live in them. *Hearings on the Independent Offices and Department of Housing and Urban Development Appropriations for 1968 before the Subcommittee on Indep. Offices and Dept. HUD of the House Comm. on Appropriations*, 90th Cong., 1st Sess. pt. 3, at 4 (1967).

24. For a discussion of the many federal lending programs *see* Fitzpatrick, *FHA and FNMA Assistance for Multifamily Housing*, 32 L. & CONTEMP. PROB. 439 (1967).

25. For discussion see comment on section 308.

26. As noted by one commentator, "...housing problems have taken on new dimensions. Adequate housing now signifies much more than a well-built structure. It includes accessibility to schools, parks, playgrounds, highways, public transportation, and shopping facilities." *Foreword*, 32 L. & CONTEMP. PROB. 187 (1967). Furthermore, construction of community facilities may be an inducement to private capital. Note, *Urban Renewal: Problems of Eliminating and Preventing Urban Deterioration*, 72 HARV. L. REV. 504, 532 (1959).

ect and enable it to participate in the planning and construction of new cities and suburbs.[27]

B. Incentives to Developers and Landlords. The Corporation may, rather than construct housing itself, encourage others to do so through low cost loans to developers. Especially helpful should be loans of "seed" or "front" money to developers who can secure permanent financing through the Federal Housing Administration. More importantly, it may agree in advance to purchase privately constructed housing by a method similar to the highly acclaimed "Turnkey" approach used by some public housing authorities.[28] Or the Corporation may agree to a sale and lease back arrangement with the same private developer.[29] A guarantee against a "negative net income" on low or middle income units is offered by the insurance provisions.[30]

C. Ownership. A major thrust of the bill is to facilitate the acquisition of ownership by low and middle income persons. The assumption is that ownership is often politically, socially and economically more desirable than tenancy.[31] The

---

27. See Spengler, *Population, Pressure, Housing, and Habitat*, 32 L. & CONTEMP. PROB. 191, 206, 208 (1967), citing examples of planned cities. Professor Spangler argues, "Perhaps the greatest promise lies in the development of an adequate number of additional cities of such size—say 100-200 thousand—as provides communal opportunity, together with near-optimum conditions for housing and macrohabitats as well as abundant access to amenities and recreational space."

28. "Turnkey" housing is 10% cheaper than traditionally constructed public housing and can be completed in two-three years less time. Burstein, *supra* note 5, at 534; *see also* Boston Sunday Globe, at B-41, col. 1, November 5, 1967, quoting Asst. Sec. of HUD Don Hummel.

29. While the developer would lose amortization deductions, INT. REV. CODE of 1954, § 167, he could deduct rent, § 162. The rent would provide him with a source of income and would lessen the stigma of public—or "quasi-public"—housing by substituting a private landlord.

30. The idea is taken from a bill of Senator Robert Kennedy, S.2100, 90th Cong., 1st Sess.

31. The Riot Commission states, "The ambition to own one's own home is shared by virtually all Americans, and we believe it is in the interest of the nation to permit all who share such a goal to realize it," *supra* Note 3, at 477. A number of studies indicate that homeowners take better care of their dwellings than do tenants. BOSTON REDEVELOPMENT AUTHORITY, PLANNING DEPARTMENT, HOUSING IN BOSTON 8 (July 1967). *See also* MILLSPAUGH & BRECKENFELD, THE HUMAN SIDE OF URBAN RENEWAL, 223-33 (1958). Ownership is said to provide low income families with a "stake" in society. RIOT COMMISSION REPORT, *supra* note 3, at 477. Increased ownership has been made one of the principal goals of Boston's Model Cities program. Application to the Department of HUD for a Grant to Plan a Comprehensive City Demonstration Program (City of Boston, Massachusetts) (April 27, 1967) at Part III B & C, 8.

bill thus attempts to bring home or condominium ownership within the reach of those who want it.

The opportunity for condominium or home ownership is increased through the "ownership corporation" provisions. The Corporation, having obtained housing, creates an "ownership corporation." The housing is then transferred to the ownership corporation in exchange for all its shares. Low and middle income persons are invited to purchase shares which entitle them to full ownership of a unit, plus joint ownership of common property such as halls, stairs or elevators, lobbies and recreation areas. In addition, the share gives the owner a vote in electing directors to manage the corporation. An important difference from the normal condominium arrangement is that the Corporation, rather than a probably skeptical private lending institution, stands as mortgagee to the low or middle income owner to be.

Further provisions authorize the Corporation to insure low interest rate loans made by private lenders to low or middle income persons. The loan is to be used to make a downpayment toward ownership.[32] Where the Corporation is satisfied that a private lender will not advance the insured loan, it may lend the funds itself to a qualified person, again to be used for a downpayment.

D. Rehabilitation. Increasing criticism of the urban renewal "bulldozer" approach[33] has resulted in more emphasis on rehabilitation of existing lower and middle income hous-

32. Many low and middle income persons could convert rent payments to mortgage payments but are denied the chance for ownership because of downpayment requirements. Wall Street Journal, *supra* note 21; Interview with David Wylie of the Boston Redevelopment Authority, November, 1967 (Boston, Massachusetts).

33. One problem has been with relocation methods used by renewal authorities. *See* NATIONAL COMMITTEE AGAINST DISCRIMINATION IN HOUSING, HOW THE FEDERAL GOVERNMENT BUILDS GHETTOES (1967); Note, *Judicial Review of Displacee Relocation in Urban Renewal*, 77 YALE L.J. 966 (1968). *See generally* C. ABRAMS, THE CITY IS THE FRONTIER (1965); Note, *Urban Renewal*, *supra* note 26. Another frequent criticism has been that urban renewal destroys more housing than it creates. Appleby, *Logue's Record in Boston: An Analysis of his Renewal and Planning Policy*, May 1966 (mimeo). Cited in *The Case Against Urban Desegregation*, 12 SOCIAL WORK., no. 1, at 16 (1967). Finally, the program is said to be too slow. Leach, *The Federal Urban Renewal Program: A Ten-Year Critique*, 25 L. & CONTEMP. PROB. 777-78 (1960), who notes that though Boston's urban renewal program "has made discernible progress ... the rate of renewal activity is being outstripped by the rate of decay.... 22,000 more dwellings have fallen into the substandard category. This is nearly three times the amount of poor housing eliminated in the last ten years. What is true in Boston is true in virtually every urban area in the United States."

ing.[34] The Corporation attempts to encourage rehabilitation by use of carrots and a stick. As a positive incentive, the Corporation is authorized to insure loans to landlords of low and middle income housing made by private lenders. The funds must be used for rehabilitation. Preference is given to resident single parcel landlords.[35] As in the case of loans to low and middle income tenants for downpayments, the Corporation, when satisfied that the insurance offer is insufficient to attract private funds, may directly advance funds.[36]

Landlords are encouraged and helped to organize within neighborhoods and blocks to insure that a single parcel is not improved over and above the rest of the neighborhood.[37]

The Corporation may assist in sanitary code enforcement and receivership. The subject of an adequate sanitary or housing code per se is beyond the scope of the bill.[38] Taking

---

34. *Finding a Profit in Slum Streets*, BUS. WEEK 52 (Feb. 4, 1967). However, the expense of rehabilitation is said to be a significant deterrent. *Model Cities Hearings* at 499 (Statement of Professor Paul Davidoff, Hunter College).

35. An excellent study of Newark housing by George Sternlieb repeatedly stresses the virtues of the resident single-parcel landlord over the absentee multi-parcel tenement owner. He argues that a major problem in slums is the attitude of tenantry, "*largely a function of their basic alienation from the absentee landlord*," (emphasis original). Sternlieb also discovered that the single-parcel owner "by a very large margin has the smallest proportion of poorly-kept and the highest proportion of well-kept parcels." STERNLIEB, THE TENEMENT LANDLORD xv (Summary of Findings), 233 (1966).

36. There are several federal insurances, loan or grant programs for rehabilitation. FHA insurance for rehabilitation in urban renewal areas is provided by section 220(h) of the National Housing Act of 1934, *as amended*, 12 U.S.C. § 1715k(h) (Supp. 1967). The program has been described as "virtually inoperative, presumably because of lack of interest on the part of private lenders." Keith, *National Housing Needs*, 32 L. & CONTEMP. PROB. 209, 217 (1967). Section 312 of the Housing Act of 1964, 42 U.S.C. § 1452b (Supp. 1967) extends three percent loans to owners for rehabilitation in renewal or code enforcement areas. Up to $10,000 per unit is available. Section 115 of the Housing and Urban Development Act of 1965, 42 U.S.C. § 1466 (Supp. 1967), offers direct rehabilitation grants of up to $1,500 to low income homeowners in code enforcement areas. Early reports on use of the latter two programs are discouraging. For instance, Boston has more than 312 loans and 236 grants than any other city in Region I; yet these total only 124 loans and 236 grants. Indeed in Boston more rehabilitation has been performed with conventional bank loans than with 3 percent 312 loans. *See* HOUSING IN BOSTON, *supra* note 31, at 17.

37. As one landlord explained, "I'd like other landlords on ... Street to get together, it just does not make any sense for one of us to do it alone." Sternlieb, *supra* note 35, at 223.

38. The necessity of a program of code enforcement in an area in order to obtain federal grants, insurance, and loans has been cited in note 36, *supra*.

the New York code as it is, the Corporation's role will be to act as receiver of property in continued violation of the code pursuant to court order. Despite New York's pioneering "prior lien" technique,[39] it has been difficult to find private receivers for repairing slum properties; and though eligible, cities usually cannot afford to do the work themselves.[40] In view of its non-profit status and state financial backing, the Corporation, therefore, should be an excellent candidate for the role of receiver.

E. Advisory. The need of developers, banks, landlords and the poor for advice concerning available housing programs is well established. In addition to providing advice and clarification generally about state and Corporation programs, the Corporation focuses on two areas: (1) advice to persons seeking to form housing cooperatives and obtain federal aid under section 213 of the National Housing Act;[41] and

For an article explaining Congress' view that code enforcement should be a prerequisite to participating in federal programs, *see*, Rhyne, *The Workable Development*, 25 L. & CONTEMP. PROB. 685, 686 (1960).

Of course, enforcement of housing codes has intrinsic merit apart from the obtaining of federal money. It compels violators to meet standards of health and safety for residential housing; and it serves to deter others from allowing their property to fall below these standards. *See* Note, *Enforcement of Municipal Housing Codes*, 78 HARV. L. REV. 801 (1965). As a result, private investment in slum housing is stimulated (or forced), leading to a savings of public money. Note, *Preference Liens for the Costs of Repairing Slum Property*, 1967 WASH. UNIV. L.Q. 141. *See generally*, Note, *Enforcement of Municipal Housing Codes*, *supra*, note 157; WHEATON, MILGRAM & MEYERSON, URBAN HOUSING 373-409 (1966); MANDELKER, MANAGING OUR URBAN ENVIRONMENT 655-89 (1966).

39. Basically, the New York law provides that a court appointed receiver shall have a lien on the property for his repair expenses. Recognizing that slum properties are usually heavily mortgaged, and that the normal lien would thus be worthless, the lien is made prior "over all other mortgages, liens and encumbrances of record except taxes and assessments made pursuant to law." N.Y. MULT. DWELL. LAW § 309(4)a (McKinney Supp. 1967). *See* Note, *Preference Liens*, *supra* note 38; Gribetz, *New York City's Receivership Law*, 21 J. OF HOUSING 297 (1964).

40. "Now one of the great problems [in enforcing New York's receivership law] is that there are not adequate funds available for the city. It has receivership powers but it has very limited funds." *Model Cities Hearings* (Statement of Professor Davidoff), at 499.

41. 12 U.S.C. § 1715e (Supp. 1967). Basically, a cooperative arrangement works as follows: A corporation usually owns the housing. Each member owns stock which entitles him to live in the housing and vote for directors. A single mortgage covers the whole dwelling or project. The corporation pays all expenses, including payments on the mortgage, out of fees collected from the cooperators. The fees may vary with the size and quality of individual units within the cooperative. The section 213 program provides mortgage insurance for cooperatives. Title must reside in a non-profit corporation or trust which is owned by, and provides housing for, the cooperators. (The Corporation for Urban Development is thus ineligible for insurance, because it is not owned by the residents).

(2) assistance to non-profit or limited profit corporations in applying for federal rent supplement funds under section 101 of the Housing and Urban Development Act of 1965.[42]

AN ACT

To establish a Corporation for Urban Development in order to provide safe and sanitary low and middle income housing and related facilities.

PART I

TITLE AND DEFINITIONS

SECTION 101: *Short Title*

This statute may be referred to as the "Corporation for Urban Development Act."

SECTION 102: *Definitions*

(a) "Corporation" means the Corporation for Urban Development which is established in section 201 of this statute.

(b) "Organization" includes a corporation, business trust, estate, trust, partnership or association, two or more individuals having a joint or common interest, or any other legal or commercial entity.

(c) "Person" includes an individual or an organization.

(d) "Urban development" means the orderly design, construction and rehabilitation of residential, commercial and industrial sites, buildings and transportation facilities according to a general plan approved by the municipality or other political subdivision.

(e) "Low income housing" means housing constructed, or to be constructed for, and provided, or to be provided to tenants whose income levels conform to the income level re-

42. The federal rent supplement program has been described as "potentially the most important development in federal housing policy since the advent of urban renewal in 1949." Note, *Government Housing Assistance to the Poor*, *supra* note 8, at 518. A principal purpose of the legislation was to eliminate public landlords and construction, and shift the emphasis to private sponsors such as churches, labor unions and private limited-dividend corporations. Thus public sponsors such as the Corporation are basically ineligible. 12 U.S.C. § 1705s(b) (Supp. 1967). The only present provision under which a "public body" can receive funds is the experimental program of housing for the elderly or handicapped. 12 U.S.C. § 1705s(h).

strictions enforced by the local public housing authority in the municipality in which the housing is, or is to be, located.

(f) "Middle income housing" means housing constructed, or to be constructed for, and provided, or to be provided to tenants whose income levels exceed the income level restrictions enforced by the local public housing authority but which are not sufficiently high to enable them to afford safe and sanitary private housing with one-fourth of their net income. "Net income," for the purposes of this subsection, means gross income less those exemptions allowed by a local housing authority against the gross income of a tenant of public housing.

(g) "Low or middle income person" is a person whose income qualifies him for low or middle income housing respectively.

(h) "Slums" include a building, buildings or area designated as substandard under the rules and conditions of the federal Department of Housing and Urban Development.

(i) "Non-profit corporation" means a corporation no part of the income or profit of which is distributable to its members, directors or officers.

(j) "Net income" means the amount of "taxable income" of any person as defined in Section 63(a) of the Internal Revenue Code of 1954. (Jan. 1, 1966 ed.)

(k) "Project" means a specific work or improvement by the Corporation, including low or middle income housing, lands, buildings and related community facilities.

(l) "Housing project" means a specific work or improvement by the Corporation of (1) a single multi-resident dwelling place of twenty-five or more units, or (2) fifteen or more multi-resident and/or single-resident separate dwelling places within at least one, and no more than three, blocks of a neighborhood.

(m) "Initiation of a housing project" occurs whenever performance of the project has been adopted by the Corporation in the ordinary course of its business.

(n) "Subsidiary corporation" means a corporation created or recognized by the Corporation in accordance with section 304(a) of this act.

(o) "Ownership corporation" is a corporation created by the Corporation in accordance with section 304(b) of this act.

PART II

CREATION, MEMBERSHIP, AND DIRECTORS OF THE CORPORATION

SECTION 201: *Creation of the Corporation*

There is hereby created the Corporation for Urban Development as a membership corporation. The Corporation shall have the powers, duration, immunities and obligations of a membership corporation organized under the Membership Corporation Law, in addition to the powers herein prescribed. The Corporation shall possess all the powers conferred upon corporations by the Business Corporation Law insofar as they do not conflict with this act and the Membership Corporations Law.

COMMENT: Due to the diversity of corporation laws in the several states, it may be necessary to adapt this section and others to the applicable state laws which are analogous to the laws of New York upon which this statute is based. Sections 209 and 210 also rely upon New York's law by way of example.

SECTION 202: *Non-profit Status*

The Corporation shall be operated without profit:

(a) No member, director or officer, may be compensated by the Corporation, except reasonably for services performed other than as a member, director or officer.

(b) Upon dissolution of the Corporation and after payment of all of its debts and liabilities of whatever kind, all of its remaining funds, property, and rights and interests in property shall vest in the state. No member, director, officer or other person shall be entitled to any distribution or division thereof.

SECTION 203: *Membership*

Membership in the Corporation shall be open to all domestic or foreign organizations with offices in the state or authorized to do business in the state.

SECTION 204: *Board of Directors*

(a) In addition to the special directors described in section 205, the Board of Directors shall consist of thirty-six general directors, of whom twenty-four shall be public and twelve shall be private.

(1) All general directors shall be appointed by the governor.

(2) Of the original thirty-six, twelve shall serve for one year, twelve for two years, and twelve for three years. All subsequent general directors shall be appointed for terms of three years, provided that the original ratio of two public directors for every private director shall at all times be maintained.

(3) Any public director shall resign within sixty days of the termination of his public status.

(4) Any director may be removed for cause by a two-thirds vote of a quorum of the board.

(b) The public directors shall be appointed as follows:

(1) fourteen representatives of local government, and

(2) five officials in the executive branch and five representatives from the legislative branch of the state government.

(c) The private directors shall be appointed as follows:

(1) four representatives from the private sector, and

(2) at least one representative from each of the following categories: labor, finance, insurance, construction, real estate, landlords of low and middle income housing, tenants of low income and tenants of middle income housing.

COMMENT: The number of public directors (state and municipal officials) is set at two-thirds the total board, because anything less could jeopardize the Corporation's "public" status and make tax exempt bonds harder to justify. In addition, granting of powers of eminent domain and condemnation seems less arbitrary with a board the majority of which consists of public officials.

Terms of office are staggered to provide continuity and carry-over of experience from year to year. The draftsmen strongly urge that designation of tenants or owners from low and middle income housing as directors is essential to carry out the corporation's objective.

SECTION 205: *Special Directors*

(a) Whenever a specific housing project, as defined by section 102(l), is initiated, as defined in section 102(m), by the Corporation, the residents shall have the opportunity to choose a special director.

(1) Within ten days after a housing project has been initiated, the Corporation shall inform by registered mail each resident of the housing project of his right to choose a special director and shall explain the nature of the special director's duties. The Corporation shall provide upon request any further assistance to the residents to help them in making their selection.

(2) Any dispute over selection shall be resolved by the Corporation's board or their delegate upon petition of at least twenty-five per cent of those then residing within the housing project.

(3) In the event that no special director is selected by the residents within forty days of the housing project's initiation, the Governor may appoint a resident of the housing project as special director. The appointment of any special director shall expire whenever the residents select a special director.

(b) A special director shall serve for the duration of a housing project or for three years, whichever is shorter, but may be selected again by the residents should a project continue for more than three years.

(c) A special director may be removed as provided in section 204(a) (4) or upon petition of three-fifths of those then residing within the housing project.

(d) A special director shall have only the powers of a director which directly relate to the particular project for which he is chosen, including, but not limited to, the power to vote on matters pertaining to the

(1) construction or rehabilitation of a particular project;

(2) selection of a site;

(3) design of units; and

(4) allocation of funds already appropriated for the particular project.

COMMENT: The section on special directors went through a number of revisions. The central ideal remains: to meaningfully involve low and middle income persons in the decision-making process of the Corporation. The residents of a Corporation "housing project" may elect a special director when the housing project is "initiated." Ten days after initiation, the Corporation must notify residents by registered mail of their opportunity to select a special director. The Corporation must explain the nature of the special director's duties and, upon request, assist residents in making their choice. Any dispute over selection is resolved by the Corporation upon petition of at least twenty-five percent of the residents of the project. Provision is made for removal for cause and for length of service.

If no special director has been selected within forty days of initiation, the Governor may appoint a special director. The appointment terminates when a special director is selected by the residents.

The powers of a special director are like those of a general director, except that they only extend to matters that "directly relate to the particular project" for which the special director was selected. Thus a special director will have equal powers with general directors on matters concerning, among other things, construction or rehabilitation of the project, design, site selection and allocation of funds already appropriated for the project.

Special directors should give the affected neighborhood a sense of participation far beyond the routine, ritualistic, and ineffective "hearings" to which the residents are now summoned long after crucial decisions have been made. Further, such directors would possess an intimate knowledge of their particular neighborhood problems and thus be of service to the regular board.

A problem area of interpretation is in limiting a special director to "related" matters. Special directors should not have a vote on long range policy matters or broad financial decisions concerning the overall Corporation program; nor should they be permitted to vote on other projects being considered or performed by the Corporation. At the same time, they must possess all the powers of general directors as regards matters concerning their particular projects.

It should be noted that special directors will not upset the balance of two-thirds public and one-thirds private directors. In the first place, major policy decisions and long-range planning will be conducted by the general directors. In the second place, a special director will be voting and sitting as a director *only* as relates to his particular project. Thus to the extent he participates, the balance of public directors will be two-thirds less one.

SECTION 206: *Status of Public Directors*

All employees and elected officials of state or local government shall be eligible to serve as directors or officers of the Corporation, notwithstanding their exercise of official political control over the Corporation or its activities.

SECTION 207: *Duties of Private Directors and Members*

The fact that an organization is a member of the Corporation, or that its members, officers or directors are directors of the Corporation, shall not prevent it from concluding contracts with the Corporation in good faith, publicly, and in accordance with the provisions of applicable law and procedures set forth in the by-laws.

SECTION 208: *Limited Liability*

Neither regular nor special directors, nor any officer or employee of the Corporation, while acting within the scope of his authority, shall be subject to any personal liability resulting from the activities of the Corporation.

SECTION 209: *By-Laws*

The by-laws shall be adopted at the initial meeting of the Board of Directors. The by-laws shall provide

(1) procedures for the annual election of officers and definitions of their powers;

(2) procedures for the admission and withdrawal or expulsion of member organizations; and

(3) all necessary provisions for the management of the affairs of the Corporation pursuant to the Business Corporation Law or this Act.

SECTION 210: *Contract Regulation*

In negotiating, awarding and carrying out any contract to which the Corporation is a party, the Corporation and those dealing with it shall be subject to the provisions of Article 5-A of the General Municipal Law insofar as those provisions do not conflict with this Act.

PART III

PURPOSES, POWERS AND PROGRAMS

SECTION 301: *Purposes*

The Corporation shall be operated for the following purposes:

(1) constructing, developing, acquiring or rehabilitating low and middle income housing to be owned and/or operated by others or by the Corporation, and commercial and industrial facilities to be operated by others;

(2) purchasing, leasing or otherwise acquiring slum properties to be developed or rehabilitated;

(3) encouraging the formation of local and regional non-profit organizations to operate the residential, commercial and industrial facilities which are constructed, developed or rehabilitated by the Corporation;

(4) encouraging the private construction, development and rehabilitation of low and middle income housing; and

(5) performing all other acts which the Corporation shall deem necessary and advisable to promote the development of adequate safe and sanitary housing for low and middle income families.

SECTION 302: *General Powers*

The Corporation shall have the following general powers:

(1) To borrow money and to issue negotiable obligations therefor, provided that the state shall be surety for all debts of the Corporation except those otherwise insured.

(2) To receive grants from corporations, trusts, foundations, associations and other private sources, and from federal, state and municipal governments.

(3) To receive loans and mortgage insurance from federal, state and municipal sources.

(4) To acquire by purchase, lease, gift, bequest, devise or otherwise real or personal property including existing low or middle income housing or interests therein.

(5) To sell, lease, mortgage or otherwise dispose of or encumber any of its real or personal property including existing low or middle income housing or any interest therein upon such terms as it may determine, notwithstanding anything in the Membership Corporations Law to the contrary. Preference in transferring existing multifamily housing shall be given to purchasers or lessors who intend to reside therein.

(6) To conduct, assist, promote and encourage such research as will aid the Corporation or others in better carrying out the purposes and policies of this act.

(7) To perform all other acts which the Corporation shall deem necessary and advisable to carry out its purposes pursuant to this act.

COMMENT: Most of the section is self-explanatory. Subsections (4) and (5) enable the Corporation to buy up existing multifamily housing and transfer it to resident landlords. The idea is to encourage ownership by the resident, single-parcel landlord, as a means of lessening tenant alienation and improving maintenance. Since the Corporation is nonprofit, it should be able to transfer the housing on easy terms.

SECTION 303: *Purchase and Construction of Housing*

(a) The Corporation may purchase housing for sale, rent, or leaseback in order to provide a market for developers and to enable them to recover their investments expeditiously.

(1) Any person may submit a proposal that the Corporation should purchase a low or middle income housing project. If the proposal meets the requirements specified by the Board of Directors, the Corporation may issue a letter of intent to purchase so that the developer may prepare final plans and specifications.

(2) If the Corporation approves the final plans and specifications, the Corporation and the developer shall appoint an independent appraiser to prepare cost estimates which they shall use to negotiate a price and execute a contract of sale. The Corporation may finance the construction costs of the developer if he agrees to renegotiate the price so as to limit his net income to six per cent.

(3) The Corporation may

(i) rent units to low or middle income tenants;

(ii) sell units to low or middle income persons on a condominium basis;

(iii) lease back the project to the developer for rental to low or middle income tenants, subject to the rules and regulations established by the Board of Directors; or

(iv) otherwise dispose of the project in any manner consistent with the provisions of this Act.

COMMENT: This subsection authorizes the Corporation to acquire housing pursuant to the currently favored turnkey approach. It is patterned after the provisions of the Housing Assistance Administration's "Low Rent Housing Manual" of September, 1967. It also enables the turnkey developer to lease back the housing from the Corporation. In addition to the incentives of turnkey, the section offers the developer a chance to regain the housing and thus a source of income by subletting. Furthermore, the developer could deduct rent paid to the Corporation from its gross income. Finally, the section would eliminate the stigma of public (or quasi-public) housing by substituting a private landlord.

Developers who limit their net income to six per cent per annum are eligible for Corporation financing and insurance under sections 306 and 305.

SECTION 303(b) The Corporation may purchase real estate and construct, rehabilitate, or improve low and middle income housing thereon.

(1) The Corporation shall transfer completed projects to:

(i) non-profit or limited dividend organizations controlled by prospective or actual residents of the projects; but if these organizations are not available, then to

(ii) other non-profit or limited dividend organizations; or

(iii) public housing authorities.

(2) If the Board of Directors finds that the completed projects cannot feasibly be transferred according to subsection(b) (1), the Corporation shall rent the units to tenants of whom at least seventy-five percent shall be low or middle income families. Rentals shall be computed on a unit cost basis which will amortize the total cost of each project; any rentals in excess of the unit cost shall be used to subsidize rents paid by low income families who are tenants of any projects owned or operated by the Corporation.

COMMENT: This subsection authorizes the Corporation itself to undertake construction and suggests preferential treatment for tenant associations. It authorizes the Corporation to retain title and act as landlord. In order to make units available to persons who could not otherwise afford them, the Corporation is permitted to rent a certain percentage of the units at a cost-plus rate to be set by the Board. In effect the Corporation is using middle income rentals to subsidize lower income tenants. This provision also has the desirable effect of promoting economic integration.

In New York the constitution permits aid to "persons of low income as defined." Article XVIII, section 1. Thus it is left to the legislature to define what is meant by "persons of low income." *Minkin* v. *City of New York*, 198 N.Y.S. 2d 744, at 746 (1960). Courts have upheld publicly aided housing that benefits "a middle income group as long as income is not sufficient to produce that rental which attracts private industry to build housing." *Chelcy* v. *Buffalo Municipal Housing Authority*, 24 Miss. 2d 598, 206 N.Y.S. 2d 158 (1960).

Neither case deals with the use of middle income rentals to subsidize low income rentals. But in view of the absence of restrictions in the constitution there would seem to be no problem with subsidies as long as the middle income tenants fall within the *Chelcy* criterion.

SECTION 303(c) In carrying out its powers under this section, the Corporation may construct such recreational, educational, cultural and other community facilities as may be incidental or appurtenant thereto.

COMMENT: This subsection expands the Corporation's powers beyond the isolated project to construction of recreational, educational, cultural and related community facilities. The authorization recognizes that provision of adequate housing is not limited to provision of a well-built structure.

SECTION 304: *Subsidiary and Ownership Corporations.*

(a) The Corporation may delegate, initially or at any later stage, the acquisition, construction, reconstruction or rehabilitation of a housing project or any part thereof to a non-profit subsidiary corporation.

(1) A majority of the subsidiary corporation's board must be residents of the delegated housing project.

(2) The Corporation shall, upon request, assist persons interested in forming a subsidiary corporation, in obtaining financing and in carrying out delegated projects or parts of projects.

(b) The Corporation may transfer ownership of housing projects to ownership corporations comprised of groups of tenants.

(1) The Corporation shall initially lease a housing project to a group of tenants and organize a training program to enable them to operate and maintain the housing project and to manage an ownership corporation.

(2) The Corporation shall then create an ownership corporation and transfer the housing project to it in return for all of its shares. The shares shall not be of equal value. The value of each share shall be equal to the value of one housing unit and an undivided interest in the common property of the housing project.

(3) The Corporation shall offer these shares solely to the tenant group. When the tenant group agrees to buy the shares after satisfactorily completing a training program organized pursuant to subsection (b) (1), the Corporation shall

(i) cancel the existing leases,

(ii) take in exchange for the shares either modest downpayments in no case to exceed six months rent or unsecured promises from the purchasers to perform maintenance or other services of equal value, and

(iii) retain individual security interests in each housing unit and common property to secure the remainder of the debt.

(4) Each share shall entitle the holder to vote for directors of the ownership corporation. Each share shall vest title to the particular housing unit in the shareholder, and shall vest in him an undivided interest in all the common property of the ownership corporation.

(5) One share shall be transferable, subject to the security interest of the Corporation, to any resident or prospective resident who

(i) shall have satisfactorily completed a training program organized pursuant to subsection (b)(1), and

(ii) owns no other share in any ownership corporation of the Corporation.

COMMENT: Mere provision in section 205 for special directors selected by the poor does not guarantee effective citizen participation. Section 304(a) thus supplements section 205 by enabling the Corporation to delegate all, or any part of, a housing project to a subsidiary corporation. Delegation may be made at any stage of project development. The Corporation may delegate the project to a subsidiary already formed by neighborhood residents; or if no subsidiary has been formed, it shall, upon request, aid residents in formation and related activities.

Section 304(b) represents an attempt to improve upon condominium arrangements. To the normal bundle of rights attendant to full ownership of the property are added the responsibilities of management. Completion of a management training program acquainting the shareholder with what he is getting into is a precondition to ownership.

The board of directors is chosen by the resident shareholders. It is felt that shareholders should participate at the director level, since their concerns with their own em-

ployment would probably preclude a more active role. Furthermore, a professional manager would be better trained for running the day-to-day affairs of the housing complex. Finally, participation at the director level puts the low and middle income shareholder in the unusual position of employer; as such, he has meaningful redress when broken windows, plaster or toilets are left unrepaired.

The arrangement is quite similar to a condominium; however, the Corporation rather than the normal lending institution is in the position of mortgagee. Thus the prospective unit owner, lacking capital and credit, should find this type of ownership easier to acquire than that offered under normal condominium plans.

SECTION 305: *Insurance*

(a) The Corporation may insure loans to landlords for improvements of low and middle income housing and to residents of low and middle income housing for use as downpayments in acquiring an ownership interest in a house, a condominium or a cooperative apartment. The insurance shall be guaranteed by the state. The Corporation may charge a premium for the insurance at a rate of . . . . . percent of the amount of the principal obligation of the loan outstanding, without taking into account delinquent payments or prepayments. Upon receiving notice of any default, the Corporation may acquire the loan and any security therefor upon payment to the creditor in cash or debentures of a total amount equal to the unpaid principal balance of the loan, plus any accrued interest and any collection costs, court costs and attorneys' fees which are approved by the Corporation.

(1) Loans to landlords must

(i) not exceed the Corporation's estimate of the total cost of the improvement or [4,000] dollars per family unit or [250,000] dollars in all, whichever is less;

(ii) bear interest at a rate prescribed by the Corporation, but not in excess of six percent per annum of the principal obligation outstanding and any other charges approved by the Corporation;

(iii) have a term satisfactory to the Corporation, but not to exceed twenty years or three-quarters of the remaining economic life of the structure, whichever is less;

(iv) be made only to the owner of the property or to a lessee under a lease which will expire more than ten years after the maturity date of the loan, provided that the owner or lessee must reside in the building;

(v) be used to implement a plan for rehabilitation or repair which has been approved by the Corporation;

(vi) comply with any other terms, conditions, and restrictions prescribed by the Corporation.

(2) Loans to residents of low and middle income housing must

(i) be made to a mortgagor and held by a mortgagee which are satisfactory to the Corporation;

(ii) represent a downpayment or similar lump sum initial payment of up to [2,000] dollars on a home, a condominium or other interest, and a principal obligation not in excess of [15,000] dollars;

(iii) have a term satisfactory to the Corporation requiring periodic payment by the mortgagor not in excess of his reasonable ability to pay as determined by the Corporation;

(iv) bear interest at not more than six percent per annum on the principal outstanding; and

(v) provide in a satisfactory manner for the application of the mortgagor's periodic payments to the amortization of the principal.

(b) The Corporation may set up and administer an Equity Insurance Fund for owners of low and middle income housing projects.

(1) Participants shall agree

(i) to limit their net income on the particular insured project to six percent per annum, and

(ii) to pay a reasonable premium established by the Board of Directors of the Corporation for protection against extraordinary costs due to abnormal maintenance costs or rates of vacancy.

(2) For purposes of this subsection a project shall include a group of units within an apartment structure or a housing project, so long as at least seventy-five percent of the units within the group are leased to low or middle income persons.

(3) The Corporation shall reimburse any participant with an amount necessary to make his net income for a fiscal year equal to zero percent; but it shall not reimburse a participant who willfully causes his net income for a fiscal year to fall below zero percent.

(4) The amount hereby appropriated for the original fund shall be . . . . . dollars.

(i) Insurance premiums shall be increased whenever the amount in the fund drops below . . . . . percent of the original amount.

(ii) Insurance premiums shall be reduced whenever the amount in the fund exceeds . . . . . percent of the original amount.

COMMENT: The insuring of loans made to landlords for rehabilitation and repair is regarded as a first step toward providing an adequate incentive for the modernization of housing. The program is patterned after the FHA Home Improvement Loan program and Rehabilitation Loan programs as set out in sections 203(k) and 220(h) of the National Housing Act, as amended.

The state guarantee should lower the interest rate payable by the borrower-landlord; at the same time the Corporation avoids making a large initial cash outlay. The 4,000 dollar limit per family unit is an estimate of what this type of low-scale rehabilitation and repair program would cost. The intention is to stay away from large programs of wholesale improvement where loans may be more easily obtained in a conventional manner from lending institutions. That provision could be amended to allow all loans at the Corporation's estimate of the total cost of the improvement or at the 10,000 dollar limit per family unit set by the FHA for its programs.

The plan required from the landlord is intended to be a tight estimate of the work to be done, its costs, the type of units to be built and the expected ratio of low and middle income tenants. The insurance is restricted to the single parcel resident landlord.

Many would-be homeowners are deterred by the requirement of a downpayment. Therefore, the Corporation may insure loans made to low or middle income persons for use as

a downpayment. Specific provisions governing the loans are patterned after the similar FHA requirements.

Often, a mortgage taken as security for a downpayment advance will follow a mortgage on the rest of the property in priority; however, the offer of insurance should make the investment attractive notwithstanding its lower priority.

The basic provisions of section 305(b) are self-explanatory. They offer the developer insurance against losing money on his investment if he agrees to limit his net profit to a maximum of six percent per year. This type of protection should be particularly attractive to "charitable" sponsors of housing. Again the idea is to encourage an increase in investment of private capital indirectly, *i.e.*, by insuring another's capital rather than by providing that capital initially. Obviously, this means less capital will be required than would be the case were the Corporation supplying the funds.

The provision extends to any still hesitant developer the option of making more than six percent on higher priced units while retaining insurance against loss on the low priced units. It has, of course, the attendant benefit of encouraging economic integration.

SECTION 306: *Loans*

The Corporation may lend money at an interest rate specified by its Board of Directors, but not exceeding six percent per annum, and under terms and conditions specified by the Corporation, to the following persons:

(a) Landlords who

(1) reside in the dwelling which they plan to rehabilitate with the loan,

(2) establish to the satisfaction of the Corporation that they have been unable to secure a loan, notwithstanding the insurance provided by section 305(a) (1), and

(3) provide a mortgage or other security interest to the Corporation.

(b) Residents of low and middle income housing who

(1) plan to purchase low or middle income housing,

(2) establish to the satisfaction of the Corporation that they have been unable to secure a loan notwithstanding the insurance provided by section 305(a)(2), and

(3) provide a mortgage or other security interest to the Corporation, unless it would impose an undue hardship.

(c) Private developers of low and middle income projects who

(1) agree to limit their net income on the particular project to six percent per annum, and either

(2) intend to organize and initiate a project with the loan proceeds, or, failing this test,

(3) intend to carry out an existing project.

(d) Purchasers of multifamily housing who agree to reside in the housing.

COMMENT: Subsection (c) gives preference to developers who need the loan to meet expenses of organization or initiation. This "seed" or "front" money, often unavailable through long-term federal programs, *e.g.*, 221(d)(3), and always in considerable demand, would be applied against architectural and legal fees, soil borings, engineering work, application fees and general organizational expenses. A developer must limit his net profit to six percent per annum to be eligible.

Subsection (d) extends low cost loans to the prospective resident single parcel landlord.

SECTION 307: *Receivership*

Subject to the approval of its Board of Directors, the Corporation may be appointed receiver pursuant to New York Multiple Dwelling Law, § 309(5)(c)(3).

COMMENT: This subsection amends the relevant portions of § 309 of the Multiple Dwelling Law to enable the Corporation to perform all the functions of the municipal receiver under that law. Under section 309(5)(d)(1) the receiver's duties comprise more than the mere abatement of a statutory nuisance. It has the power to "make other improvements to effect a rehabilitation of the property, in such fashion as is consistent with maintaining safe and habitable conditions over the remaining useful life of the dwelling."

It should be noted that, in the event rents and other income from the property are insufficient to meet expenses of repair, the receiver obtains a lien which has priority "over all other

mortgages, liens, and encumbrances of record except taxes and assessments levied pursuant to law." (§ 309(4) (a)). Thus the Corporation is protected against losses in the event of foreclosure by otherwise prior mortgagees.

The section is not as hard on prior mortgagees as some have assumed. For they may make insured loans to their mortgagors for rehabilitation under section 305(a)(1).

SECTION 308: *Eminent Domain*

The Corporation may exercise the power of eminent domain pursuant to article 18, section 2, of the State Constitution. It may acquire property through court petition after a public hearing held in the community where the property is situated. The procedure shall follow that specified for public housing authorities in the N.Y. Public Housing Law, Article 7, § 125. The Corporation shall not be responsible for assuming local tax liens of property which it acquires. Reasonable compensation shall be paid for acquired property.

COMMENT: Under article 18, section 2, of the State Constitution the power of eminent domain is given to municipal bodies, public corporations and corporations "regulated by law as to rents, profits, dividends and disposition of its property or franchises and engaged in providing housing facilities." The Corporation would appear to fit under the definition of public corporation, defined as any corporate governmental agency (except a county or municipal corporation) organized pursuant to the law for housing purposes, despite the fact that the only cases in the area upholding condemnation apply to housing authorities and redevelopment corporations that are completely public in character. *Stuyvesant Hous. Corp.* v. *Stuyvesant Town Corp.,* 183 Misc. 662, 51 N.Y.S.2d 19 (1944); *Murray* v. *LaGuardia,* 43 N.Y.S.2d 408, 291 N.Y. 320, 53 N.E.2d 884 (1943); *Cannata* v. *City of New York,* 11 N.Y.2d 210, 182 N.E.2d 395 (1962). Alternately, the Corporation should fall under the category of a corporation regulated by law.

SECTION 309: *New Cities*

(a) The Corporation may participate with others in the planning of new cities and suburbs and may construct or rehabilitate low and middle income housing therein.

(b) The Corporation may encourage and assist others to provide public transportation from any such new city or suburb to existing public transportation.

COMMENT: The Corporation may also participate in the planning and construction of whole new cities and suburbs. Since many low and middle income persons work in the inner cities and may be without private means of transportation, the Corporation is encouraged to assist others in making public transportation available.

SECTION 310: *Technical Assistance*

(a) The Corporation may assist in the organization of sponsors of cooperative housing, especially non-profit corporations, which shall be eligible for mortgage insurance under section 213 of the National Housing Act, 12 U.S.C. § 1715(2); and the Corporation may render advice and technical assistance to prospective participants in a cooperative venture in buying or leasing land, financing, arranging for construction, and all other matters attendant to qualifying for mortgage insurance under section 213 of the National Housing Act.

(b) The Corporation may assist non-profit or limited profit corporations in applying for aid under the federal rent supplement program. The assistance may include seeking out and organizing groups which will be eligible to participate, forming non-profit and limited profit corporations and drawing up applications.

COMMENT: Section 213 of the National Housing Act, as amended, has been used only rarely. Basically, it provides mortgage insurance for cooperatives. The section requires that title reside in a non-profit corporation or trust which is owned by, and provides housing for, the cooperators. Obviously, it is difficult for a group of legally unsophisticated persons to organize, acquire a site, arrange for construction and obtain financing, making sure to qualify for FHA insurance at the same time. The difficulty must certainly be magnified when the organizers are low or middle income persons without substantial training or credit. Subsection (a) should make the technicalities less burdensome. In addition, it is hoped that the Corporation will take the initiative in bringing interested persons together and in organizing them for par-

ticipation in the section 213 program which allow sponsors to transfer housing to the cooperators.

The federal rent supplement program is potentially the best current vehicle for providing housing aid to low income families. It provides that payments be made to a housing owner on behalf of the tenants for a period up to forty years. Unfortunately, the term "housing owner" is defined so as to exclude the Corporation for Urban Development. At present it includes only a private non-profit corporation or other private non-profit legal entity, a limited dividend corporation or other limited dividend legal entity or a cooperative housing corporation. 12 U.S.C. 1705a(b). The only present provision under which a "public body" can receive aid is the experimental program of housing for the elderly or handicapped described in section 1705s(j)(h). This corporation is not particularly interested in building housing on a large scale for a community of heterogeneous persons. Thus the Corporation's role in the program will be to provide the information and technical knowledge whereby local non-profit groups can be encouraged to seek such aid. It should actively seek out potential local sponsors and offer to help them get their application processed through the Regional Office of the Department of Housing and Urban Development.

SECTION 311: *Landlord Organizations*

The Corporation may aid and encourage the organization of landlords into neighborhood improvement associations. It shall provide:

(1) information about various financial aid available for rehabilitation projects,

(2) assistance in drawing up applications for aid,

(3) help in organizing joint efforts by landlords to rehabilitate their neighborhoods,

(4) lists of reputable repairmen,

(5) any further services within the Corporation's powers that will further the purposes of this section.

COMMENT: Some landlords who would like to improve their property feel caught in the prisoner's dilemma. They would like to rehabilitate; yet they must avoid improving over and above their neighborhood. This section seeks to organize landlords into improvement associations designed to promote

the uniform upgrading of the entire neighborhood. The section also instructs the Corporation to provide further advisory services and technical assistance.

PART IV

FINANCING AND TAX EXEMPTION OF THE CORPORATION

SECTION 401: *Housing Development and Tax Appreciation Bonds*

The Corporation may issue Housing Development Bonds and Tax Appreciation Bonds which shall be exempt from all state and local taxes and which shall qualify as state and municipal bonds under the provisions of section 103 of the Federal Internal Revenue Code of 1954, as amended. The Board of Directors may establish appropriate rates of interest, but not in excess of . . . . . percent per annum.

(a) The state shall guarantee the principal of Housing Development Bonds and an interest rate thereon equal to that paid by the state for similar bonds issued at the time of the particular issue of Housing Development Bonds.

(b) The municipality or other political subdivision in which the project for which the Tax Appreciation Bonds are issued is located shall agree with the Corporation to set aside in a special fund all or part of the revenues due to the increment in real estate tax base which is due to the construction of the particular project.

(i) The increment in real estate tax base shall be the difference between the tax base of the project area in the tax year immediately preceding the initiation of the project or acquisition of the property for the project and the tax base of the project area in the year of collection.

(ii) The special fund shall be used to retire the Tax Appreciation Bond issue and to pay all or part of the interest thereon.

COMMENT: Tax-exempt bonds guaranteed by the state will provide one of the principal means of financing the operations of the Corporation. Despite recent statements by Treasury officials deploring the use of municipal bond financing by private and quasi-private interests, no major changes have been made in the interpretation of section 103 of the Internal Revenue Code, which excludes the interest on such bonds from gross income as interest on the obligations of a State or its political subdivision.

The controlling Rev. Ruling 60-248 held interest on the bonds of the New York Housing Finance Agency (a public housing corporation) excludable from gross income. The Ruling emphasized the state's responsibility for, and control of, the HFA in finding it to be within the meaning of "political subdivision." In view of the state's guarantee of the bond's principal and interest, and the ratio of public to private directors, as well as the public purpose involved, the Corporation should have no trouble qualifying; however, since certainty will increase marketability, a specific ruling should be requested by appropriate state officials.

This section authorizes the Corporation to issue bonds whose principal and/or interest shall be paid out of the anticipated increase in taxes generated by redevelopment in the affected political subdivision. While the increased revenues from a single project might be insufficient to back up a sizable bond issue, the increase in property taxes from an urban renewal project or a number of the Corporation's projects should make such bonds attractive. The municipality, while giving up the increase in property taxes, retains at the very least its old base tax. Furthermore, the attendant benefits, economic and otherwise, of rehabilitation should constitute sufficient inducement to city councils. Perhaps the chief objection to these bonds is that the method of payment conflicts with the granting of tax abatements to private redevelopers. Since the value of a piece of property may be increased several-fold, however, a partial tax abatement could be offered while retaining the remainder of the tax increase for bond payment.

SECTION 402: *Financing through Investment*

The Corporation may invest funds received from any source,

unless otherwise restricted, in short-term federal government notes and bonds for terms up to one year.

COMMENT: The practice of arbitrage—the issuance of a tax-exempt bond by a state or political subdivision for the purpose of investing the proceeds in higher yield federal government securities—has been frowned upon by the Treasury Department in recent years. Last year it was announced that the Department would no longer give advance rulings on a specific case where arbitrage was involved. TIR 840, August 11, 1966.

In the 90th Congress companion bills were introduced by Rep. Byrnes and Senator Ribicoff to limit the practice of arbitrage (H.R. 11757, S. 2636); however, investment in the short term, specified in this section, is permitted by the bills. The dispute in the area, however, again underscores the need for the state to request a specific ruling from the Treasury Department.

SECTION 403: *Tax Exemptions*

The property of the Corporation and the income and operations of the Corporation shall be exempt from all state and local taxation.

A DIVORCE REFORM ACT

INTRODUCTION*

The memorandum and statutory model below propose a new ground for divorce and a new procedure for protecting children in divorce proceedings. On the one hand, a judge will be permitted to grant a divorce where a marriage has irreparably broken down. On the other hand, children whose parents seek divorce will be provided with lawyers and will have the status of parties in order that their interests may be adequately represented. The proposed statute will liberalize divorce where no one is harmed, but restrain or restructure it where children are threatened.

I. DIVORCE BASED ON IRREPARABLE BREAKOWN

Marriage and the family are fundamental legal institutions in American society. Because they are fundamental the legal issue of when a dissolution of the family unit ought to be allowed has always been difficult to resolve. The Divorce Reform Act contains one answer to this question. The reasons for this proposal are set forth in this introduction.

In ancient times, the state made no attempt to interfere with what it considered the totally personal questions of marriage and divorce. By the twelfth century, however, the church had developed ecclesiastical courts to deal with marital problems. Marriage was felt to be an indissoluble covenant with a paramount obligation owed to God. The present fault notion of divorce arose at this time with the concept that the commission of a matrimonial offense was not so much a sin against the other spouse as against God, justifying the innocent party in ceasing to live with the guilty one.[1] Of course, because of the doctrine of indissolubility, only annulments and separations were granted. After the Reformation, marriage and divorce matters, including the power to grant a complete dissolution of the marriage, were transferred to the civil courts. Yet civil law naturally built upon the preceding clerical approach, thus maintaining in the

---

* This Introduction was prepared by Andrew J. Kleinfeld and Guy B. Moss, members of the Class of 1969 in the Harvard Law School.

1 Note, 45 ILL. L. REV. 399, 400 (1950).

United States and many other countries a basically fault oriented system predicated on the commission of some specific matrimonial offense.[2] A secular legal explanation is that where the state as a political entity is considered an omnipresent third party to the marriage, then only under a fault oriented system can the state be deemed to have relinquished its interest in deference to the injured party.[3] Whatever the origin, many states predicate their divorce proceedings on the concept of fault.[4]

Divorce law in America has been labelled by numerous critics as a "mockery," "unrealistic," "fictitious," a "comic melodrama," and a "tragically imperfect remedy."[5] Today numerous sociological, psychological, practical, and legal reasons militate against the fault basis as the only means of terminating a marriage. The Divorce Reform Act is a means of introducing a needed non-fault ground for divorce — "irreparable breakdown in the marital relationship."

A. The Existence of Non-Fault Grounds for Divorce in the United States and Elsewhere in the World

To the extent that any ground for divorce is based on fault, many scholars believe that such concepts of guilt or innocence have no relevance to the viability of the marital relationship. Consequently they recommend the abolition of all grounds for divorce and the substitution of the standard of "marriage breakdown" (as in the Divorce Reform Act, to be distinguished from divorce by mutual consent).[6] Divorce after proof of marital breakdown is already in opera-

---

2 For a brief discussion of the historical development of divorce see Mace, *Marriage Breakdown or Matrimonial Offense: A Clinical or Legal Approach to Divorce?*, 14 AM. U. L. REV. 178 (1965); Rheinstein, *Trends in Marriage and Divorce Law of Western Countries*, 18 L. & CONTEMP. PROB. 3 (1953).

3 Note, 45 ILL. L. REV. 399, 401 (1950).

4 *See, e.g.*, N.H. REV. STAT. ANN. §458.7 (Supp. 1957), which, in listing the grounds for divorce, begins: "A divorce from the bonds of matrimony shall be decreed *in favor of the innocent party . . . .*" (emphasis added).

5 For a list of recent critics see Tenney, *Divorce Without Fault: The Next Step*, 46 NEB. L. REV. 24, 32-3 (1967).

6 *See* Bradway, *Family Dissolution—Limits of the Present Litigious Method*, 28 IOWA L. REV. 256 (1943); M. PLOSCOWE, THE TRUTH ABOUT DIVORCE, 256 (1955); M. VIRTUE, FAMILY CASES IN COURT (1956); Sayre, *Divorce for the Unworthy: Specific Grounds for Divorce*, 18 L. & CONTEMP. PROB. 26 (1953); Tenney, *Divorce Without Fault: The Next Step*, 46 NEB. L. REV. 24 (1967).

tion in Greece, Switzerland, Yugoslavia and Japan. It is the sole basis in the Soviet Union and most communist countries. In England members of the Royal Commission on Marriage and Divorce were evenly divided on recommending that divorce procedures based on the principle of marital breakdown be the law of the land. Moreover, to go further, mutual consent of husband and wife is ground for divorce, with certain safeguards, in Norway, Sweden, Denmark, Belgium and Portugal.[7]

In the United States, the concept of "marital breakdown" is implicit in some of the statutory grounds for divorce appearing in the various states. Such grounds suggesting breakdown rather than matrimonial offense are insanity, living separate and apart, physical malformation preventing intercourse, feeble-mindedness, epilepsy, and incompatibility.

Early statutes of Indiana, Iowa and Washington, now repealed, authorized divorce on the ground of an inability to live together or on a finding by the court that divorce would be proper and that both parties could no longer live together in peace and harmony.[8] Incompatibility as a ground for divorce is of comparatively recent origin and today is present in some form in the laws of three states and one territory: Alaska,[9] New Mexico,[10] Oklahoma,[11] and the Virgin Islands.[12] However, while incompatibility is usually seen as a liberal non-fault standard, some commentators believe it should be distinguished from a marital breakdown approach, albeit similar, because the history of statutes using the incompatibility ground contains cases which by judicial interpretation have included the concept of fault as at least one consideration in determining whether a divorce should be granted.[13]

Twenty-two states, Puerto Rico and the District of Columbia now provide for divorce on the ground of living separate and apart without cohabitation for periods ranging from

7 Mace, *supra* note 2, at 182.

8 Annot., 58 A.L.R.2d 1218 (1958).

9 ALASKA STAT. ANN. § 09.55.110(5) (c) (1962) ("incompatibility of temperament").

10 N. M. STAT. ANN. § 22-7-1(8) (1953) ("incompatibility").

11 OKLA. STAT. ANN., tit. 12, § 1271(7) (1961) ("incompatibility").

12 V. I. CODE tit. 16, § 104 (a) (8) (1964) ("incompatibility of temperament").

13 Tenney, *supra* note 5, at 37; Wadlington, *Divorce Without Fault Without Perjury*, 52 VA. L. REV. 32, 44 (1966); see Rutman, *Departure From Fault*, 1 J. FAMILY L. 181, 183-91 (1961).

two to ten years.[14] This ground has been praised by critics who, like those urging a marital breakdown standard, see disparity between the ideas behind present legislation and the reality of the situation as a major problem in divorce law.[15] To the extent that an element of consent is evidenced[16] and considering that the separation provision is premised on the notion that remaining apart for a given time is conclusive evidence of the fact of marriage breakdown,[17] the separation provision is probably the major non-fault ground for divorce in America. However, a minority of states do not so construe their separation statutes, thus again allowing fault to be a consideration in determining whether to grant a divorce.[18]

Lastly, it should be noted that another recent reform focusing on the deterioration of the family and marriage is the addition of conciliation departments to divorce courts. They exist in varying degrees in fifteen states.[19] While this development is not an updated ground for divorce, but rather a method for saving marriages, it still stands for the proposition that a simple fault oriented system ought to be replaced or supplemented by an "investigatory system which

---

14 ALA. CODE, tit. 34, § 22(1) (1958); ARIZ. REV. STAT. ANN. § 25-312 (West, 1956); ARK. STAT. ANN. § 34-1202 (Bobbs-Merrill, Replacement, 1962); COLO. REV. STAT. ANN. § 46-1-1(J) (Supp. 1960); DEL. CODE ANN., tit. 13, § 1522(11) (1957); D. C. CODE ANN. § 16-403 (1961); IDAHO CODE ANN. § 32-610 (1947); KY. REV. STAT. § 403.020(1)(b) (1955); LA. REV. STAT. ANN. § 9-301 (1950); MD. ANN. CODE art. 16, § 24(5) (1957); MINN. STAT. ANN. § 518.06(8) (1958); NEV. REV. STAT. § 125-010 (1957); N.H. REV. STAT. ANN. § 458.7 (Supp. 1957); N.Y. DOM. REL. LAW § 170 (McKinney Session Laws 1966); N.C. GEN. STAT. § 50-6 (1950); N.D. CENT. CODE § 14-06-5 (1943); P.R. LAWS ANN., tit. 31, § 321(9) (1955); R.I. GEN. LAWS ANN. § 15-5-3 (1956); TEX. REV. CIV. STAT., art. 4629(4) (1958); UTAH CODE ANN. § 30-3-1(8) (Supp. 1963); VT. STAT. ANN., tit. 15, § 551 (1958); WASH. REV. CODE ANN. § 247.07(6) (Supp. 1965); WYO. STAT. ANN. § 20-47 (1957).

15 *See, e.g.*, McCurdy, *Divorce—A Suggested Approach with Particular Reference to Dissolution for Living Separate and Apart*, 9 VAND. L. REV. 685 (1956); Wadlington, *supra* note 13, at 68.

16 *See. e.g.*, N.Y. DOM. REL. LAW § 170(6) (McKinney Session Laws 1966) allowing a court to grant divorce following a two year separation pursuant to a written agreement of separation filed in the office of the county clerk.

17 Tenney, *supra* note 5, at 36.

18 M. MAYER, DIVORCE AND ANNULMENT IN THE 50 STATES 32 (1967). For example, in some states the separation must be voluntary and agreed to by the defending party for a divorce to be granted; in others, the libellant must show provocation for his or her having left to live separate and apart.

19 McIntyre, *Conciliation of Disrupted Marriages by or Through the Judiciary*, 4 J. FAMILY L. 117 (1964).

will establish with reasonable certainty whether the marriage has deteriorated to the point of being unworkable.'"[20]

B. The Realities of Modern Life

1. Social Realities

Even in American society, where the state plays a considerable regulatory role, marriage and the family are essentially social rather than legal institutions. Marital duties thus find their source principally in the moral or religious conscience of the parties, in established traditions and in social conventions.[21] When the marriage has irreparably deteriorated, the state should not attempt by legal controls to preserve what by social controls can no longer be preserved.

Moreover, in a number of ways the structure of society is no longer as conducive to the maintenance of marriages. The industrial revolution and the growth of modern urban life have changed the family from a nuclear community and a major economic and social control unit to a more limited institution and a weaker unit of social control. It is now psychologically and economically easier to break up a family.[22] Dissolution in fact is facilitated by a less homogeneous and more complex, impersonal and mobile world.

Additionally, the emancipation of women has helped eradicate the old view that divorce was a privilege for men and something evil for women to desire. In fact women of prior generations had less chance to remarry or support themselves. Today, however, a woman can be economically relatively independent of her husband, and she has an extremely high chance of remarrying if she is relatively young.[23]

2. Psychological Realities

While divorce may be predicated on fault, the notion that there exists a truly innocent spouse is predominantly a

---

20 Mace, *supra* note 2.

21 Rheinstein, *supra* note 2, at 7.

22 C. FOOTE, R. LEVY & F. SANDER, CASES AND MATERIALS ON FAMILY LAW 773-74 (1966); *cf.* Selznick, *Legal Institutions and Social Controls*, 17 VAND. L. REV. 79, 80-82 (1963).

23 FOOTE, LEVY & SANDER, *supra* note 22, at 773.

myth.[24] Listed grounds for divorce are not really indicative of the true causes of marital breakdown, but rather are representative of the symptoms.[25] Marriage counsellors find it impossible to apply concepts of guilt or innocence to the complex interrelationship marriage must be and are unlikely to say there is ever a guilty or innocent party.[26] Thus the dissolution of a marriage is probably caused by the acts and temperaments of both parties. To allow nonfault divorce is to emphasize real social consequences and to recognize the failures of both to create a viable marriage, without granting victories or rewarding supposed virtue.

3. Legal Realities

The present system of divorce predicated on fault induces to an astounding extent perjury, collusion, staged hotel affairs, professionl co-respondents, misuse of the law of annulment, and the commission of proscribed acts solely to create a ground for divorce.[27] To give but one example, a wife may go to Nevada for a "quickie" divorce and may swear falsely that she intends to settle there for residence purposes or may describe a spurious incident of adultery.[28]

The vast majority of all divorces today are by mutual consent and mutual action despite defenses such as recrimination or collusion, despite the theory of marriage as a sacred institution, and despite religious attitudes, judicial platitudes or legislative intent. Thus, in fact uncontested divorce is the main cause for termination of marriages, though contrary to the adversary system and to the existing theory of

---

24 "Lawyers know that the accusation [necessary for fault divorce] is a legal fiction, that neither husband nor wife is a wicked person and that neither believes the other to be so." J. ULMAN, A JUDGE TAKES THE STAND 172 (1933).

25 FOOTE, LEVY & SANDER, *supra* note 22, at 784.

26 Mace, *supra* note 2, at 181-2.

27 *See, e.g.*, Leach, *Divorce by Plane Ticket in the Affluent Society — With a Side-Order of Jurisprudence*, 14 KAN. L. REV. 549, 554-55 (1966); Pound, *A Symposium on the Law of Divorce — Foreword*, 28 IOWA L. REV.. 179, 180 (1943) ("collusion goes on notoriously and establishment of 'extreme cruelty' involves either facile swearing amounting to perjury, or finding of facts to meet the law instead of applying the law to found facts"); Rheinstein, *The Law of Divorce and the Problem of Marriage Stability*, 9 VAND. L. REV. 633, 634 (1956); Note, 4 HARV. J. LEGIS. 149 (1966); Note, 36 COLUM. L. REV. 1121, 1131 (1936).

28 Mace, *supra* note 2, at 179.

marital law.[29] Of course, this is not to say that all uncontested divorces are tainted with collusion; yet it cannot be doubted that most couples could not meet the statutory requirements, should all the facts really be known to the courts. To illustrate, when New York granted divorces solely on the ground of adultery, over 90% of all matrimonial actions in New York were uncontested. In effect it became an easy divorce state.[30]

4. Personal and Professional Dignity

The present discrepancy between the law on the books and the law in action has developed into a serious threat to the morals of the bar and the respect for law among the public.[31] Law cannot remain workable or maintain dignity when, like the American experience under alcoholic prohibition, a substantial part of the country believes that prohibited conduct is in fact right and another part does not care about strict enforcement. Such is the case with divorce law, an area where many have their only litigious experience. People are faced not only with a fault oriented basis which they try to circumvent, but also with the spectacle of ritualistic name calling at a public trial.

Non-fault reform, such as the proposed Divorce Reform Act, allows the law to be brought in accord with what a large number of people feel is a realistic view of the marriage institution. Such a law should avoid the collusion between parties and allow people to be divorced with dignity. Moreover, the reform should please the bar by making possible a divorce without the need for any questionable practices demeaning to the profession.[32]

---

29 M. MAYER, *supra* note 18, at 56-57.

30 Wels, *New York: The Poor Man's Reno*, 35 CORN. L. Q. 303, 315-16 (1950).

31 Rheinstein, *supra* note 2, at 19; *see* J. ULMAN, A JUDGE TAKES THE STAND 174-5 (1933) ("where, as in divorce litigation, legal theory is allowed to depart so widely from social practice, a hypocritical society may get the law it wants . . . but the price it pays is a weakened respect for its own law and the loss of moral fiber that always goes with self deception.")

32 *See* H. O'GORMAN, LAWYERS AND MATRIMONIAL CASES 30-34 (1963) (quoting from a New York attorney: "It's embarassing to go [to court] . . . I tell you it's insulting to a lawyer."); Drinker, *Problems of Professional Ethics in Matrimonial Litigation*, 66 HARV. L. REV. 443 (1953).

5. Discrimination, Waste, Misallocation — Socioeconomic Chaos

To the extent that parties cannot get a divorce in their own state because of clogged calendars or strictly enforced fault grounds, or to the extent that they must engage in collusion, a couple will often resort to measures that result in economic discrimination, economic waste, or the defeat of other parts of the divorce law system such as alimony or child support payments. To illustrate, given both time and money, parties can travel to more liberal jurisdictions such as Mexico or Nevada, where a divorce may be more easily and quickly achieved.[33] Needless to say, the poor cannot afford either the time lost from work, the cost of travel or the cost of such collusion as a staged hotel affair. They are consequently left to the mercy of fault grounds which make it more difficult for them than for the wealthy to get a divorce.[34] To the extent that these trips or payments must be made because the home state's law is inadequate there is economic waste. Consider, also, the case of an irreparably broken down marriage where there is true adultery but the adulterous spouse is unwilling to cooperate. The libellant may have to spend hundreds of dollars in fees for private investigators to catch the libellee in a compromising situation.[35]

The distortion of alimony, support and child custody provisions is another type of waste and harm which results when mutual consent or collusion is for practical reasons needed to gain a divorce. Consider here the case of a wife eager for a divorce to which the husband could refuse to consent and which he could win in a contested action. He has total power over a negotiated pretrial agreement and can in effect bargain for the custody of his children or for very low alimony or support payments. In short, a law based on fault alone could lead to determinations, which should be made by relevant social and economic factors, being made instead

---

33 *See* Leach, *Divorce by Plane Ticket in the Affluent Society — With a Side-Order of Jurisprudence*, 14 KAN. L. REV. 549, 555 (1966); M. MAYER, *supra* note 18, at 57.

34 *See* Note, 36 COLUM. L. REV. 1121, 1131 (1936).

35 Pilpel & Zavin, *Separation Agreements: Their Function and Future*, 18 L. & CONTEMP. PROB. 33, 34 (1953).

by the comparative eagerness of the spouses to dissolve their marriage.[36]

6. Religious Considerations

In the eyes of the church, the sanctity of marriage need not be synonymous with the fault notion of divorce. The non-fault marital breakdown standard for divorce is compatible with a marital covenant of lifelong intention. While the divorce as a civil dissolution recognizes that even the most intimate of relationships may weaken because of unsolvable internal conflicts, yet the marriage vows may persist in effect after the divorce on a moral-spiritual level with both parties refraining from remarrying and thus maintaining fidelity until the death of the other party. The marital breakdown approach has been approved recently by a group appointed by the Archbishop of Canterbury, the group feeling that such a standard in fact would assist the stability of marriages.[37] To the extent that some Catholics adhere to the strict view that every marriage is by divine law indissoluble, then they cannot be heard to favor either the old law or the proposed statute. However, one commentator adopting the above view of Catholic law recognizes that American Catholics generally adopt the position that the State has sole and exclusive jurisdiction over the marriages and divorces of its citizens, the jurisdiction of the church being confined to blessing the marriage.[38] For these Catholics reform should be a relevant and important issue.

7. Repeal of Recrimination

If a non-fault basis for divorce, such as the proposed "irreparable breakdown" or "incompatibility," is to be enacted by a legislature, it is important to consider the applicability of the common defense of recrimination.[39] This

36 *Id.* at 35.

37 PUTTING ASSUNDER: A DIVORCE LAW FOR CONTEMPORARY SOCIETY (London 1966).

38 Kelly, *Separation and Civil Divorce*, 6 JURIST 187, 214-216 (1946).

39 Basically, this defense arises when the libellee to a divorce action can show that the libellant is guilty of misconduct which in itself would be a ground for divorce. It is an application of the equitable doctrine that one who invokes the aid of a court must come into it with a clear conscience and clean hands. *See generally* 24 AM. JUR. 2d *Divorce and Separation* § 226.

defense may arise either from a common law background or from the wording of a statute.[40]

While the doctrine of recrimination has been criticized generally,[41] it is especially important to point out its weaknesses when there is present a non-fault ground for divorce. Recrimination really is a progeny of the fault concept. It does not belong with a non-fault ground because there the fact that both parties wronged each other, that there were no "clean hands," is actually further evidence of the deterioration of the marriage.[42] When two people cannot live with each other, it makes no sense at all to deny them relief and remit them to each other's company as punishment for their misconduct.[43] It cannot be anything but socially sadistic to maintain the marital bonds in the face of the parties' evident inability to live together as husband and wife. It is unlikely that children benefit from this type of enforced relationship. In the proposed Divorce Reform Act, Section 101 (a) (1) *a* has the court consider the performance of acts otherwise grounds for divorce as evidence of a breakdown in marriage, but Section 101(b) bars the use of recrimination as a defense to a libel brought on the non-fault ground.

8. Conclusion

It is apparent that there exists in America a disparity between the idea and the reality of marriage and divorce legis-

40 *E.g.*, in New Hampshire a libellant for divorce must be "the innocent party" (*supra* note 4); this has been interpreted to mean "free from guilt," i.e., coming into court with clean hands. Rockwood v. Rockwood, 105 N.H. 129, 194 A.2d 771 (1963).

41 Gradwohl, *The Doctrine of Recrimination in Nebraska*, 37 NEB. L. REV. 409 (1958); Johnson, *Suppressed, Delayed, Damaging and Avoided Divorces*, 18 L. & CONTEMP. PROB. 72, 79 (1953).

42 Case authority supports this view. The defense is not available in the Virgin Islands to bar a divorce upon the ground of incompatibility of temperament; rather evidence of misconduct may be considered along with other evidence in determining whether in the court's discretion the best interests of the parties will be served by granting the divorce. Shearer v. Shearer, 356 F.2d 391 (3d Cir. 1965), *cert. den'd*, 384 U.S. 940 (1966); *accord* Burch v. Burch, 195 F.2d 799 (3d Cir. 1952). In New Mexico, however, the courts are not *required* to but may treat recrimination as a valid defense to a libel for divorce brought on the ground of incompatibility. Clark v. Clark, 54 N.M. 364, 225 P.2d 147 (1950). Incompatibility itself may not be pleaded by way of recrimination; other traditional grounds may be.

43 M. MAYER, *supra* note 18, at 53; Rutman, *supra* note 13, at 184-89; Wadlington, *Divorce Without Fault Without Perjury*, 52 VA. L. REV. 32, 52 (1966).

lation. While numerous reforms are of course possible, the introduction of a new standard based on marital breakdown, where the parties to a marriage are so irreconcilable as effectively to preclude a return to a normal marital state, should be a fruitful step in combating the evils inherent in the present system. This proposal is by no means the same thing as consensual divorce at the parties' whim. The entire purpose is to prevent a divorce for any trivial reason or any single offense. The proposal should instead provide a more dignified and blameless way out from an irreparably destroyed union.

II. Protecting Children in Divorce

A. The Need for Representation

In most areas of American law, intervention as of right and permissive intervention are doctrines of considerable vitality.[44] Generally, where a lawsuit substantially affects important interests of persons other than the plaintiff and defendant, these third persons may become parties and contest outcomes which, though desirable as between the original parties, would adversely affect the third parties. The pattern for intervention as of right in federal and many state courts follows the Federal Rules of Civil Procedure:

> Upon timely application anyone *shall* be permitted to intervene in an action . . . (2) when the applicant claims an interest relating to the property or transaction which is the property or transaction which is the subject of the action and he is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.[45]

Third persons with a right to intervene often fall also into the class of necessary or indispensable parties:

> A person . . . *shall* be joined as a party in the action if . . . (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the

[44] Shapiro, *Some Thoughts on Intervention Before Courts, Agencies, and Arbitrators*, 81 Harv. L. Rev. 722 (1968).
[45] Fed. R. Civ. P. 24(a) (2) (Emphasis added).

> action in his absence may (i) as a practical matter impair or impede his ability to protect that interest . . . .[46]

This scheme provides extremely important insurance against irreparable damage to persons who have had no opportunity to present their case in court.

When spouses with children obtain a divorce, important interests of the children may suffer harm. The divorce itself prevents the child from living in a home with both his parents. The custody award may prevent the child from living with the parent whom he prefers or who would be best for his welfare. The child support award may truncate the child's financial resources. Yet these interests are usually not represented at the divorce, and can rarely be urged afterward. Because they are appropriate, the legal principles and policies for parties who intervene as of right and for necessary or indispensable parties should be applied to children whose parents seek divorce.

The legal literature rarely notes the wounds that divorce may inflict on children. But the psychological and sociological literature seems fairly united behind the proposition that a child stands a far greater chance of developing serious personality defects if his parents obtain a divorce than if they stay together.[47] The event of divorce seems to reduce children's selfesteem, more in Jewish and Catholic than in Protestant families and more for younger than for older children.[48] When boys grow up in homes without fathers present, as is usual after divorce, they tend to be more aggressive than boys with fathers,[49] to do relatively worse in school,[50] and to become juvenile delinquents more frequently.[51] One explanation of the finding on self-esteem is that a divorce during the child's Oedipal period is interpreted by him as punishment for his negative feelings to-

---

46 FED. R. CIV. P. 19(a) (2) (i) (Emphasis added).

47 This argument may not apply to parents who obtain a divorce only to ratify an already extant marriage breakdown and separation.

48 M. ROSENBERG, SOCIETY AND ADOLESCENT SELF IMAGE 85-106 (1965). This lowering of self esteem occurs when families are broken by divorce, but does not occur when they are broken by the death of one parent.

49 McCord, McCord & Thurber, *Some Effects of Paternal Absence on Children*, 64 J. ABNORMAL SOC. PSYCH. 36 (1962).

50 Wylie & Delgado, *A Pattern of Mother-Son Relationship Involving the Absence of the Father*, 29 AM. J. ORTHOPSYCHIATRY 644 (1959).

51 McCord et al., *supra* note 49.

ward his parents or as fulfillment of fantasy wishes.[52] The personality defects of boys without fathers are generally explained by two theories: as the result of the boys' identifying with their mothers, then over-compensating by exaggerated masculinity;[53] and transference by divorced mothers of their erotic and hostile feelings toward their departed husbands to their sons.[54] Girls without fathers seem not to be as badly affected as boys, but do tend to become abnormally dependent on their mothers.[55]

Psychological findings suggest, not only that divorce and its usual consequence of fatherlessness tend to harm children, but also that divorce has differential effects according to the age and sex of the children. Other things being equal, divorce tends to harm boys more than girls.[56] Boys are most vulnerable to the ravages of fatherlessness between the ages of six and twelve.[57] These findings suggest that divorces ought to be less readily available to parents of boys than girls, and to parents of boys under twelve than to boys over twelve. If there are boys nearly twelve, delay of divorce may be warranted for the boys' welfare although denial is not.

Those favoring more liberal divorce laws often argue that a child will be better off in a peaceful home with one parent than in a home rent by battles between the parents. This argument does not square with the extensive psychological research literature showing harmful effects. The argument also rashly assumes that the post-divorce home of the child will be a peaceful one with a happy parent. We can reasonably assume that while some children and some homes are such that the child will be better off with a divorced parent than with feuding parents, others are such that the child will be substantially better off if the parents do not obtain a divorce. Since psychological findings indicate that cases tend to fall into the second category, the burden of argument ought to fall on those who allege the absence of harm.

52 A. Freud & D. Burlingham, War and Children 58 (1943). Anna Freud maintatins that the guilt substantially increases the probability of emotional disturbance.

53 Burton & Whiting, *The Absent Father and Cross-Sex Identity*, in Studies in Adolescence 107 (R. Grinder, ed. 1965); Lyn & Sawrey, *The Effects of Father-Absence on Norwegian Boys and Girls*, 59 J. Abnormal Soc. Psych. 256 (1959); McCord et al., *supra* note 49.

54 Wylie & Delgado, *supra* note 50.

55 Lyn & Sawrey, *supra* note 53.

56 *Id.*

57 McCord et al., *supra* note 49.

Even if we could assume that divorce left children unharmed and that custody arrangements generally served their best interests, divorce proceedings would nevertheless threaten serious harm to the important interest of the child in adequate financial resources. Before the divorce both parents are involved every day in financing the needs of their children. After the divorce, both parents' incomes must be stretched thinner to support two households instead of one, so less money is available for the children. The mother, who usually wins custody, may have more limited assets and earning ability than the father. The parent without custody has his legal liability for support explicitly limited by the decree; he may feel disinclined to contribute more than this limit, if he fears that the parent with custody will reduce her contributions to the child proportionately with his increases, or if his lack of daily contact with his child reduces his awareness of the child's needs or his feeling of obligation toward the child.

Some cases hold that, though divorce imperils significant interests of the child, the parent seeking custody adequately represents these interests.[58] They argue that the parent awarded custody shares the child's interest in getting as much child support money as possible, because she will wish to minimize the child's drain on her own resources. This argument overlooks the other elements often at barter in the settlement process. Often the parents strike a bargain whereby the father lets the mother take custody without a contest in return for which she accepts mere token child support payments.[59] Offered a particular sum by the father, the mother may wish to have as much of it designated as alimony and as little of it as child support as possible, to maximize her discretion over the spending of it. The father may eagerly accept such an arrangement because of its tax advantages to him.[60]

---

58 *E.g.*, Groulx v. Groulx, 98 N.H. 481, 103 A.2d 188 (1954) (annulment, paternity of child at issue). In *Groulx* the court's reasoning cannot be faulted, but it should not be carelessly extended to tougher cases.

59 Pilpel & Zavin, *supra* note 35, at 35.

60 INT. REV. CODE of 1954, sec. 71, requires that a wife include alimony payments, but lets her exclude from her taxable income amounts specifically earmarked as child support payments; however, her tax interest in large child support payments may be countered by her interest in discretion as to how the money will be spent. Section 215 lets the husband deduct only what is includible

The considerations discussed above warrant the proposition that children ought to be parties, separately represented to assert their interests, when their parents seek divorces. Children's interests relating to the subject of the action may be that they continue to live with both parents, that custody be awarded to one parent rather than the other, or that child support payments be high. A divorce granted without separate representation for the child jeopardizes all of these interests. Neither parent's interests coincide with the child's, and both may have interests at odds with the child's; therefore, representation of the child cannot safely be left to the parents.

B. The Law as it Stands

The law in most jurisdictions disallows children any opportunity to be represented in their parents' divorce actions. No state permits children to contest the granting of a divorce to their parents.[61] There do not seem to be any cases deciding whether or not a child may intervene as to which parent should get custody. There is much authority for the proposition that a child is not a proper party in a proceeding for modification of a custody decree, and none for the contrary proposition.[62] While the judge may conduct a private interview with the child to determine his preferences as to custody,[63] the general rule is that custody should be awarded according to the court's concept of the child's welfare, even when the child's preference is opposed to the judge's choice.[64]

to the wife under Section 71; he can claim a Section 151 exemption for his child only if he provides over one-half the child's support, and divorced parents are rarely so cooperative as to collaborate on their tax returns in order to let the father prove that his child support payments amounted to over half.

61 *E.g.*, Baugh v. Baugh, 37 Mich. 59 (1877). Baugh was decided prior to Michigan's statute, discussed below, permitting the prosecuting attorney to contest the granting of a divorce, apparently on behalf of the children.

62 Many cases to this effect are cited in footnotes 4 and 4.5 in 27A C.J.S. *Divorce* § 317(5).

63 *E.g.*, Oakes v. Oakes, 195 N.E.2d 840, 99 A.L.R.2d 949 (App. Div. 1964). The annotation at 99 A.L.R.2d 954 recommends that the due process considerations for basing the decision on evidence produced in open court be balanced against the social-medical consideration that the child's interest is better served by letting him reveal his preference in the privacy and calm of the judge's chamber. Most states hold that the private interview is proper, even without the parents' consent, *e.g.*, Sheehy v. Sheehy, 88 N.H. 223, 186 Atl. 1, 107 A.L.R. 635 (1936).

64 For citations, see 27A C.J.S. *Divorce* § 309(2), n. 28, and § 309(3).

Children probably cannot intervene to contest the adequacy of the child support payments proposed.

This palisade between children and the divorce court is inconsistent, not only with general principles of law regarding representation of third parties, but also with rules on representation of children and rules on representation of third parties in divorce. For example, if it appears that a child may have an interest in an estate, probate court routinely appoints guardians ad litem to represent his interest. Where there may be a conflict of interest between parent and child, as where the parent is a remainderman and the child is a contingent remainderman in the same estate, there cannot be "virtual representation" of the child by the parent; the child must be separately represented.[65] In divorce a third party other than a child whose property interests may be adversely affected by the divorce may intervene.[66] This principle stretches to children, however, only in special situations, such as *adult* children claiming interest in realty which stands in the name of their parents may intervene to protect their interests.[67]

A few jurisdictions have made the theoretically easy and desirable, but in practice rare, end-run around the rule barring children from representation in divorce. Where the child's legitimacy is put in issue, some courts order that the child be made a party and appoint a guardian ad litem to represent the child.[68] Family Court Judge Robert W. Hanson of Milwaukee, Wisconsin, appoints a guardian ad litem for children in every case where custody is in dispute. The guardians may subpoena witnesses, present witnesses for testimony and cross-examine the parents and their witnesses, use background information on the family discovered by the court's conciliation department, and make a statement on behalf of the children. Judge Hanson orders the parents

---

65 In re Estate of Sage, 283 N.Y.S.2d 442 (1968), is a recent case holding against "virtual representation."

66 See the extensive citations in 27A C.J.S. *Divorce* § 91, n. 12.

67 Elms v. Elms, 4 Cal.2d 681, 52 P.2d 223, 102 A.L.R. 811 (1935).

68 Wisconsin requires this by statute: WISC. STAT. ANN. § 328.39 (1957). New York courts have adopted this practice without a statute; *see* Ohms v. Ohms, 285 App. Div. 839, 137 N.Y.S.2d 397 (1955). England may have a similar practice; *see* Hewat's Divorce Bill, L.R. (1887) App. Cas. 312 (H.L.). *See generally* Annot., 65 A.L.R.2d 1392, § 7 (1959).

to pay the guardian's fee unless they cannot afford it, in which case he finds lawyers willing to represent the children without remuneration.[69] Michigan provides by statute that in all divorce actions where the spouses have children under seventeen, the prosecuting attorney or friend of the court "shall enter his appearance in the cause, and when, in his judgment, the interest of the children or the public good so requires, he shall introduce evidence and appear at the hearing and oppose the granting of a decree of divorce."[70]

C. A Proposal for Reform

The rule against making children parties in their parents' divorce action conflicts with general rules of law and offends sound policy as well as logic. Whatever benefits may be secured by the rule fail to outweigh the harm done by it to children whose parents obtain divorces.

While judges have sufficient reasons and precedents to change the rule by themselves, legislative action is desirable. Among the difficult issues requiring a balancing of interests are whether the child should be permitted to contest the divorce itself[71] as well as custody and child support payment arrangements, who should pay the child's lawyer, who should choose the lawyer, and whether children with possibly conflicting interests ought to be represented by the same lawyer. The proposed Divorce Reform Act lays out a statutory scheme resolving these issues. The general idea is that children whose parents seek a divorce ought to be parties and have lawyers so that their important interests will receive due consideration.

---

69 Judge Hanson has published numerous articles on representation of children in divorce. One of them, describing his practice and delineating his authority for it quite clearly, is Hanson, *Guardians ad Litem in Divorce and Custody Cases: Protection of the Child's Interests*, 4 J. FAMILY L. 181 (1964).

70 MICH. COMP. LAWS ANN. § 552.45 (1967). The same section gives the judge discretion to require the prosecuting attorney or friend of the court to appear where the children are all over 17.

71 As the prosecutor or friend of the court can in the Michigan statutory scheme. MICH. COMP. LAWS ANN. § 552.45 (1967).

AN ACT

To reform the grounds for divorce and to provide for representation of children in divorce proceedings.

SECTION 101: *Absolute Divorce For Irreparable Breakdown*

(a) A divorce from the bonds of matrimony shall be decreed in favor of either party in the event of an irreparable breakdown in the marital relationship.

COMMENT: This section states a new ground for absolute divorce and adopts a twin standard to be applied — the breakdown in a marriage and the quality of irreparability attached to the breakdown. It is predicated on the belief that the state should allow a divorce when the husband-wife relationship has effectively ceased, beyond reasonable hope for revival, to be a normal marriage. In divorce proceedings under this new section comparative degree of fault or guilt should not alone be a basis for granting or refusing to grant an absolute divorce.

SECTION 101(a)(1) The term breakdown shall be construed to mean the absence of a normal marital relationship over a reasonably prolonged period of time because of profound conflicts in the personalities, dispositions and temperaments of the parties. In determining whether or not a marriage has broken down, the court shall consider, but not limit itself to:

a. the performance of any act or acts otherwise listed as a cause for divorce under the applicable sections of the divorce law of this state;

b. the performance of any act or acts indicating hatred, cruelty, malice, indifference, distrust, an intent to humiliate or defame, or any other aspect of emotional incompatibility;

c. any indication of physical or sexual incompatibility between the parties;

d. any indications of severe differences between the parties in respect to issues of pressing personal concern; and

e. the extent to which, if at all, the parties have lived separate and apart.

COMMENT: This subsection defines and provides criteria for determinating whether or not a marriage has ceased to be a normal one because of profound differences in the temperaments and actions of the parties. The marriage will not be considered broken down unless this marital disharmony has been prolonged over a reasonable period of time, a period about which case law and judicial discretion will come to supply a more exact definition. The court is given criteria to apply, but it is not meant to be limited to these criteria. In every case, the court must view all the circumstances of the parties and the extent to which any action or personality characteristic is a cause of disharmony. Thus, breakdown is not to be found merely from the existence of any one act apart from the context in which it was performed and the response, if any, it elicited from the other spouse. For example, political differences, even where leading to severe arguments, might be either healthy or harmful to a marriage depending on the circumstances.

SECTION 101(a)(2) The term irreparable shall be construed to mean a high probability that the marital relationship cannot be substantially improved. In determining whether or not a marriage that has broken down is irreparable, the court shall consider, but not limit itself to:

a. the extent to which there has been a bona fide effort by the parties to reconcile their differences;

b. the extent to which the parties have sought qualified help from such practitioners as doctors, psychologists, psychiatrists, ministers or marriage counselors, and the extent to which such guidance is likely to erase a material part of the cause or causes of disharmony;

c. the presence of children, if any, and the extent to which they are likely to reduce the causes of disharmony or act as a unifying force to the marriage;

d. the length of time the parties have been married and the length of time during which the disharmony between the parties has manifested itself in some form; and

e. the nature of the cause or causes of the breakdown.

COMMENT: This provision defines and provides criteria for determining whether or not a marriage that has broken down is irreparable, that is, so irremediable as to justify the court in granting a divorce even though the court's primary obligation is to save a marriage from dissolution. The court is not limited to the statutory criteria and may use its discretion, based on information acquired by the application of the criteria and otherwise, in determining both the probability and the substantiality of improvement.

SECTION 101(b) Recrimination shall not be allowed as a defense to a libel for divorce brought under this section.

COMMENT: This provision is specifically meant to eliminate the application of either a common law rule or any statutory construction making the grant of an absolute divorce contingent upon the libellant's meeting any standard of freedom from guilt or freedom from fault. Any guilt or fault as commonly understood in divorce proceedings should instead be considered to the extent warranted in determining whether or not the test for breakdown in the marital relationship is met.

SECTION 101(c) The court shall so construe this section as to preserve the marital relationship in case of serious doubt as to the proper application of any of the above standards.

COMMENT: This provision states the premise that, in case of conflict, the primary duty of the court is to preserve the marriage the state has created; however, this rule is not meant to create a narrow reading of the statute. Instead, the statute should be read with the understanding and meaning normally given the statutory terms. Only in borderline cases, when applying the above flexible reading of the statute, should the court which is faced with a choice decide against granting the divorce.

SECTION 201: *Representation of Children in Divorce*

(a) (1) Every libel for divorce shall state fully the names, addresses, ages, histories of custody, and names and addresses of natural parents, if known, of all minor children for whose care the spouses are responsible.

(2) Every answer to a libel for divorce either shall state that all of the libellant's allegations under subsection (a)(1) are true and complete or shall recite true and complete allegations pursuant to subsection (a)(1).

(3) If at any time the court learns that the libellant or libellee has not complied with subsections (a)(1) or (2), it may order that the noncomplying party be punished for contempt of court and may (i) dismiss the libel or permit an amendment of the libel if a decree has not yet been granted, or (ii) modify the decree if a decree has been granted.

COMMENT: Since children cannot be expected to assert their rights by themselves, this section puts the burden on their parents to provide the court with enough information so that it can provide for their representation.

The statute covers "all minor children for whose care the spouses are responsible," rather than limiting itself to natural children of the marriage, since adopted or foster children, or other children for whom the spouses have assumed responsibility, may be harmed as much by divorce as natural children of the marriage.

Requiring disclosure by both spouses and laying both spouses open to the same range of penalties should minimize the number of careless errors and intentional omissions. The court has discretion to deal with omissions in accord with the needs of the particular case.

SECTION 201(b) The court shall appoint lawyers for the children named pursuant to subsection (a) (1).

(1) At the beginning of or during the proceedings, the court may appoint a single lawyer for children whose interests appear to coincide, or separate lawyers for children whose interests appear to conflict.

(2) The court shall set the fees of the appointed lawyers at the conclusion of the proceedings on the basis of their supporting affidavits.

(i) The court may order payment of the fee by the libellant, the libellee, the child, or a fund which may be established by the state or other organizations for that purpose.

(ii) The court shall reduce or eliminate the children's lawyers' fees where the financial resources of the parties so warrant.

COMMENT: The inability of children to select their own lawyers creates a dilemma. If the court does not assume the responsibility of appointing lawyers, the children will not obtain them; but court appointed lawyers may not pursue their clients' interests as avidly as those selected by the client. The latter problem may be solved in part by involvement of older children in the selection process, and frequent consultation between the children and their counsel; however, the ethics of the bar will be important.

The court has discretion to decide whether to appoint one or several lawyers where there are several children. The desideratum of separate representation of every party who may have a separate interest must be balanced against the needs for economy and efficiency.

The court has discretion to charge children's lawyers' fees on the basis of fault, ability to pay, and other factors which may be relevant. Since the spouses seeking divorce create the need for representation of their children, the cost of representation may fairly be imposed on them.

Divorce should not be made more expensive than it now is for the poor; therefore, they are not required to pay more than they can afford for children's lawyers. Legal aid societies and attorneys who contribute services to the poor should be as willing to represent poor children whose parents seek divorce as they are to represent other poor clients. Provision is made for counsel's fees to be charged to a fund which the state or private philanthropies may contribute.

SECTION 201(c) (1) The children named pursuant to subsection (a) shall be treated as parties to the divorce proceeding; they shall have the same procedural powers as other parties to the libel.

(2) The lawyers designated pursuant to subsection (b) shall represent the interests of the children as they appear to the lawyers, taking account of the children's own opinions and other relevant considerations. Counsel may oppose the issuance of any divorce decree, argue for a delay

before a decree is granted, argue for a particular custody arrangement, contest inadequate child support allowances, and make such other arguments as may be in the interests of the children.

COMMENT: The child has the same rights of discovery, presentation of evidence and so forth as any other party to the action. Whether or not the child may be formally termed a party is left to the local law of civil procedure.

The children's lawyers are not restricted as to which interests of the children they may advocate. Where interests of the children and the parents conflict, it is left to the court to judge and balance them.

NOTE: BUILDING CODES: REDUCING DIVERSITY AND FACILITATING THE AMENDING PROCESS

I. INTRODUCTION

The present body of building code[1] law would be quite satisfactory were no one concerned with cost or efficiency. In theory, the purpose of building codes is to ensure safe and adequate construction of public and private buildings; and in fact, they have undoubtedly been instrumental in raising and maintaining standards for safe construction. But they have had some less desirable effects as well. They have retarded innovation and forced higher costs,[2] one result of which has been that lower income groups have been priced out of the market for newly constructed housing.[3] Certainly, building codes have not been the sole cause of the

1. *Building Codes*, which are the subject of this Note, are to be distinguished from *housing codes* in that the former apply to new construction and generally to substantial alterations and renovations, whereas the latter apply to the condition of buildings already in existence. *Building codes* regulate such matters as structural loads and stresses, heating system construction and equipment, plumbing and electrical installation and materials, wall thickness, exits, light and ventilation, stairways, ramps, landings, and railings, elevator and escalator construction and safety equipment, fireproofing, sprinkling, and fire-extinguishing equipment, chimney, flue and vent pipe construction, heights and distances from streets, other buildings, property lines, and the projection of towers, poles, signs, and other structures. *Housing codes* on the other hand, regulate the living conditions in existing buildings, covering such items as room sizes, occupancy ratios, standards of maintenance, and the presence, type, and condition of facilities such as bathrooms, hot water, and wiring. There is some overlapping coverage between the two types of code, the major distinction between the two being the time in the life of a building at which they are applied. Related to these codes are mechanical, electrical, plumbing, and fire codes, which may or may not be part of the general building code, setback ordinances, zoning ordinances, multiple dwelling laws, health codes, house trailer codes, and business and professional codes.

2. In 1958, a panel for HOUSE AND HOME MAGAZINE asserted that the building code situation cost home buyers an average of $1,000 a house. 14 HOUSE AND HOME 116 (1958).

3. Former Senator Paul V. Douglas, chairman of the President's newly-appointed Commission on Urban Problems, has stated that building codes are a serious obstacle to the technological innovations necessary to produce low-income housing. N.Y. Times, Dec. 7, 1967, at 39, col. 4.

high price of construction; but just as certainly, they have been a contributing factor.[4]

Currently, there are 5,000 *different* building codes in effect in the United States.[5] In metropolitan areas, there may be as many as from thirty to fifty different building codes.[6] Many of these codes are out of date, and more of them will very likely be out of date in the near future.[7]

To visualize the problems confronting a materials manufacturer, prefabricator, or general contractor who does business nationwide, suppose that General Motors had to make a different car for sale in every county in the United States in accordance with local safety requirements. Suppose further that these local requirements were comprehensive, covering virtually every item in the automobile—and that some counties allowed fuel injection but others did not, some required no more than two cylinders in the engine but others no less than eight, some allowed engines made of aluminum but others allowed only engines made of steel with certain specified alloys, and some required the spokes on the wheels to be made of oak and no less than two inches in diameter.

---

4. There is some confusion over the extent to which building codes actually raise costs. The Advisory Commission on Intergovernmental Relations suggests that the HOUSE AND HOME estimates, *supra* note 2, are exaggerated since they combined the excesses of several codes, rather than concentrating on any one typical example. U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BUILDING CODES: A PROGRAM FOR INTERGOVERNMENTAL REFORM 2-3 (1966) [hereinafter cited as ACIR]. One recent study commented, "Undoubtedly many building codes have incorporated excessive standards; however, conclusive evidence that the situation is as bad or costly as one is led to believe is notably lacking." PUGET SOUND GOVERNMENT CONFERENCE, A SURVEY OF BUILDING CODES 8 (1967) [hereinafter cited as PSBC]. The study cited a San Francisco survey of local home building the results of which showed no costs increases for 33% of the houses, less than 1% increases for 50% of the homes, and no more than 3% increase for the remainder. S. MASEL, HOUSE BUILDING IN TRANSITION 249 (1953). However, another author commented on this study that "... the observed lack of builder complaints in San Francisco stems from the fact that the average builder is not an innovator, but is content to build a house in a traditional manner, familiar both to him and to the building inspector." B. KELLY, DESIGN AND THE PRODUCTION OF HOUSES 307 (1959). Furthermore such surveys as the one in San Francisco do not measure the cost of restraints on innovation of securing numerous code approvals and reapprovals, or generally the amount to which excessive code restrictions have contributed to the final cost of all the materials and methods which the contractor is permitted to use.

5. ACIR, *supra* note 4, at 1.

6. *E.g.*, the Cleveland metropolitan area has about thirty different building codes, while the Chicago area has about fifty.

7. *See* note 17 *infra*.

Then suppose that shop plans for each automobile had to be submitted to a local automobile commission for approval and certification, and that each car had to be assembled in the county in which it was to be sold, where the process of assembly could be observed by local inspectors of varying competence and integrity. Of course, cars are not buildings,[8] and there are a number of reasons, none of them very overwhelming,[9] why their systems of regulation should be different. The point of the illustration is simply that if cars were subject to a system of regulations similar to that which governs buildings, the business of making cars would be a good deal more complex; they would cost considerably more, and fewer persons would own them. It is also to suggest that the process of building could be simpler, more economical, and more accessible to a wider public if building codes were less numerous, better written and administered, and more consistently up to date.

The unfortunate effects of building codes stem basically from two sources: (a) the form and content of the particular codes; and (b) the legal and political distributions of authority for promulgating the codes. Since the latter source may often feed the former, it will be considered first.

---

8. Although mobile homes (trailers) are buildings for the most part. Eighty-five per cent of trailers are fixed in place as permanent dwellings. In 1964, mobile homes constituted eighteen per cent of private, one-family housing starts. The construction of mobile homes is generally not regulated. ACIR, *supra* note 4, at 3. *But see* C. RHYNE, SURVEY OF THE LAW OF BUILDING CODES 58-59 (1960). B. HODES & G. ROBERTSON, THE LAW OF MOBILE HOMES (1964). Although certain provisions of building codes where they overlap with the basic subject matter of housing codes, notably in dealing with space and occupancy ratios, have been applied to trailers. *See* Lower Merion Tp. v. Gallop, 158 Pa. Super. 572, 46 A.2d 35 (1946), *appeal dismissed*, 329 U.S. 669 (1946).

9. At the time of the first building codes, almost all of the construction was on-site. Materials were brought to the building site in their crudest form and from this the workmen completed all the necessary assemblies. Architectural details were scanty, as the architects either personally supervised the construction or left the construction details to the contractor. In short, most of the activity was local and it was appropriate that it be locally regulated. With rising labor costs, more was done to save labor at the site—prefinishing, preassembling, prefabricating and pre-casting, although some of these methods had qualitative as well as economic advantage. Also, as standards of comfort rose, the technological level and complexity of building materials increased, particularly for use in large buildings which had been made possible by the use of steel skeletons and reinforced concrete. More of the work came to be done off the site. Automobiles, on the other hand, have always been manufactured in central locations and shipped out to buyers.

II. DISTRIBUTION OF AUTHORITY— THE PROBLEM OF DIVERSITY

By charter or enabling legislation, most states delegate power over building codes to the municipalities to be exercised as part of the local police power. In addition to codes drafted locally at the municipal level, about eighty per cent of the states have special codes covering subjects like plumbing and fire prevention.[10] Six states have mandatory general

10. Alaska (boilers) ALASKA STAT. §§ 18.60.180-18.60.390 (1962); California (electrical) CAL. PUB. UTIL. CODE §§ 8001-8057 (West 1965), CAL. LABOR CODE § 55 (West 1955), (fire) CAL. HEALTH & SAFETY CODE §§ 13100-13146.5 (West 1964); Colorado (plumbing) COLO. REV. STAT. ANN. §§ 142-1-1 to 141-1-22 (1963); Connecticut (elevator) CONN. GEN. STAT. ANN. §§ 19-410 to 19-418 (1958), (fire) CONN. GEN. STAT. ANN. §§ 29-40 to 29-44 (1958); Delaware (boiler) DEL. CODE ANN. §§ 553.01-553.13 (1962); Hawaii (fire and electrical) HAWAII REV. LAWS (1953); (plumbing) DEL. CODE ANN. tit. 16, §§ 7901-7933 (1953); Florida (elevator) FLA. STAT. ANN. §§ 399.01-399.14 (1960); (plumbing) FLA. STAT. ANN. §§ 553.01-553.13 (1962); Hawaii (fire and electrical) HAWAII REV. LAWS §§ 184-1 to 184-16 (Supp. 1963); Idaho (electrical) IDAHO CODE ANN. §§ 54-1001 to 54-10017 (1947), (plumbing) IDAHO CODE ANN. §§ 39-2701 to 39-2734 (1947); Illinois (boiler) ILL. ANN. STAT. ch. 24, §§ 1225-1240 (Smith—Hurd 1961); Indiana (boiler) IND. ANN. STAT. §§ 20-632 to 20-664 (1964), (fire and electrical) IND. ANN. STAT. 20-807 (1964), (elevator) IND. ANN. STAT. 20-1201 to 20-1217 (1964); Iowa (boiler) IOWA CODE ANN. §§ 89.1-89.12 (1949), (fire) IOWA CODE ANN. §§ 103.1-103.17 (1949), (plumbing) IOWA CODE ANN. §§ 135.12-135.15 (1949); Kansas (boiler) KAN. STAT. ANN. §§ 44-901 to 44-911 (1964), (fire) KAN. STAT. ANN. 31-101 to 31-130 (1964); Kentucky (boiler) KY. REV. STAT. §§ 236.005-236.990 (1962), (fire) KY. REV. STAT. §§ 227.200-227.400 (1962), (plumbing) KY. REV. STAT. §§ 318.071-318.130 (1962); Louisiana (boiler) LA. REV. STAT. ANN. §§ 23:531-23:542 (1964), (fire) LA. REV. STAT. ANN. §§ 40:1561-40:1622 (1965); Maine (boiler) ME. REV. STAT. ANN. tit. 26, §§ 141-247 (1964), (electrical) ME. REV. STAT. ANN. tit. 30, §§ 2551-2560 (1964), (elevator) ME. REV. STAT. ANN. tit. 26, §§ 401-467 (1964); Maryland (boiler) MD. ANN. CODE art. 48, §§ 167-180 (1957), (fire) MD. ANN. CODE art. 384, §§ 1-14 (1957); Massachusetts (boiler) MASS. ANN. LAWS ch. 22, §§ 10-11 (1966), MASS. ANN. LAWS ch. 146, §§ 1-69 (1965), (electrical) MASS. ANN. LAWS ch. 143, § 36 (1965), (elevator) MASS. ANN. LAWS ch. 22, § 11A (1966), MASS. ANN. LAWS ch. 143, §§ 62-71 (1965), (fire) MASS. ANN. LAWS ch. 22, § 14 (1966), MASS. ANN. LAWS ch. 148, §§ 1-56 (1965), (plumbing) MASS. ANN. LAWS ch. 142, §§ 1-22 (1965); Michigan (boiler) MICH. COMP. LAWS §§ 408.751-408.776 (1967), (electrical) MICH. COMP. LAWS §§ 338.881-338.892 (1967), (elevator) MICH. COMP. LAWS §§ 408.351-408.374 (1967), (fire) MICH. COMP. LAWS §§ 29.1-29.75 (1967), (plumbing) MICH. COMP. LAWS §§ 338.901-338.965 (1967); Minnesota (boiler) MINN. STAT. ANN. §§ 183.375-183.62 (1966), (electrical) MINN. STAT. ANN. §§ 326.241-326.248 (1966), (fire) MINN. STAT. ANN. §§ 73.01-73.45 (1946); Montana (boiler) MONT. REV. CODES ANN. §§ 69-1501 to 69-1518 (1962), (fire) MONT. REV. CODES ANN. §§ 82-1201 to 82-1237 (1966), (plumbing) MONT. REV. CODES ANN. §§ 66-2401 to 66-2426 (1962); Nebraska (boiler) NEB. REV. STAT. §§ 48-701 to 48-718 (Supp. 1965), (elevator) NEB. REV. STAT. §§ 48-418.1 to 48-418.12 (1960), (fire) NEB. REV. STAT. §§ 81-501.01 to 81-541 (1966); Nevada (fire) NEV. REV. STAT.

building codes[11] although in each case certain categories of construction, such as one and two-family dwellings, are ex-

§§477.010-477.050 (1964); New Hampshire (boiler) N.H. REV. STAT. ANN. §§ 157-A:1 to 157-A:13 (1964), (elevator) N.H. REV. STAT. ANN. §§ 157-B:1 to 157-B:17 (1964), (fire) N.H. REV. STAT. ANN. §§ 153:1 to 153:26 (1964), (plumbing) N.H. REV. STAT. ANN. §§ 330:1 to 330:10 (1966); New Jersey (boiler) N.J. STAT. ANN. §§ 34:7-14 to 34:7-26 (1965); New Mexico (fire) N.M. STAT. ANN. §§ 4-16-1 to 4-16-39 (1966); North Carolina (boiler) N.C. GEN. STAT. §§ 95-54 to 95-69.2 (1965); North Dakota (boiler) N. D. CENT. CODE §§ 65-12-01 to 65-12-13 (1960), (electrical) N.D. CENT. CODE §§ 43-09-01 to 43-09-25 (1960), (fire) N.D. CENT. CODE §§ 18-01-01 to 18-01-33 (1960), (plumbing) N.D. CENT. CODE §§ 43-18-01 to 43-18-24 (1960); Ohio (boiler) OHIO REV. CODE ANN. §§ 4104.01 4104.99 (Page 1965), (elevator) OHIO REV. CODE ANN. §§ 4105.01-4105.99 (Page 1965), (fire) OHIO REV. CODE ANN. §§ 3737.01-3737.99 (Page 1954), (plumbing) OHIO REV. CODE ANN. §§ 3703.01-3703.99 (1954); Oregon (boiler) ORE. REV. STAT. §§ 480.510-480.990 (1967), (electrical) ORE. REV. STAT. §§ 479.510-479.990 (1967), (elevator) ORE. REV. STAT. §§ 460.05-460.155 (1967), (fire) ORE. REV. STAT. §§ 476.010-476.130 (1967), (plumbing) ORE. REV. STAT. §§ 447.010-447.140 (1967); Pennsylvania (boiler) PA. STAT. ANN. tit. 35, §§ 1301-1318 (1964), (elevator) PA. STAT. ANN. tit. 35, §§ 1341-1382 (1964), (plumbing) PA. STAT. ANN. tit. 53, §§ 4591-4669, 14791-14857 (1957); Rhode Island (boiler) R.I. GEN. LAWS ANN. §§ 28-25-1 to 28-25-18 (1956), (elevator) R.I. GEN. LAWS ANN. §§ 23-33-1 to 23-33-28 (1956), (fire) R.I. GEN. LAWS ANN. §§ 23-28.1-1 to 23-28.28-26 (1956); South Carolina (fire) S.C. CODE ANN. §§ 37-80 to 37-86 (1962); South Dakota (electricity) S.D. CODE §§ 31.04B01-31.04B06 (Supp. 1960); Tennessee (boilers) TENN. CODE ANN. §§ 53-2701 to 53-2724 (1966), (fire) TENN. CODE ANN. §§ 53-2401 to 53-2543 (1966), (elevators) TENN. CODE ANN. §§ 53-2601 to 53-2615 (1966), (plumbing) TENN. CODE ANN. §§ 62-1233 to 62-1246 (1955); Texas (boilers) TEX. REV. CIV. STAT. ANN. art. 52216, §§ 1-19 (1962); Utah (boilers) UTAH CODE ANN. §§ 35-7-5 to 35-7-9 (1953), (fire) UTAH CODE ANN. §§ 63-29-1 to 63-29-12 (1953), (plumbing) UTAH CODE ANN. §§ 26-15-1 to 26-15-8 (1953); Vermont (boilers) VT. STAT. ANN. tit. 21, §§ 141-152 (1967), (public bldgs.) VT. STAT. ANN. tit. 18, §§ 1301-1306 (1959), (fire) VT. STAT. ANN. tit. 20, §§ 2721-2727 (1959), (plumbing) VT. STAT. ANN. tit. 26, §§ 2171-2198 (1967); Virginia (boilers) VA. CODE ANN. §§ 59-227 to 59-235 (1950), (fire) VA. CODE ANN. §§ 27-55 to 27-88 (1964), (plumbing) VA. CODE ANN. §§ 32-406-32-410 (1964); Washington (boilers) WASH. REV. CODE ANN. §§ 70.79.010-70.79.330 (1962), (electrical) WASH. REV. CODE ANN. §§ 19.28.010-19.29-060 (1961), (elevator) WASH. REV. CODE ANN. §§ 70.87.010-70.87.900 (1962), (fire) WASH. REV. CODE ANN. §§ 48.48.010-48.48.130 (1962); West Virginia (boilers) W. VA. CODE ANN. § 21-3-7 (1966), (electrical) W. VA. CODE ANN. §§ 21-3-3a, 29-3-4a (1966), (fire) W. VA. CODE ANN. §§ 29-3-1 to 29-3-33 (1966); Wisconsin (boilers) WIS. STAT. ANN. §§ 101.01-101.30 (1957), (electrical) WIS. STAT. ANN. §§ 101.01-101.60, 167.16 (1957), (elevator) WIS. STAT. ANN. §§ 101.01-101.60 (1957), (plumbing) WIS. STAT. ANN. §§ 145.01-145.14 (1957); Wyoming (electricity) WYO. STAT. ANN. §§ 37-1 to 37-64 (1957), WYO. STAT. ANN. §§ 33-213.1 to 33-213.9 (1957), (fire) WYO. STAT. ANN. §§ 35-420.1 to 35-436 (1957).

11. California, CAL. HEALTH & SAFETY CODE §§ 18900-18917 (West 1964); Indiana, IND. ANN. STAT. §§ 20-416 to 20-434 (1964); New Mexico, N.M. STAT. ANN. §§ 67-35-1 to 67-35-63 (1953); North Carolina, N.C. GEN. STAT. §§ 143-136 to 143-143.1 (1963); Ohio, OHIO REV. CODE ANN. §§ 3781.01-3791.07 (Page 1954); Wisconsin, WIS. STAT. ANN. §§ 101.01-101.60 (1957).

cluded.[12] Four states have general building codes which are optional,[13] that is, the localities are free to adopt the state code or not at their election.

There is no federal code as such. The Federal Housing Administration (FHA) has a set of minimum standards, and the various agencies concerned with construction attempt to be as current as possible in drafting specifications for construction of federal facilities. Neither the FHA minimum standards nor any federal specifications, however, supersede any local code where the latter is more stringent.

There are also four unofficial codes of an advisory nature which are referred to as "national" or "proprietary" codes.[14] One of these is sponsored by the insurance industry, and the others by associations of building officials. These codes are kept up to date and are fairly widely adopted[15] both because of their high quality and because many municipalities lack facilities for writing a good code on their own.

According to a survey made in 1964 by the International City Managers' Association,[16] a small majority of cities with a population over 100,000, including New York, Los Angeles, Chicago, Philadelphia, Detroit, Houston, and Baltimore, write their own codes. A majority of cities under 100,000, on the other hand, adopted one of the so-called national codes. It should be observed, however, that many, if not most, of the cities adopting national codes have made changes from the model versions, or else the local versions are out of date, thus subverting any uniformity which might have re-

---

12. Indiana, North Carolina, Ohio and Wisconsin exclude one- and two-family dwellings and rural and farm buildings. Ohio also excepts three-family dwellings. California excludes public buildings, but these are covered by other regulations.

13. CONN. GEN. STAT. ANN. §§ 19-395 to 19-403 (1958); MINN. STAT. ANN. §§ 16.83-16.87 (1967); N.J. STAT. ANN. § 13:1B-7 (1968); N.Y. EXEC. LAW §§ 370-387 (McKinney 1951).

14. These are the "National Building Code," sponsored by the American Insurance Association, The "Uniform Building Code," sponsored by the International Conference of Building Officials, the "Basic Building Code," sponsored by the Building Officials Conference of America, and the "Southern Standard Building Code," sponsored by the Southern Building Code Congress.

15. Of slightly over one thousand cities surveyed by the International City Managers' Association in 1964, more than sixty per cent had adopted one of the national codes. INTERNATIONAL CITY MANAGERS' ASSOCIATION, MUNICIPAL BUILDING INSPECTION PRACTICES 14 (Information Service Rep. No. 241, 1964).

16. *Id.*

sulted.[17] Of the states with mandatory codes, four allow the localities to pass stricter regulations. North Carolina, however, requires that local improvements be submitted to the state officials for approval.[18] The state of New York, with its optional code, has a similar arrangement.[19] In addition, New York has a statewide appeals board, composed of members of the State Building Code Council, for hearing appeals from local decisions, thus providing a further measure of uniformity.[20] By mid-1965, nearly one-third of the municipalities in New York had adopted the state code.[21]

The main objection to having 5000 different building codes, or fifty different codes in a metropolitan area, aside from the fact that buildings essentially the same may have to be constructed differently and may cost substantially more in one municipality than in another, is that such widespread diversity impedes the progress of standardization and mass production in building construction, and furthermore increases the costs of design and bid-preparation. The problem is not necessarily that a local code prohibits such innovations as prefabricated assemblies, mechanical cores, pre-finished materials, or modular construction. It may be possible to get changes or variances in individual situations.[22] The problem is rather that diversity serves to discourage the widespread acceptance and use which is essential to the profiitability of a new product or enterprise.[23]

In order to promote a new product or method, the producer must secure approval from every code group which has jurisdiction over the area in which he wishes to do business.[24]

---

17. In the San Francisco area, although nearly all of the municipalities had adopted the Uniform Building Code, only 60% were using the latest edition. ACIR, *supra* note 4, at 70. In the Puget Sound Region, it was discovered that nearly 80% of the sixty cities and towns had adopted the Uniform Building Code. However, 22 different codes were being enforced, and of the municipalities adopting the UBC, one third had made local modifications, 70% were using an old edition, and there was little consistency in the amendments which were made locally. PSGC, *supra* note 4, at iii.

18. N.C. GEN. STAT. § 143-138(c) (1964).

19. N.Y. EXEC. LAW § 386 (McKinney 1951).

20. N.Y. EXEC. LAW § 381 (McKinney 1951).

21. ACIR, *supra* note 4, at 74.

22. *See* pp. 607-08, *infra*.

23. For a more thorough discussion, see ACIR *supra* note 4, at 3-4.

24. For a good general treatment and selective examples of the procedures for obtaining product approvals, see W. DEMAREST, BUILDING CODES: PRODUCT APPROVALS (1964).

This may involve getting approvals from the FHA, one or more of the national code organizations, state groups, and local code officials. The process of securing approval may be both costly and time consuming, since tests must be made, including tests by independent laboratories,[25] and the results submitted along with fees to cover the costs of the code body.[26] Of course, there is a great saving of effort, time, and money where a single code is used by a large number of localities. When a new product or method is accepted by the New York State Building Code Council, for example, that change is automatically effective in each of the member localities.[27] When the national codes accept changes, these changes are usually adopted as a matter of course by the participating localities, although in general some official approval at the local level is required by state law, and consequently, some localities may not get around to adopting the national code change.[28] In contrast to the situation in the United States, both France and England have established central agencies for testing and approval of new methods and materials.[29]

The time and expense involved in clearing a path through the codes for new products and methods, even at the local level, may be such that only the wealthiest owners and builders can afford to innovate.[30] When institutional obstructions to new products are added to the natural conservative tendency

25. *Id.* at 1-2.

26. The greatest cost of having to secure numerous product approvals, according to Sheldon Cady, is not the required fees but the time spent by sales personnel. Cady also criticizes reapproval fees. 9 ARCHITECTURAL & ENGINEERING NEWS, April 1967, at 29, 49.

27. N.Y. EXEC. LAW §§ 377(5), 378(3) (McKinney 1951).

28. *See* note 17 *supra.*

29. In France, the *Centre Scientifique et Technique du Batiment* issues seals of approval to materials meeting its test standards which are recognized in all of the major cities in France. In England, much the same process occurs. The French system appears to be preferable because more information is given along with the approval certificate as to the conditions under which the materials should be used. ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 31, 32, 64.

30. According to Paul Douglas, "The suppliers of housing construction materials include some giants, but it is essentially the smart builder who has to run the building code obstacle course and he cannot afford the high risks of experimenting with short cuts." Nat'l Comm'n on Urban Problems Press Release, Dec. 7, 1967. Indeed, William Tabler, president of the New York City Chapter of the American Institute of Architects, and a noted designer of hotels, reports having spent $100,000 appealing an adverse code ruling on a motel project in California. ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 46.

of preferences among consumers, architects, engineers, and builders,[31] the result is a building industry whose technological rate of change is considerably less than it might be.

Another problem, sometimes as serious as differences in the codes themselves, is variation in code interpretation.[32] Even where codes are written and enacted at the state levels, their administration and enforcement is left to the localities.[33] In many cases, the local officials will have to exercise discretion in approving or evaluating a method or material. Such situations are likely to increase as more codes tend to be "performance" oriented.[34] The statewide Board of Review in New York is one resolution of the problem of conflicting interpretation. Another solution might be to have administration and enforcement under state or county auspices,[35] although it still might be possible in the former case for decentralized units of the state authority to develop their own viewpoints on interpretation. A third proposal, advanced by the Advisory Commission on Intergovernmental Relations,[36] is that building inspectors be licensed and trained by the states. Today, building officials are not generally licensed as such, but many codes require that certain officials be registered as engineers or architects, or as some form of skilled artisan with a certain minimum number of years of practical experience.[37] This proposal, if enacted, would correct a number of deficiencies by introducing inspectors to new and varied practices and by weeding out unqualified persons. All of these proposed solutions assume a state

31. All of these groups tend to prefer the familiar, unless some new product is clearly superior and the old ones are clearly inadequate. Given this scale of preferences, the burdens of code approval may often sway the balance toward the familiar.

32. PSGC, *supra* note 4, at 11.

33. N.Y. EXEC. LAW § 383 (McKinney 1951).

34. A performance standard bases acceptability upon the functional performance of a material or method. This is contrasted with a specification-type standard which specifies the types, amounts, and sizes of acceptable materials. *See* p. 604, *infra*.

35. About thirty municipalities in both Los Angeles and St. Louis counties have inspection services provided by the county. ACIR, *supra* note 4, at 70.

36. ACIR, *supra* note 4, at 98-102.

37. Joseph Platzker, a former Buildings Commissioner of New York City, reports that he had discovered increasing professionalization in building departments across the country. ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 30. Douglas Parsons and the International City Managers' Association, however, report what they consider to be a low degree of professionalism. *Id.* at 43.

code.[38] Where the common code is one of the national advisory codes, schemes for statewide administration or review would not be workable unless such a code were adopted by a state itself.[39]

The proliferation of building codes is a direct result of reposing the power of enactment in the municipalities. This reposal follows from legal and political theories that the immediate duty of protecting citizens lay, under the rubric of the police power, upon the nearest unit of legal authority. However well that theory might work when applied to the regulation of traffic, sewers, sanitation, and parks,[40] it becomes dysfunctional when applied to the building construction industry, which is no longer, nor should it be, a purely local activity.[41] A basic premise of local regulatory authority is that the effect of local laws are confined to the boundaries of the authority.[42] But in the case of building codes, an industry stretching across the country and comprising 10 per cent of the gross national product is vitally affected by what operate as local trade barriers.

Apparently there is considerable feeling that municipalities have a vested right in promulgating local building codes.[43] However the classic doctrine on state-local relations has been

---

38. The International Conference of Building Officials, however, maintains that in making the suggestion for state licensing and training, not enough consideration was given to their educational programs, sponsored in cooperation with universities, to increase the professional knowledge and skill of building officials. International Conference of Building Officials, Newsletter, March 17, 1966, at 1.

39. This is actually done in the case of special codes. *See, e.g.*, FLA. STAT. ANN. §§ 399.01-399.14 (1960); HAWAII REV. LAWS §§ 184-1 to 184-16 (Supp. 1963); IND. ANN. STAT. §§ 20-632 to 20-664 (1964).

40. The Advisory Commission on Intergovernmental Relations identified fifteen services which municipalities were regularly called upon to perform. The commission then listed these services in the order of the appropriateness of local as opposed to regional control. In that order the services are: fire protection, public education, refuse collection and disposal, libraries, police, health, urban renewal, parks and recreation, welfare, hospitals and medical care facilities, transportation, planning, water supply and sewage disposal, and air pollution control. U. S. ADVISORY COMM'N ON INTER-GOVERNMENTAL RELATIONS, METROPOLITAN AMERICA: CHALLENGE TO FEDERALISM 33 (1966).

41. Lewis Davis, an architect and a member of the National Commission on Urban Problems, has stated that architecture is practiced on a national and international basis. ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26A, at 31.

42. *See* Smith v. Spring Garden Tp., 34 Pa. D. & C.2d 54 (York Co. C.P. 1964); Babcock & Bosselman, *Citizen Participation: A Suburban Suggestion for the Central City*, 32 L. & CONTEMP. PROB. 220, 226 (1967).

43. *See* B. KELLY, *supra* note 4, at 305.

that "Municipal corporations owe their origin to, and derive their powers and rights wholly from, the legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so it may destroy. If it may destroy, it may abridge and control."[44]

Even in states where some form of home rule obtains, there could be no persuasive objection to an optional building code promulgated by the state. In the case of mandatory state codes, as long as the state code purports only to be a set of minimum regulations upon which localities may improve, there should be little merit in the objection that any locality is being deprived of a vested right. Even where state approval was required of local variations of the state code, it would be difficult to maintain that there was any deprivation where the state agency applied a standard of reasonableness. If the state agency applied a stricter standard, however, it could be argued that the state's interest in uniformity outweighed the localities' interests in having unique building codes.

Furthermore, the vested right theory would impose no obstacle to a mandatory national building code under the authority of either the commerce clause or the general welfare clause of the Constitution. Were a code to be written by the national government, however, it would probably be advanced on an optional basis in deference to state and local sensitivities.

Finally, on general policy grounds, whatever right a municipality may be considered to have to regulate the construction of buildings within its jurisdiction, this right is outweighed by the public interest in having more uniform building codes. The general public would benefit more from a rationalized building industry than from the retention of local legislative prerogatives.[45] It should be pointed out, however, that these arguments do not necessarily apply to housing codes insofar as they regulate the condition and not the construction of buildings.

---

44. City of Clinton v. Cedar Rapids & Mo. River R.R., 24 Iowa 455, 475 (1868).

45. Of the "vested rights" theory, Kelly has stated ". . . new elements of public policy must enter the picture when the question is one of encouraging the national development of a top national industry supplying the most expensive product purchased by the average family. Clearly building regulation required a broader view. . ." B. KELLY, *supra* note 4, at 305.

In order to reduce the current confusion, the ACIR has suggested that the federal government sponsor the writing of an optional building code which could apply to every locality,[46] allowing for local geographical differences.[47] The supporters of this controversial suggestion include the Home Manufacturers Association,[48] the National Association of Counties,[49] and the National Advisory Commission on Civil Disorders.[50] Since the building industry plays such a significant part both in our national economy and in the budgets of private individuals, and since the diversity of building codes interferes with progress in the industry and with the developments of locally and federally-encouraged low-income housing, this suggestion is not unattractive. The arguments for a federal code are that such a code would lower construction costs, stimulate innovation, eliminate the burdens on localities of writing codes and keeping abreast of technological developments, be more universally up to date, and harmonize the uncoordinated approach toward the development of standards in the different industries.[51]

The objections[52] to a federal building code are threefold.

---

46. ACIR, *supra* note 4, at 89-91.

47. The fact that Canada has a national building code suggests that this would be feasible. NATIONAL RESEARCH COUNCIL OF CANADA, NATIONAL BUILDING CODE, N.R.C. No. 8305-A (1965). For a general description, see ARCHITECTURAL ENGINEERING NEWS, *supra* note 26, at 60.

48. *Id.* at 52-3.

49. 112 CONG. REC. 20, 420 (daily ed. Aug. 30, 1966).

50. NATIONAL ADVISORY COMM'N ON CIVIL DISORDERS, REPORT 480 (Bantam ed. 1968).

51. ACIR, *supra* note 4, at 90.

52. The reactions to suggestions for a national building code have been predictable. The National Chamber of Commerce opposed it for numerous and sometimes contradictory reasons. *See* CHAMBER OF COMMERCE OF THE UNITED STATES, BUILDING CODES (1963). The joint committees of the national advisory code groups suggested that the outcome of their efforts be accepted as the national code.

The American Insurance Association, showing perhaps a lack of solidarity with the other advisory code groups, suggested that its code be accepted as the national code. The National Association of Homebuilders and the American Institute of Architects have undertaken to write their own version of the national code. N.Y. Times, Dec. 4, 1967, at 29, col. 2.

Douglas Parsons, an observer well-versed in the intricacies of standards and codes, favors a continuation of progress along the lines of the current situation. D. PARSONS, BUILDING CODES AND THE PRODUCERS OF BUILDING PRODUCTS (1967). *Cf.* Thompson, *The Problem of Building Code Improvement*, 12 L. AND CONTEMP. PROB. 95, 110 (1947). The Republican Coordinating Committee issued a statement opposing a national code, apparently on general principles. 112 CONG. REC. 20, 420 (daily ed. Aug. 30, 1966).

First, a federal takeover or intrusion into the drafting of building codes should arguably be a last resort, because rights to local self-rule should be preserved insofar as possible, and if any consolidation of building codes is called for, it should be at the metropolitan or state levels. Secondly, rather than streamline the overall system, a federal code would subject the building industry to the toils of federal bureaucracy and actually act as a brake on progress.[53] Thirdly, there is objection by those who fear federal control over product approval, presumably on the grounds that discrimination at the federal level would be virtually irrevocable and that products could be blocked from distribution once and for all.[54] However rational it might be to have a federal building code, its advocacy may be pushing rationality beyond the point of political feasibility. Unless something like an epidemic of collapsing buildings occurs (which is improbable since a major complaint about codes is that they compensate too much rather than too little in the direction of safety,[55] the question of a federal building code is likely to remain academic.

Recently, there have been promising efforts toward code consolidation in the metropolitan areas of Denver, Atlanta, Detroit, San Francisco, Los Angeles, Miami, Cleveland, and Washington, D.C.[56] These efforts are commendable and no doubt will prove beneficial. However desirable such metropolitan codes may be, statewide codes would have several advantages. Not only would the geographical area of coverage be greater, but the state code could be more easily co-

53. CHAMBER OF COMMERCE OF THE UNITED STATES, *supra* note 52 at 6.

54. Howard Michner, manager of safety and engineering for the National Electrical Manufacturers' Association, has stated that although his organization favored completely the "National Electrical Code," a widely-used advisory code written by the National Fire Protection Association, it would not favor a code developed by a strictly federal panel because ". . . we don't feel that government people are completely knowledgeable to do this particular business." ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 62. What the NEMA would favor, apparently, is a code written much like Canada's national code, NATIONAL RESEARCH COUNCIL OF CANADA, *supra* note 47, by collecting standards representing the consensus of the directly concerned industries. This is currently what the United States of America Standards Institute (formerly the American Standards Association) does, though not on a scale large enough to constitute the compilation of an entire code. *See* ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 55.

55. Lehman, *Building Codes, Housing Codes and the Conservation of Chicago's Housing Supply*, 31 U. OF CHI. L. REV. 180, (1963).

56. ACIR, *supra* note 4, at 65-71.

ordinated with existing institutions of governmental authority. Metropolitan codes promulgated on a cooperative rather than an authoritative basis, on the other hand, may lack the teeth effectively to sustain the uniformity of their adoption or the original quality of their contents. The danger is that once written and adopted initially, the metropolitian codes are likely to be at the mercy of the various municipal legislative bodies. Even if a metropolitan code agency were to be established, it would probably lack substantive power to amend or modify the code short of having to submit any proposals for change to the individual municipal governments, at which point it would be hard to guarantee that the proposals would be adopted either promptly or at all.

Possibly the best prospects for consolidation lie with a general state building code.[57] There are already specific codes in forty of the states.[58] Nine of the states have general codes which are either mandatory or optional.[59] The same arguments which apply to the suggestion of a federal code would also apply, to a lesser extent, to a state code.[60] At the same time, the counterarguments would apply hardly at all.[61] Even if the alternative of state building codes were to be widely adopted, however, there would still be a need for the federal government to play a large role in the stimulation and direction of research and in the collation and formulation of data and standards.

III. UPDATING AND THE AMENDING PROCESS

The larger cities tend to write their own codes.[62] This

57. Thompson, *supra* note 53, at 104.

58. *See* note 10 *supra.*

59. *See* notes 11 & 12 *supra.*

60. The Advisory Commission on Intergovernmental Relations and the National Association of Counties, which advocated a model code sponsored by the national government, also advocated model codes sponsored by the state governments. ACIR, *supra* note 4, at 94-5; 112 CONG. REC. 20, 420 (daily ed. Aug. 30, 1966). The U. S. Conference of Mayors, in reaction to the Advisory Commission's proposals, issued its own proposal calling for state model codes. *Id.*

61. General state-wide codes would not violate the principals of federalism, would be less likely to become mired down in their administration by huge bureaucracies (*e.g.*, New York), and would not be as likely (or would not be seen to be as likely) to disrupt the markets for building products by arbitrary decisions as would a code drafted by the federal government.

62. Of approximately one hundred cities with populations greater than 100,000 polled in 1964, slightly over half wrote their own codes. INTERNATIONAL CITY MANAGERS' ASSOCIATION, *supra* note 15, at 7.

task is generally assigned to an *ad hoc* group rather than the agency which regularly has the job of code enforcement.[63] There are two basic reasons for such an arrangement. First, it will probably be possible to obtain more professional expertise by going outside the local administration to recruit draftsmen. Secondly, code writing can be subject to numerous pressures from which it may be desirable to isolate the city commission responsible for enforcement.[64] Many groups are interested in the provisions of a building code, including materials suppliers and manufacturers, general contractors, home builders, labor unions, architects, engineers, financial institutions, and owners of real estate.[65]

Perhaps it is superfluous to add that another interested group is the consuming public. But this group is probably the least articulately represented in the process of code drafting. Hearings held during the process of drafting are apt to include representatives of the groups mentioned above plus representatives from various municipal agencies. But if the public is represented in this process, it is mainly by coincidence. Part of the problem is that the public tends to be unaware of the ways in which it is affected by building codes.[66] But the public is very much affected, and there is a danger that code draftsmen, no less than other administra-

---

63. The job of writing a new code for New York City was assigned to a group at the Brooklyn Polytechnic Institute, which in turn enlisted the aid of professional firms in the city. Page, *N.Y.C.: A Code's Progress*, ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 66.

64. *See* Thompson, *supra* note 52, at 100-101. Some notion of the pressures inherent in code drafting may be gleaned from reports of the hearings before the New York City Council on the proposed new building code. For example, the new code was assailed by plumbers (both unions and contracting) as being too liberal, and by architects as not being liberal enough. N.Y. Times, Oct. 3, 1967, at 37, col. 3; *id.*, Oct. 12, 1967, at 66, col. 1. Another indication of the difficulties is that work on the new code was begun in 1962. The drafting was substantially completed in 1965. The code is still before the City Council.

65. Of these groups, perhaps the only one interested in reducing building costs is the homebuilders, since they are competing with other demands on the home buyers' resources. The large general contractor is not faced with the same problem since his bids for work will include any costs which he expects to incur together with what he considers an ample percentage for profit. With the other groups as well, higher building costs mean higher profits over the short run. Over the long run these groups might well benefit from lowered building costs as this would tend to expand the scope of the markets. The representatives of the various groups may not, however, see things this way. *See* Loevinger, *Handicraft and Handcuffs: The Anatomy of an Industry*, 12 L. & CONTEMP. PROB. 47-75 (1947).

66. B. KELLY, *supra* note 4, at 305.

tive agencies, may be prone to forget who their constituencies actually are.[67] This danger may be mitigated by the requirement of approval by the local legislative body, discussed below. Still, the local legislative body, like the code draftsmen, may be placed in the position of being a judge in an adversary proceeding in which the public does not participate as an adversary.

In both large and small cities, the state enabling legislation or local charter will require passage and amendment of the code in the form of an ordinance by the municipal legislative body. This requirement may, depending on the locale, impede timely and regular changes which are needed to take advantage of new methods and materials.[68] Legislative inertia can be cited as the principal foe of up-to-date codes. Legislatures often prove to be distracted from or unmotivated toward the less spectacular problems of building codes as opposed to matters which are seemingly more urgent, with the result that codes are neglected and become more and more outmoded.

There are three basic methods for relieving the bottleneck which may be imposed by legislative inertia and by which codes could be better kept up-to-date. These are (1) the mandatory periodic submission of suggested amendments by an authorized body concerned with revision, possibly the building appeals board;[69] (2) the passage of general health standards under which the building commission or some similar body is empowered to issue regulations which will achieve these standards, together, perhaps, with the requirement that changes in the regulations be "laid on the table" for a certain time with the local legislative body for its inspection and review;[70] and (3) the use of performance standards instead of material standards.[71]

The mandatory periodic submission scheme has been found to be necessary, although not in itself enough, to keep codes

---

67. *See* W. GELLHORN & C. BYSE, ADMINISTRATIVE LAW: CASES AND COMMENTS 1011-1012 (4th ed. 1960) and 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 103 (1958) on the 'captive agency' problem.

68. Joseph Newman of the Tishman Research Corporation claims that the biggest problem with building codes is amending them. Consequently, he favors local reform over a national code. ARCHITECTURAL & ENGINEERING NEWS, *supra* note 26, at 27.

69. Thompson, *supra* note 52, at 102.

70. C. RHYNE, *supra* note 8, at 10-11.

71. ACIR, *supra* note 4, at 55.

current,[72] and has been recommended for universal adoption by the Chamber of Commerce of the United States.[73] The responsibility for proposing amendments could lie with the building commissioner or with the board of appeals, if there is one. The vantage of the board of appeals may be especially suited for such a responsibility since a good many pleas for changes will come before it in the course of its business.[75] This would be even more true were the boards enabled to hear pleas from parties other than the owners and contractors on a particular project, such as materials suppliers and manufacturers.

The second scheme is that of having the legislative body pass general health standards under which the local building authority could promulgate the building code in the form of administrative regulations. This would avoid the primary bottleneck of legislative approval. On the other hand, it would subject the local building authority to all the pressures of code drafting,[76] in addition to the risk of capture by the factions which the authority was intended to regulate.[77] Furthermore, such a delegation would vest the building authority with considerable power with which the local legislative body might be reluctant to part.[78] Assuming that the local legislative body is willing to make the delegation, there is the problem of whether such a delegation would be allowed under the particular state constitution. It is one of the venerable principals of municipal law that although ministerial functions may be delegated, legislative functions may not.[79] The crucial question would be whether the general standards passed by the legislative body gave the building authority too much discretion.[80] Even with the more comprehensive municipal building codes, however, a

72. Thompson, *supra* note 52, at 102.

73. CHAMBER OF COMMERCE OF THE UNITED STATES, BUILDING CODES AND CONSTRUCTION PROGRESS 25 (1951).

74. BOSTON, MASS., BUILDING CODE, § 115 (1964).

75. Thompson, *supra* note 52, at 106.

76. *Id.*

77. *See* p. 601, *supra.*

78. Although New York City's proposed new building code originally provided for amendments to be made administratively by the Building Commission without recourse to the City Council, this provision was later scrapped. N.Y. Times, Jan. 6, 1968, at 21, col. 3.

79. Louisville & Jefferson County Air Bd. v. American Air Lines, Inc., 160 F. Supp. 771 (W.D. Ky. 1958).

80. Godshalk v. City of Winter Park, 95 So.2d 9 (Fla. 1957).

fair amount of discretion may be left to the building commissioner to issue regulations with regard to the use and installation of various materials.[81] It is very difficult to say where a clean line could be drawn between proper and excessive discretion which a court would be predictably willing to accept. Perhaps this problem could be eased if the state enabling legislation specifically allowed such a delegation. In neither case, however, is there any known example of this second scheme's having been tried.[82] The delegation problem might also be eased by a requirement that newly written regulations be "laid on the table" before the local legislative body for a certain period after which time they would become effective unless any objections were raised. Although this device probably would not be very effective as a means of legislative inspection, and courts might be inclined to view it as such, it may be particularly appropriate with regard to building code amendments. Non-controversial amendments would be incorporated into the code almost automatically, and controversial amendments could be discussed by interested parties before a body less partial to the amendment as written than would be the authority which wrote the amendment originally.

State codes are promulgated in the form of administrative regulations, and no legislative approval is necessary.[83]

The third scheme, that of using performance rather than specifications standards, is not exclusive of the other two, and should be utilized in any case. The difference between a performance and a specifications code is that the former focuses on functional requirements whereas the latter requires specific materials of specific grades and sizes.[84] The advantage of the former type of requirements is that it would leave a code open-ended as to the methods or materials which could be used. Any product or procedure would be acceptable so long as it performed its function properly.

---

81. *See, e.g.*, BOSTON, MASS., BUILDING CODE § 116(1) (1964).

82. *See* note 79 *supra*.

83. CAL. HEALTH & SAFETY CODE §§ 18900-18917 (West 1964); WIS. STAT. ANN. §§ 101.01-101.60 (1957).

84. For example, where a specifications code might say that floor joints must be made of lumber of grade B or better, and be no less than 1-5/8" thick and 7-5/8" deep, a performance code would say floor joints must be such as to maintain a floor loading of 3,200 pounds per square inch.

Although most authorities seem to be in agreement that performance codes are desirable,[85] some problems still remain. First, not enough knowledge is presently available for anyone to be able to write a complete performance code.[86] The processes and components of building construction have not been analyzed fully enough. Consequently, there is a scarcity of adequate standards by which to measure performance. Hundreds of different groups—including government agencies, trade and industry groups, and independent associations[87]—develop standards. Overall there is a considerable degree of effort duplicated as well as work conducted for conflicting and divergent purposes. Despite the general confusion, however, there appear to be several groups which in combination cover the building field, to the extent which present knowledge permits, and from whose resources designers, builders, and code draftsmen and administrators can draw.[88] This does not mean, however, that a manufacturer may not introduce a product to which no existing standards apply or to which he seeks to apply his own independent standards. There is generally no solution for the person trying to evaluate or compare products referenced to different standards.[89] Fortunately, each performance standard is

85. ACIR, *supra* note 4, at 51-60.

86. *Id.* at 58.

87. *E.g.*, the American Concrete Institute, Associated Factory Mutual Fire Insurance Co., American Gas Association, American Institute of Architects, American Institute of Electrical Engineers, American Institute of Steel Construction, Inc., American Iron and Steel Institute, American Institute of Timber Construction, Accoustical Materials Association, American Petroleum Institute, American Standards Association, American Society of Civil Engineers, American Society of Heating, Refrigeration & Air Conditioning Engineers, Inc., American Society of Heating and Ventilating Engineers, American Society of Mechanical Engineers, American Society of Sanitary Engineering, American Society for Testing Materials, American Uniform Boiler Law Society, Clay Products Association, Forest Products Laboratory, National Association of Home Builders, National Bureau of Standards, National Concrete Masonry Association, National Electrical Manufacturers Association, National Fire Protection Association, National Lumber Manufacturers Association, Structural Clay Products Institute, Steel Joist Institute, Underwriters' Laboratories Inc., United States Forest Service, and Wire Reinforcement Institute. The Building Officials Conference of America (BOCA) lists 117 accredited standards organizations, BUILDING OFFICIALS CONFERENCE OF AMERICA, BASIC BUILDING CODE 385-90 (1965).

88. These are the American Society for Testing Materials, the American Standards Association, the National Fire Protection Association, the American Concrete Institute, the American Institute of Steel Construction, the American Society of Mechanical Engineers, and the American Society of Heating, Refrigeration and Electrical Engineers.

89. Rosen, *Evaluation of Materials*, PROGRESSIVE ARCHITECTURE, December 1967, at 146.

useful in itself, and the lack of enough standards to cover the entire building field does not prevent the incorporation into a building code of as many performance standards as are available. Also fortunately, the problem of insufficient knowledge is not one which is caused or preserved by large institutional obstacles, and it is one which can be solved piecemeal by the numerous interested parties.

A second problem is that performance codes could place a greater burden on local building officials. By opening up codes toward greater acceptance of new materials and methods, building officials, some have suggested,[90] will be hard pressed to keep up with the pace of technological advance. On the other hand, once there is some consensus as to what tests and standards constitute adequate criteria of performance, it would seem that the demands of the officials would be less than are now required in the absence of consensus for product approvals and interpretation of "or equal" clauses, that is, clauses which permit the substitution of methods or materials not specifically mentioned in the code which can be shown to perform as well or better in a particular role than the items specifically mentioned.[91] What performance codes probably implicitly demand of building officials is a greater skill for interpreting test results, which may entail greater professional training. The burden of showing that a performance code standard is being met will still lie with the parties seeking approval. It will be their responsibility to submit data supporting the use of a product or procedure not already in general use and for which the local officials may have insufficient information.

Besides making codes more receptive to technological innovations, a study by the Building Research Advisory Board[92] has predicted that performance codes will have the further

90. ACIR, *supra* note 4 at 99.

91. Most building codes explicitly allow the use of materials or methods which, although not sanctioned by the code, can be shown to perform as well as or better than the materials and methods actually sanctioned. *See* pp. 607-08, *infra*. Charles Rhyne maintains that even where a code does not explicitly allow alternative methods or materials, such an allowance is implicitly in the code, and a failure by code officials to accept construction as good or better than that explicitly authorized would violate the test of reasonableness. C. RHYNE, *supra* note 8, at 37. Charles Thompson indicates that in actual practice, code officials may read in "or equal" clauses where it appears to them that the spirit of code is being observed. However, he suggests that it would be preferable that discretionary power which code officials exercise be made explicit in the codes. Thompson, *supra* note 52, at 105.

92. ACIR, *supra* note 4, at 58-60.

effect of identifying areas where further research and development are needed. It is also anticipated that although performance codes will be helpful in lowering construction costs, their impact will not be immediately visible. Other factors within the construction industry, such as the number and scale of contractors, the scale of operations, the transiency of the work and the work force, the allocation of functions between builders and subcontractors and between off-site and on-site work, the form of collective bargaining arrangements, jurisdictional disputes, and restrictive practices by both unions and suppliers all will continue to hold costs up.[93] Any incremental savings as a result of the use of performance codes will be extremely difficult to detect. Nevertheless, over the long run, performance codes, if widely adopted, should serve to lower costs by helping to rationalize the industry generally and by placing material selection and use on a more logical basis.[94]

In practice, codes are revised short of amendment, which requires legislative approval, by the devices of variances[95] and product approvals. Granting variances is usually a job for a board of appeals. The basic criterion for granting a variance is that hardship would be entailed from compliance with the code, and other measures could be taken which would assure safety and accord with the spirit of the code. The range of conditions which constitute hardship may extend from impossibility to unsuitability. Thus, a new product not sanctioned by the code could be utilized by employing the variance procedure if the product is demonstrably more appropriate for the purpose desired to be achieved than the sanctioned list of products, whose use, on the other hand, would cause the builder unnecessary trouble and additional expense. Variances, however, have no value as precedent and in no way affect the shape of the building code, although arguably it would be a denial of equal protection if variances were not granted to different builders in identical situations.

Product approvals, on the other hand, can be given by the local commissioner, and these do become an official part of the code. Opportunities to use this procedure usually occur

---

93. *Id.* at 42, 58-69.
94. *Id.* at 58-60.
95. These are similar to zoning variances, and at the municipal level, the same body may be responsible for issuing both code and zoning variances.

where the code allows the substitution of methods, materials, or assemblies which can be shown to be equally as good as or better than those prescribed by the code. The party applying for the product approval must submit data showing compliance with the applicable code standards, and then additional tests by independent laboratories will normally be required.[96] Sometimes the requirements for approval may be weighted, ostensibly in the interests of safety, against new products.[97] The primary reason for such conservatism is the difficulty of testing a product's or method's durability over a time equal to the normal life of a building. Consequently, there is a tendency to favor methods and materials which have been proven in actual use. Some localities require that a product for which approval is desired be incorporated in a building proposed to be constructed.[98] They may also restrict the parties who may apply for approval to the owner or builder.[99] The more common arrangement, however, is to allow applications for approval without regard to any particular building, and to allow materials manufacturers, as well as builders and designers, to apply.[100] This latter process is preferable since in many if not most cases it will be the manufacturers and suppliers who are most interested in getting a product approved. Then, if products can be approved prior to incorporation into building plans, it will be much easier to sell the product for the first time to the architects or engineers designing a particular project.

By the procedures of variances and product approvals, codes can be revised and made susceptible to the use of new methods and materials without recourse to legislative approval. The procedures do not, however, remove certain restrictive requirements or update obsolete standards which can be changed only by amendment. Still, they do provide a degree of flexibility which can be taken advantage of by those willing to endure a fair amount of trouble, expense, and lost time.[101]

Many smaller localities, lacking the facilities to write a good code on their own, adopt codes by reference to the vari-

96. W. DEMAREST, *supra* note 24, at 1-2.
97. *See* BOSTON, MASS., BUILDING CODE § 116(1) (1964).
98. W. DEMAREST, *supra* note 24, at 21.
99. CONN. GEN. STAT. ANN. §§ 19-395-19-403 (1958).
100. N.Y. EXEC. LAW § 328(3) (1951).
101. *See* note 30, *supra*.

ous national advisory codes.[102] This is done in about half the states, where there is either no requirement that newly passed laws be published in a newspaper or where that requirement has been removed for building and housing codes,[103] with the substitution of a requirement that a certain number of copies of the entire code be kept on file for the purposes of notice and inspection in the office of the local clerk. Since the national codes are several hundred pages in length, the expense of printing them in a newspaper may well be prohibitive. Some courts have held the publishing requirement to be only directory,[104] but usually codes adopted by reference without publication will be struck down where publication is required by the state constitution.[105]

Although there is generally no problem with the issue of delegation of authority in adopting a code written by one of the national organizations, so long as the title, name of organization, and year of issue of the code are clearly specified, there may be a problem if in the passage of the code, the municipality attempts to incorporate future amendments by the national organization. Were this attempted, it would probably be invalidated.[106] The enabling acts of some states allow the incorporation of future amendments;[107] however, these statutes have not yet been tested in court. The result of the non-delegation doctrine here is that the local codes at least trail behind the adoption of new provisions in the national codes, and there is a possibility that new provisions simply will not be passed.[108]

---

102. As a requirement for urban renewal financing, the locality must furnish evidence to the Urban Renewal Administration of a "workable program" one element of which must be an up-to-date building code.

103. For situations in which no publication was required, see Hollander v. Denton, 69 Cal. App. 2d 348, 159 P.2d 86 (1945); Paducah v. Ragsdale, 122 Ky. 425, 92 S.W. 13 (1906). For statutes revoking the publication requirement see, *e.g.*, ARK. STAT. ANN. § 19-2404 (1947); WASH. REV. CODE ANN. § 35-21-180 (1965).

104. *In re* City of New Rochelle, 46 N.Y.S.2d 645 (Co. Ct. 1943); People v. Thompson, 377 Ill. 104, 35 N.E. 2d 355 (1941).

105. City of Hazard v. Collins, 304 Ky. 379, 200 S.W.2d 933 (1947).

106. *Accord*, State v. Crawford, 104 Kan. 141, 177 P. 360 (1919); see, *e.g.*, Blitch v. City of Ocala, 142 Fla. 612, 195 So. 406 (1940); City of Cleveland v. Piskura, 145 Ohio St. 144, 60 N.E.2d 191 (1945).

107. NEB. REV. STAT. § 18-132 (1943); N.D. CENT. CODE § 40-05-01(1) (1960); WASH. REV. CODE ANN. § 35.21.180 (1965).

108. *See* note 17, *supra*.

Some localities have attempted to avoid the delegation problem by stating general health and safety standards in the form of an ordinance and adding that adherence to a given national code will be prima facie evidence of compliance with the local standards. Aside from problems of constitutional validity similar to those where a local agency might write the code in the form of administrative regulations,[109] this approach creates the further difficulty of inviting litigation and dispute over what practices are or are not reasonably in keeping with the standards.

IV. Conclusion

Building codes play an important role in an industry which, in turn, is central to the United States economy. As such, they should be the subjects of close scrutiny, particularly since their discrepant variety and rigid content act to constrict the markets and retard the pace of technological progress of that industry. The source of the trouble has been the fragmentation of authority to promulgate building codes. Power has been delegated by the states to thousands of different political entities, the municipalities. As long as power remains there, little appreciable change in the present situation can be expected. Building codes have been the subject of complaint and criticism since the 1920's.[110] Consolidation of the codes is needed, and probably the most feasible and efficient manner in which this could be done would be for the states themselves to promulgate either mandatory or optional general building codes. Were it to occur there would still be fifty different building codes, but this would be one hundred times fewer than exist now. Furthermore, once the states had assumed power over the enactment of building codes, the prospects for regional consolidation, which would be perhaps even more rational as far as the building industry is concerned, would be considerably enhanced.

Short of a reorganization of code-making authority, the quality and modernity of the municipal codes can be improved by various institutional devices coupled with a de-

109. *See* pp. 603-04, *supra.*

110. *See* Select Comm. on Reconstruction and Production, S. Rep. No. 829, 66th Cong., 3d Sess. (1921).

termination to overcome legislative inertia. Such devices as can be used are mandatory periodic submission of proposed amendments by the local code enforcement agency or board of appeals, the granting of maximum constitutionally permissible discretion to building officials to issue administrative regulations governing the building process,[111] and finally, the use of performance rather than specifications criteria to judge the acceptability of building methods and materials. For the smaller cities and towns in states without state codes, and in which building codes must be adopted by reference if there are to be building codes at all, the state enabling acts should be eased to allow adoption of such codes as are necessary without a requirement of publication of the entire code in a newspaper.

The needs for adequate living and working space are too critical in today's society to permit the continuation of unnecessary doctrinal and institutional constraints upon the process of building. The issues are less of policy than of the optimal organization of the regulatory scheme which governs building. Even the best resolution of these issues will not provide any revolutions in the field of building. But any significant reduction in the impediments presented by the current scheme of building codes would help considerably in clearing a path for a more efficient, responsive, and productive building industry.

*Ambrose M. Richardson**

---

111. *But see* note 71, *supra.*

* Member of the Class of 1969 in the Harvard Law School.