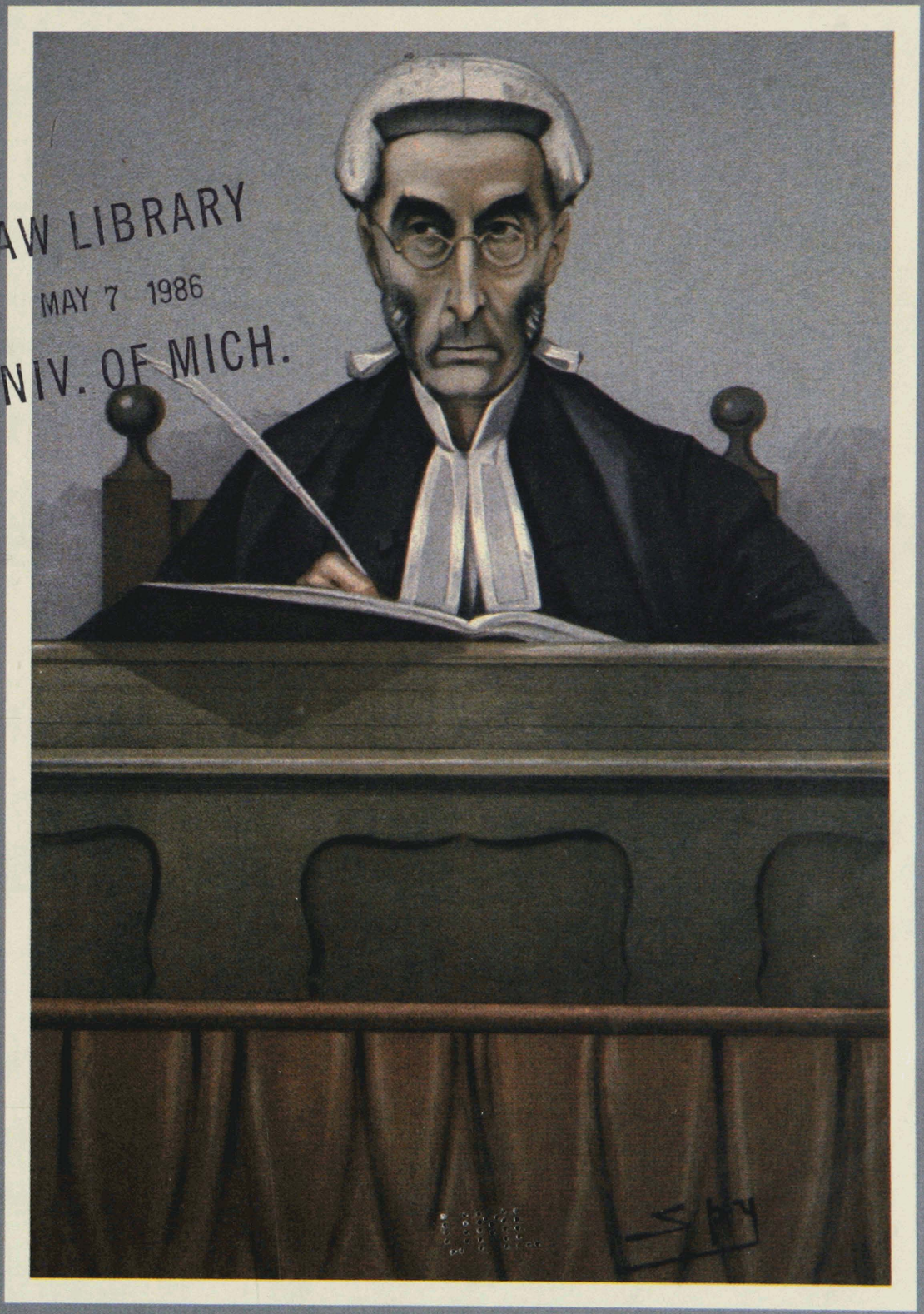
Law Quadrangle Notes

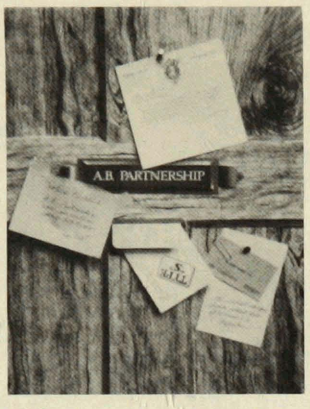
THE UNIVERSITY OF MICHIGAN LAW SCHOOL VOLUME 30, NUMBER 1, FALL 1985



Law Quadrangle Notes

THE UNIVERSITY OF MICHIGAN LAW SCHOOL VOLUME 30, NUMBER 1, FALL 1985

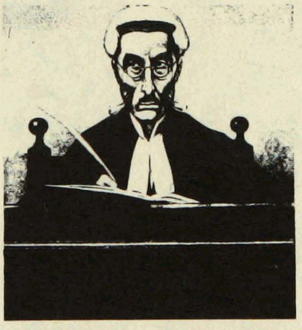
ARTICLES



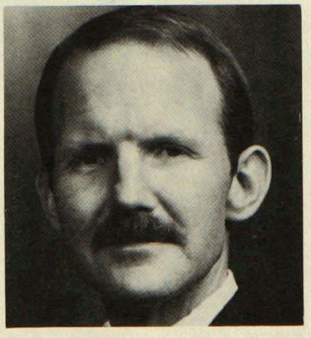
22

DEPARTMENTS

28



6



19 *James A. Martin*

Law Quadrangle Notes (USPS 893-460) is issued quarterly by the University of Michigan Law School. Second-class postage paid at Ann Arbor, Michigan. Office of publication: *Law Quadrangle Notes*, Law School, The University of Michigan, Ann Arbor, Michigan 48109-1215.

POSTMASTER, SEND FORM 3579 TO: Editor, *Law Quadrangle Notes*, Law School, The University of Michigan, Ann Arbor, Michigan 48109-1215.

Publications Chairman: Professor Yale Kamisar, U-M Law School; **Editor:** Bonnie Brereton, U-M Law School; **Graphic Designer, Illustrator:** Jennifer Spoon, U-M Office of Development and Marketing Communication; **Production Editor:** Carol Hellman, U-M Office of Development and Marketing Communication. **Photo Credits:** All photos by Gregory Fox, except photos on pages 2, 10, and 13, by Peter Yates; photo on page 7, by Bob Kalmbach; photo on page 12, by Harvard Law Art Collection; and photos on pages 17, 18, and 19.

Seats of honor

Vining, White occupy newly established chairs

Two distinguished faculty members, known for their contributions to the Law School's preeminence as a center for the humanistic study of law, have been named to newly established chairs at the School. Joseph Vining has been appointed the first Henry Burns Hutchins Collegiate Professor of Law and James Boyd White is the first L. Hart Wright Collegiate Professor of Law.

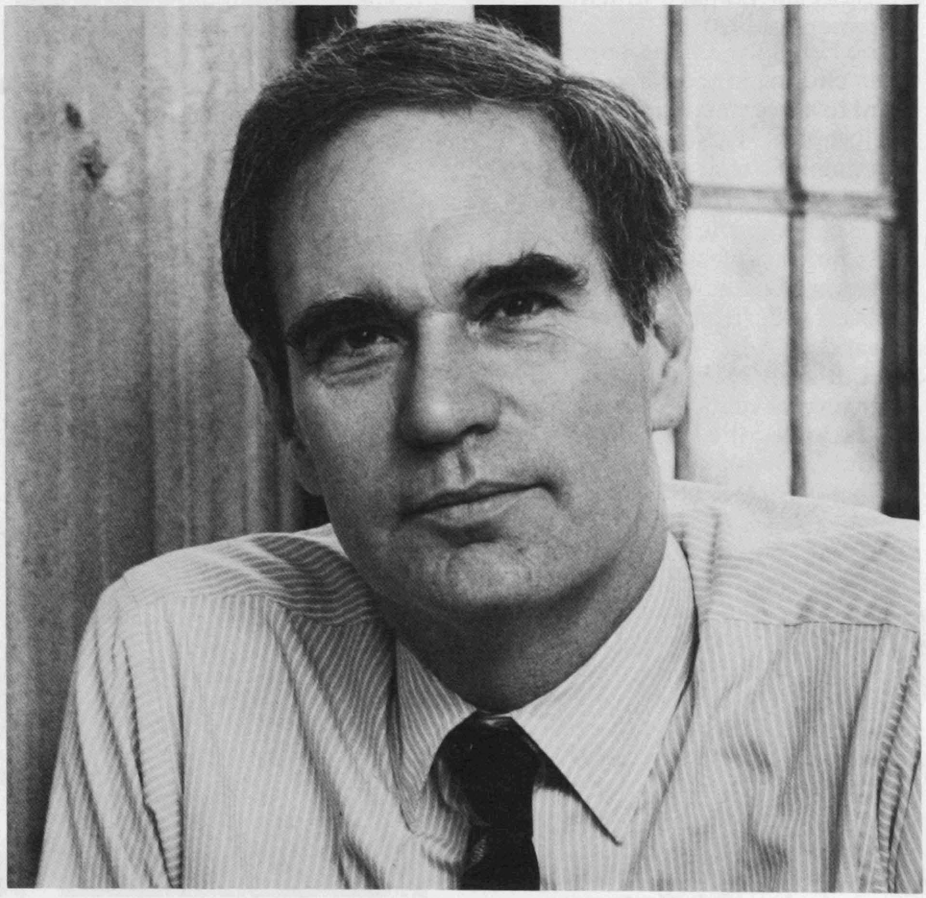
Joseph Vining has been a member of the Law faculty since 1969, and a full professor since 1974. He holds B.A.'s from Yale and Cambridge Universities, an M.A. in history from Cambridge, and a J.D. from Harvard. After completing law school, he served briefly as an attorney in the Department of Justice and thereafter as an assistant to the executive director of President Johnson's Commission on Law Enforcement and the Administration of Justice. In 1966, he entered private practice, where he remained until joining the Michigan law faculty.

Vining's latest book, *The Authoritative and the Authoritarian* (to be published this year), follows *Legal Identity* as the second in a series of studies of the phenomenon of personification in law and of the place that entities greater than the individual have in the working beliefs of (as he says) "the sophisticated as well as the simple."

His earlier book examined the nature of the persons who speak to courts or other sources of law, through an analysis of jurisdictional thinking in public law. His new work turns to the nature of the persons to whom legal arguments are addressed, and attempts to confront the professional dilemmas of practicing lawyers, which, he feels, are closely connected to the dilemmas individuals face today in seeking legitimacy and authenticity in their personal lives. Thus, *The Authoritative and the Authoritarian* is intended for an audience that extends beyond lawyers. Within the general framework of an inquiry into the consequences of the accelerating bureaucratization of courts, the book moves from the basic presuppositions of legal method to a consideration of law's distinctive institutional arrangements and the connections between law and other major disciplines, including even theology, the discipline most often omitted from modern discussions of law in the United States.

Vining's third inquiry in this series, which he is now beginning, is into the nature and function of conceived entities in commercial and corporate law, with particular attention to the responsibility and liability of organizations under the criminal law.

Dean Terrance Sandalow praised Vining's scholarship for reflecting "an unusual capacity to avoid confinement by conventional categories of thought and an ability to perceive significant intel-



Joseph Vining

lectual themes in what are often regarded as mundane areas of law and legal practice. The depth and unconventionality of his thinking about law have led to his becoming one of the School's most stimulating teachers." Vining currently teaches courses in enterprise organization, administrative law, and corporate criminality, and conducts a research seminar in legal method.

The professorship is established in honor of Harry Burns Hutchins, who joined the law faculty in 1884 as Jay Professor of Law. After serving for some years as the first dean of the Cornell Law School, he returned to Michigan in 1895 as dean of the Law Department. He held this post until 1910, when he was named president of the University, a position he retained until his retirement in 1920.

The Hutchins chair is supported by an endowment created pursuant to a testamentary gift of the late Joseph H. Parsons, J.D. '27, a prominent Detroit attorney.

James Boyd White has been professor of law, professor of English, and adjunct professor of classical studies at Michigan since 1983. He holds an A.B. from Amherst College and an A.M. (in English) and an LL.B. from Harvard University. After several years in private practice, he joined the law faculty at the University of Colorado. In 1975, he accepted a position at the University of Chicago, where he remained for a decade, until coming to Michigan. He is the author of several books, including *When Words Lose Their Meaning* (1984), which was recently awarded the Scribes Book Award by the American Society of Writers on Legal Subjects. The award is conferred annually for a book which demonstrates "a knowledge of the law and its role in the community, the equal administration of justice, respect for law and efforts at its improvement."

Throughout his career, "White has been a highly productive scholar with a consistent and original angle of vision," said Dean Sandalow. "In work after work, he has explored (and invited students to explore) the relationship of writer to reader, the relationship of language to culture, and, in the end, the relationship of all of these to the nature of law and the functions of lawyers.

"Professor White is not only a distinguished scholar, but a widely admired teacher. Among his many strengths are a deep interest in teaching students to write, the capacity to engage them in the effort, and the willingness to undertake the hard work required in assisting them."

The late Professor Wright, in whose honor the chair was established, served on the Law School faculty for 37 years, from 1946 until his death in 1983. He was a leading expert on U.S. federal and European tax procedures, who is best remembered as a distinguished and inspirational instructor. "Professor Wright gave the University his time, his energy, and his affection," said Sandalow.

Professor Wright earned an international reputation as a scholar of taxation. For his public service the U.S. Treasury Department awarded him the Civilian Meritorious Service Award, the highest civilian honor given by the government. Among other honors, he was named the Paul G. Kauper Professor of Law in 1979, and he received the University's Distinguished Faculty Achievement Award in 1968.

The professorship is to be supported by the income from an endowment established with gifts made by the alumni and faculty of the Law School and by the family and other admirers of Professor Wright. ◘

James Boyd White

Eclectic excellence

New faculty bring added diversity, expertise to Law School

Four new faculty members have joined the Law School this year: Leon E. Irish, William I. Miller, Mathias W. Reimann, and Joseph Weiler. In recent interviews, Professor Irish, a prominent Washington, D.C. tax lawyer, and Professor Miller, a specialist in Medieval literature and Icelandic blood feuds, discussed some of their ideas on legal education and their approaches to teaching. Professors Weiler and Reimann will be profiled in a future edition of *Law Quadrangle Notes* which will focus on Michigan's leading role in comparative and international law.

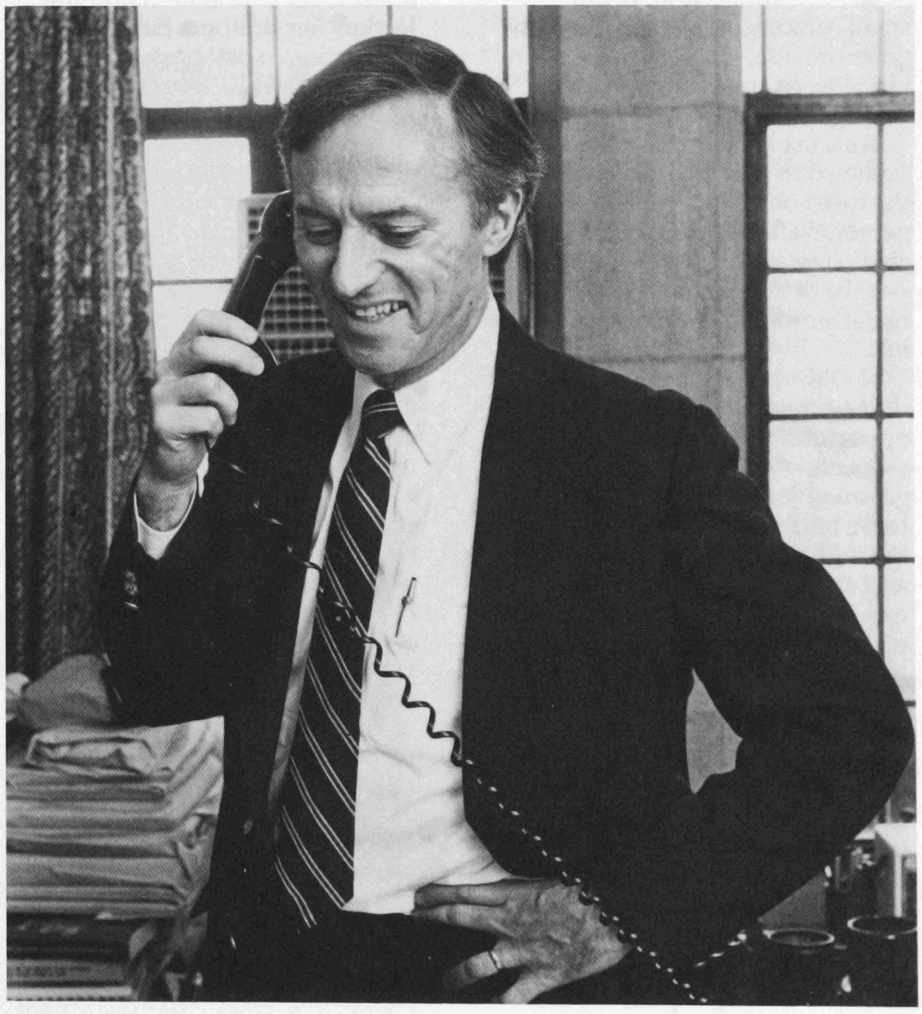
Leon Irish

Michigan graduate, prominent D.C. tax lawyer, international negotiator

Following a highly successful and satisfying career as a practicing attorney who helped build one of the country's most prominent law firms, Leon ("Lee") Irish (J.D. '64) has returned to his alma mater to begin a second career. For 17 years, Irish was associated with the Washington, D.C. firm of Caplin & Drysdale, Chartered, where he practiced federal tax law. Appointed this academic year as professor at the Law School, Irish states, "I have a real sense of completion about my law practice. Practicing law is just a hell of a lot of fun. But when I found that at mid-life, I still had the chance for another full career—especially the one I had originally intended to pursue—I couldn't turn it down."

Irish's loyalty to the Law School, his zest for new challenges, and his sense of rootedness in Ann Arbor, where he grew up, all contributed to his decision to join the faculty here. The difficult transition from the fast track of Washington to the more contemplative atmosphere of a university has been aided by the fact that his wife, Cally, an Episcopal priest, has been called to be the vicar of the Church of the Holy Cross in Saline, just outside of Ann Arbor.

Irish (who also holds the D. Phil. from Oxford) brings to the U-M a wealth of experience, not only in the area of tax practice, but also in the legislative arena, in international law, and in teaching. He has worked on every major federal tax bill in the past decade, represented the Secretary of Defense at the U.N. Conference on the Law of the Sea, and taught tax and legal philosophy as an adjunct professor at George Washington and Georgetown Law Schools for 10 years. He has also lectured widely on employee benefits subjects and played a leadership role in ABA activities.



Leon E. Irish

Urbane, dignified, and personable, Irish speaks with quiet—but unmistakeable—enthusiasm for his area of specialization. "Tax to me is the ultimate practitioner's field," he says. "In many ways it's the highest development of the law as a technical and intellectual subject. From a practitioner's point of view, it's tremendously exciting, not simply because the tax laws change all the time, but for more fundamental reasons. Tax law gets you into everything. Any human activity that people place value on winds up being taxed or exempted from tax. Consequently, as a tax lawyer, I've worked for individuals, corporations large and small, unions, museums, foreign governments, universities—all in the most amazingly diverse settings.

"As a tax lawyer, I was able to be involved in problems that went to the heart of a client's business or personal affairs. That's the ultimate challenge and reward for a lawyer —to be at the center of solving a major problem in another person's life."

Tax law, Irish feels, "is a tremendously creative field with endless opportunities for devising new ways of doing old things. You can get involved, as I did, in the legislative and administrative process through which the rules are made and changed, as well as in the more traditional areas of providing planning and advice for clients or handling their disputes. For all too many law students and lawyers, practicing law is principally analyzing words on a page. My own feeling is that nobody ought to practice law without a little better sense of how it gets made."

A former practitioner who has been involved in the pragmatics of law-making and dispute resolution, Irish employs techniques in his teaching that require students to explore problems from different points of view. "The task of the working lawyer is not to sit around and determine what is truth and justice, but to do the best he can for his client—whatever that turns out to be," he explains. "We only discover this, however, when we are required to dig deep to find the best that can be said for a client, regardless of our initial reaction or general predisposition."

Irish's extracurricular activities at the present time center around his role as chairman-elect of the largest committee in the Tax Section of the ABA (the Employee Benefits Committee) and his efforts as a representative of the Rockefeller Foundation and the Rockefeller Brothers Fund in attempting to establish a private foundation in Poland. The foundation would help revitalize the agriculture of that country, which is still predominantly conducted by independent farmers. "So far, Poland has agreed to be the first socialist country to adopt a statute permitting private foundations to exist," Irish explains. "Now we are negotiating with the Polish government over the terms of our foundation, which would seek to bring needed Western capital and technology to Polish agriculture." In addition, Irish serves as a director and vice-chairman of VITA (Volunteers in Technical Assistance), the oldest and largest private organization providing technical assistance in connection with Third World development problems.

"Tax is the most interesting way to practice law for a living," is how Irish sums it up. "My international efforts are a way to try to use my legal skills to address broader concerns and commitments. Whether it's Third World economic development or creating a more stable order in the oceans—there's a tremendous amount of work to be done by law and lawyers."

William Miller

Medieval Iceland specialist with an "irreverence for solemnity"

Although the Law School faculty is known for its eclectic interests and interdisciplinary approaches to the study of law, people are still surprised when they learn of William Miller's specialty. Professor Miller, who began a tenured appointment at the Law School this fall, developed an interest in Viking Age Icelandic blood feuds while attending law school, and continues to do research on the topic.

Miller's work, which draws upon the perspectives of law, history, literature, and anthropology, has shed new light upon medieval law as revealed through Old Norse sagas. "I'm interested in how people don't get along and manage to get on, in spite of it all," he explains. His writings grow out of careful linguistic analyses of medieval Icelandic and Old English texts. They deal with raiding and gift-giving as forms of exchange; the submission of disputes to arbitration; and the ways in which people attributed blame when crimes were committed secretly, recruited vengeance-taking expeditions, and went about deciding who their targets were to be.

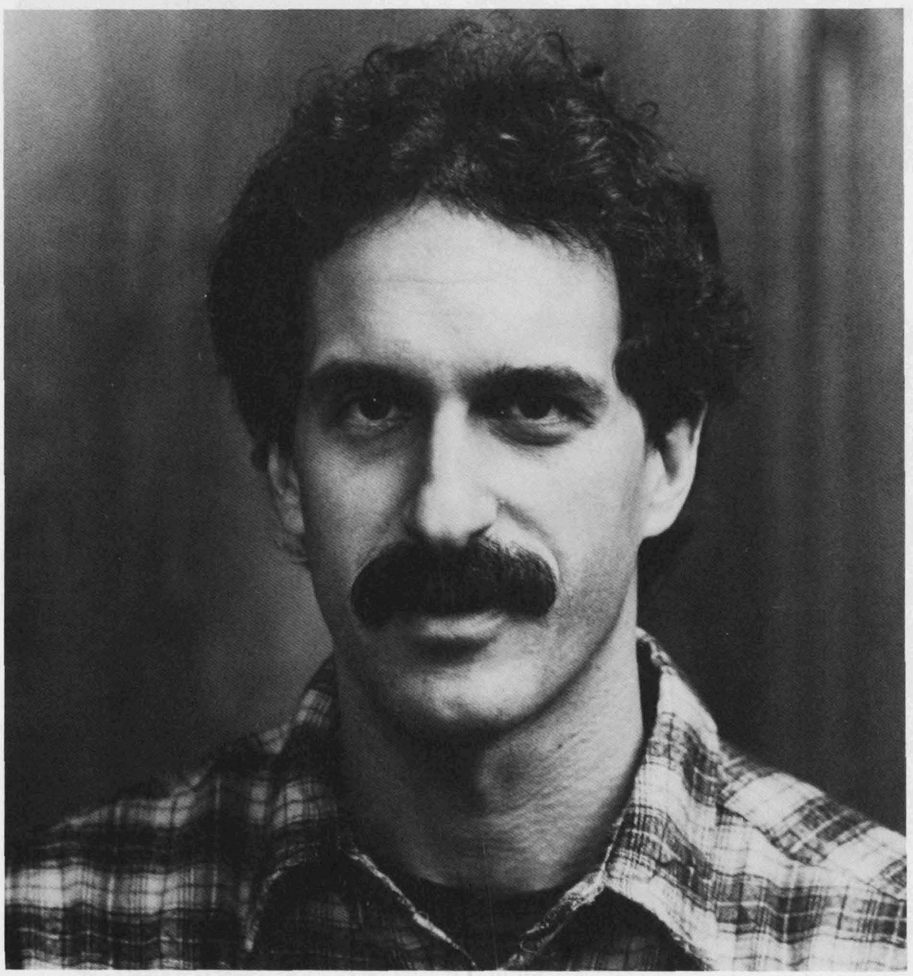
Miller received a B.A. in history from the University of Wisconsin in 1969, and a Ph.D. in historical linguistics from Yale University in 1975. He taught medieval literature at Wesleyan University while attending Yale Law School. Though he originally looked to a law degree to provide the professional security that was lacking in his academic specialty, he found law school to be an intellectually liberating experience. Suffering from post-dissertation despair—"every blank sheet of paper was a

personal threat"—Miller found new impetus to begin writing again through the study of law. "Having that new perspective and that new body of knowledge gave me a refreshing distance, as well as some new tools with which to look at the material I had studied before," he explains. "I had better things to say about what I had been working on for so long. My legal education made me a better questioner."

After completing the J.D. at Yale, Miller went to Madison, Wisconsin. There, he took the Wisconsin bar exam and went into practice briefly in a two-person firm. It took him about three months to realize he wasn't cut out to be a practicing attorney.

From 1981 to 1985, Miller taught at the University of Houston Law School. Last year he served as a visiting professor at Michigan, where student reaction to his classes was exceptionally enthusiastic. Both his teaching ability and his unusual skill in the analysis of texts caught the attention of the faculty and Miller was offered a tenured professorship.

"The wonderful thing about Michigan," Miller says, "is that they are very humane about giving you the latitude to pursue your research. You are encouraged to pursue scholarship that to some might appear unconventional, and to take the time to produce serious, thoughtful work. I like that." Miller enjoys teaching immensely, but admits that he may irritate some students with what he claims is a healthy irreverance for solemnity. His interest in the problems of textual interpretation makes him an important addition to the group within the faculty that is concerned with the relationship between law and language.



William I. Miller

Miller regularly teaches a seminar on blood feuds, and courses in trusts and estates and property. In the seminar, students closely examine translations of over a half-dozen Old Norse texts and compare these with evidence from other feuding societies.

The seminar, he feels, "teaches students how to look at the artifacts of another culture to reconstruct its ways of disputing, its ways of arguing, its legal structures. It teaches intellectual skills —how to deal with difficult source material, how to put it together in a meaningful way, how to ask hard questions or questions you never even thought of, how to read closely."

In his other courses, Miller says, he doesn't go out of his way to make connections with his special interest. "I teach traditional law in a relatively straightforward way," he explains. "But what I do emphasize is picking opinions apart. I try to get the students to figure out why the judge wrote the way he did—why the opinion takes the form it does. You can 'deconstruct' any opinion and show its underlying social and doctrinal assumptions."

"The one thing that higher education should do," Miller feels, "is to make people examine critically everything they hear, read, or say." ⊠

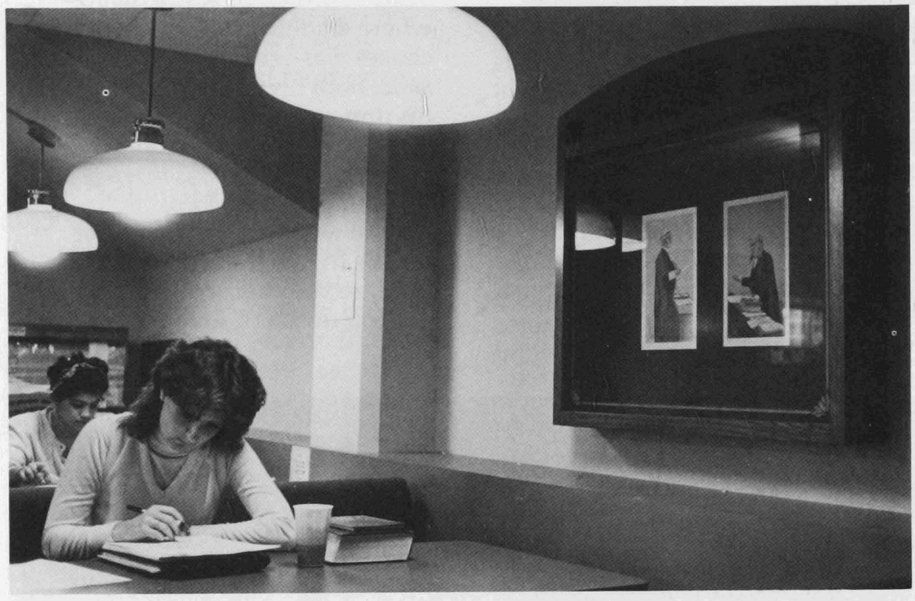
Cover stories: "Company law"

Spy prints add light touch to LQN, new student lounge

The cover of this issue of *Law Quadrangle Notes* features a reproduction of a colored print by "Spy" (Sir Leslie Ward), whose series of life portraits appeared on the cover of *Vanity Fair* between 1869 and 1913. "Company Law," as the print is called, was selected to herald the general theme of the two faculty articles in this issue, which deal with different facets of business law.

The famous "Spy" signature adopted by the London-born artist was derived from the dictionary definition, " . . . to observe secretly." The print is part of a collection formerly owned by the late Professor L. Hart Wright, and presented to the Law School recently by Mrs. Wright. In keeping with Professor Wright's wishes that the collection be displayed where it can be enjoyed by students, it is now housed in hand-made glass and wood display cases on the walls of The Bar, the newly opened student lunch room in the basement of the Legal Research Building.

The Bar is located in a site that was previously used as the faculty lounge, and before then as a cloakroom. Designed to provide a place where students and faculty can mingle, The Bar offers snack, sandwich, and beverage service in a pleasant ambiance of fresh but muted colors and soft lighting. Executed with tasteful simplicity, renovation of the former faculty lounge was completed this fall after a period of careful planning by a committee that included faculty, students, administrative staff, and an interior designer. ◘



Freshly prepared soup and sandwiches provide a welcome alternative to vending machine meals.

Replacement of plaster walls with glass between the graceful arches, a bold innovation of designer Marcia J. A. Reed, gives the room a more spacious feeling.

Conversing with Judge McCree

Special master guides Hughes case toward settlement

After nearly nine years of legal battles and over 10 million dollars in attorneys' fees, the Howard Hughes case was finally settled last spring with the active encouragement of Law School Professor Wade H. McCree, Jr. The former U.S. Solicitor General and federal judge had served as special master in the case since 1983. The special master's duty is to direct proceedings, take testimony, weigh evidence, and recommend a disposition to the Supreme Court.

The case centered on the question of Hughes's domicile. The eccentric millionaire, moviemaker, inventor, and pilot had owned numerous homes in various states and countries, and had spent his life commuting from one to the other. Ironically, even his death, in 1976, occurred in transit from Acapulco, Mexico to Houston, Texas, aboard a private plane that was transporting him for emergency medical treatment. With a multimillion dollar purse in inheritance taxes at stake, both Texas, where Hughes was born, and California, where he spent 40 years of his life, claimed Hughes as a legal resident. His estate argued for the selection of Nevada, a state whose laws do not provide for inheritance taxes.

The Hughes case, as a dispute between states, was one of those rare cases that fall within the original jurisdiction of the U.S. Supreme Court. In the vast majority of instances, the Supreme Court functions as an appellate body. It has original jurisdiction only in cases involving ambassadors, other public ministers and consuls, and those between two or more states. Because the number of cases falling within its original jurisdiction is so small, the Supreme Court, rather than maintaining a trial section, appoints a special master to serve as a trial judge in matters falling within that original jurisdiction. In the Hughes case, the parties involved had asked the Court to appoint a judge with experience on both the trial and appellate level. McCree's extensive background made him a natural choice.

Wade H. McCree, Jr.

Law Quadrangle Notes interviewed Professor McCree about his experiences as special master.

LQN: What was the primary issue that you were concerned with in this very complicated case?

WHM: The sole question I had to determine was what was the state of Hughes's domicile at the time of his death. The law doesn't say very much about this issue. A person's domicile is the place he regards as home—that is, what he *really* considers his ultimate home. This depends upon a number of manifestations, including where he votes, registers his automobile, pays property taxes, works, and so forth. A person who has as many residences and widely dispersed enterprises as Hughes did can pose problems.

LQN: What were some of the considerations in the Hughes case?

WHM: Hughes's father was an oil prospector who spent time in both Texas and California. When Hughes was born, his parents were in Texas, but they moved to California shortly afterward. If Texas was his domicile at birth, one of the first questions was whether he intended to change his domicile to California.

LQN: The first hearing was held here in the Law School's moot court room, wasn't it?

WHM: Yes, it was. That was in May of 1983. But that room was too

small to hold everyone comfortably. There were about 25 lawyers, a group from the press, and students. I wanted to be sure that students would be able to attend, so I arranged with District Judge Charles Joiner to use his courtroom in the Ann Arbor federal court building, and we held the next three sessions there.

LQN: If the case had come to trial, would you have held the trial in Ann Arbor?

WHM: I was really planning to hold it somewhere in Colorado, either in Denver or Boulder, because so many of the Hughes estate heirs, and likely witnesses, were elderly and would have had a difficult time traveling to Ann Arbor from the southwest. Colorado seemed an appropriate neutral site.

LQN: Did you play a role in encouraging the parties to reach a settlement without going to trial?

WHM: Yes. I believe strongly that parties should be encouraged to settle their own differences outside of court. If every dispute had to be litigated, there would be logjams of 10 to 15 years in most courts. Anyone concerned with the viability of courts has to favor alternate methods of dispute resolution.

LQN: What did you actively do to encourage a settlement?

WHM: Mediation is more an art than a science. The first thing is to get the parties to talk to one another amicably. Sometimes there's coaxing and cajoling. Each time I met with the two parties, I'd ask whether they had been talking to one another about the possibility of a settlement.

LQN: How responsive were the parties to your efforts to reach a settlement?

WHM: For over a year they didn't seem to be making any progress, and in June of 1984 it looked as though the case might go to trial. However, there was a significant breakthrough at this point. One side asked for 2,500 admissions of fact at one of the pre-trial conferences. Admissions are factual items of information about which there is no dispute. I told them that if there were 2,500 disputed facts that touched on the ultimate determination, both sides would run a great risk. Almost on the week that the trial was scheduled to begin, I received a call informing me that the lawyers had worked out a formula according to which each state's chances of prevailing were reduced to a certain percentage of what a favorable verdict would provide. They were willing to compromise their differences proportionally, based on those figures.

LQN: How did the heirs feel about this arrangement?

WHM: The estate derived a definite advantage because there could be an immediate distribution to the heirs without review by the Supreme Court of a proposed decree to which any aggrieved litigant could, and doubtlessly would, take formal exception.

LQN: How was your compensation determined?

WHM: I was paid on an hourly basis, which would have resulted in a considerably higher total amount if the case had been tried. Nevertheless, it was in the best interest of the litigants and the court for the case to be settled, and it was appropriate to put those interests ahead of mine. ◘

Forty-one companies that provide temporary services, together with the National Association of Temporary Services, have honored the memory of Cedric A. Richner, Jr., J.D. '55, by establishing a scholarship fund for law students in his name. Mr. Richner was executive vice-president and general counsel of Kelly Services, Inc. at the time of his death, January 28, 1985. Terance A. Adderley, at left, president and chief executive officer of Kelly Services, presented the Association's check for nearly $30,000 to Dean Terrance Sandalow to start the fund. Also shown are Mrs. Cedric A. Richner, Jr. and A. A. Agnello, executive vice-president of the firm. Gifts previously received from friends of Mr. Richner have been added to the new scholarship, and additional gifts will, of course, be welcomed.

Family Law—what next?

ACLS grant enables Schneider to study context of change, implications for the future

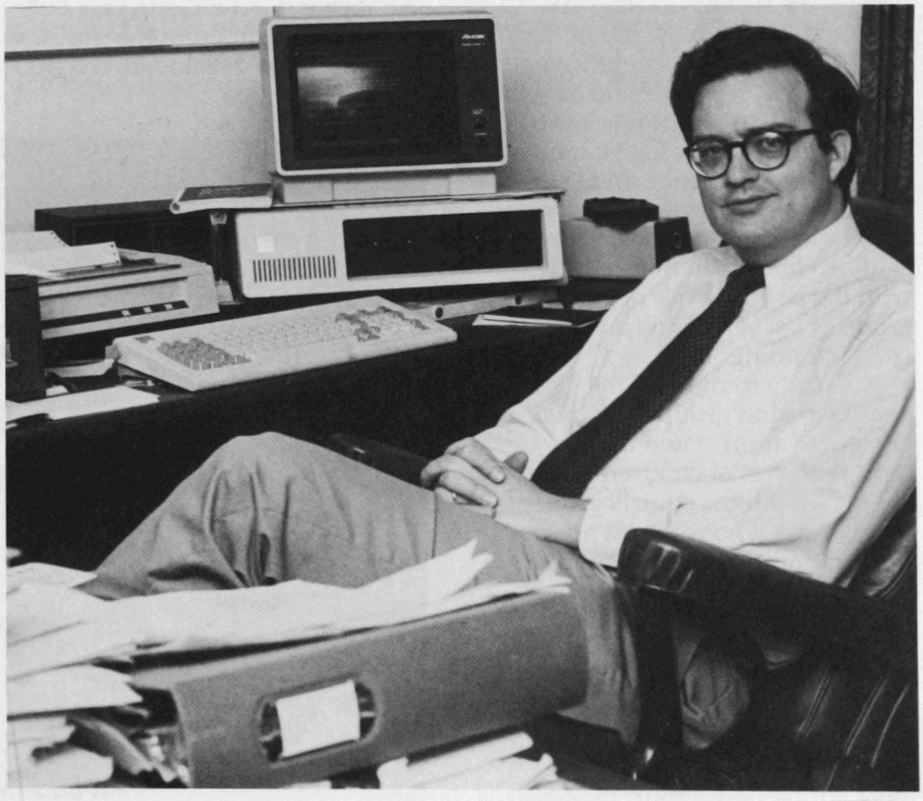
"No area of law deals more regularly and closely with moral problems than the law of the family," observes Michigan's family law specialist, Carl E. Schneider. However, during the last two decades, Schneider notes, "both legislatures and courts have tended to eliminate moral language and purpose from their discourse and to transfer moral deliberation and responsibility to families." Schneider feels that this transformation raises questions of considerable magnitude and scope, which he is exploring with the aid of a fellowship from the American Council of Learned Societies. The grant will enable Schneider to continue the work he began while on leave from the Law School during the first semester of the 1985-86 academic year.

Among a number of causes for the transformation of family law in the last twenty years, Schneider explains, is the rise of what Philip Rieff calls "therapeutic man." Schneider feels that our increasing tendency to think and talk about ourselves in psychological terms has influenced legal discourse in general, as well as the very substance of family law. For example, Schneider said, "therapeutic man seeks to discover the 'true self' concealed by social roles. Family law has sought to eliminate reliance on social roles by eliminating presumptions based on gender and illegitimacy and by requiring more elaborate hearings to discover the facts of a particular case. Again, therapeutic man assesses commitments to people, community, and creed in terms of their ability to promote his psychic well-being; and he consequently prefers 'non-binding commitments.' Family law recognizes non-binding commitments through such doctrines as no-fault divorce and its tendency to see families as collections of individuals rather than social units."

In Schneider's view, this description of the context of the transformation of family law raises questions about the assumptions underlying the transformation of family law. He asks, "What assumptions does that transformation make about the possibilities of resolving family problems fairly without considering the moral relations between the people involved? What assumptions does it make about the possibility of writing family law without making moral decisions? What assumptions does it make about human nature and the extent to which some regulation of family behavior is necessary?

The final questions of Schneider's study will be to ask whether a liberal, secular, pluralistic, individualistic society can be a moral community and whether a society can prosper which is not a moral community.

Schneider, an associate professor at the Law School since 1981, has taught courses and written numerous papers on family law, abortion, and neonatal euthanasia. He received his J.D. at Michigan in 1979 and his B.A. from Harvard (in history) in 1972. ◘



Carl Schneider

GAL training—it works

Child Advocacy Clinic lauded for outstanding research

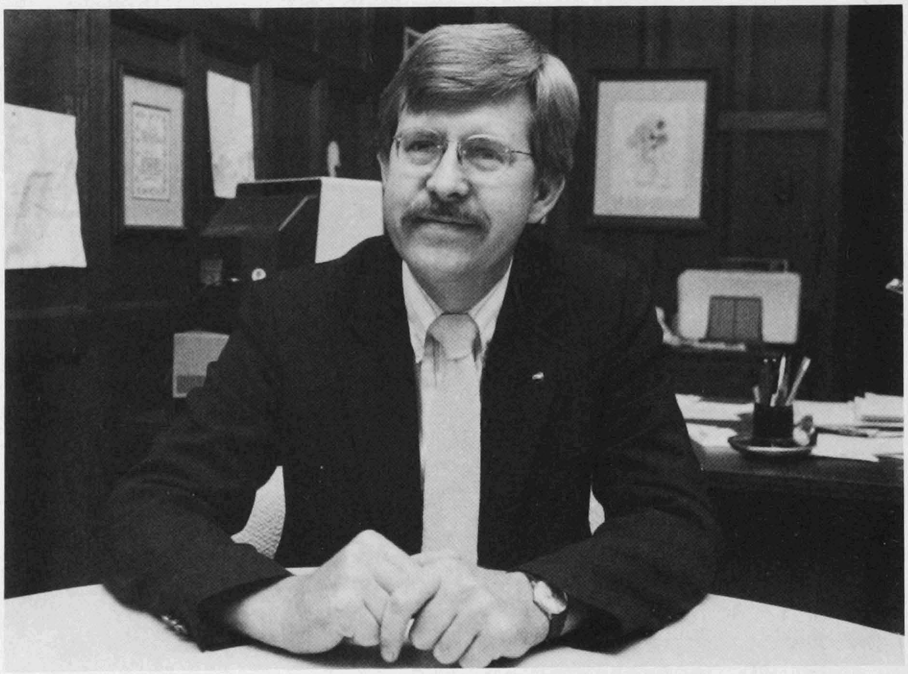
An ongoing study by the Law School's Child Advocacy Clinic of the effectiveness of guardian ad litem (GAL) services has been recognized as outstanding research by the National Court Appointed Special Advocate Association. The study, which began in 1982, is headed by Professor Donald Duquette, the founder and director of the clinic since 1976, and was described in the Spring, 1984 issue of *Law Quadrangle Notes*.

Partially funded by the federal Department of Health and Human Services, the research project sought to establish solid, empirical data on the results of using specially trained counsel, rather than court-appointed attorneys to represent children in the child abuse and neglect cases that reach the juvenile courts. The Clinic trained lawyers, law students, and lay (non-lawyer) volunteers, and compared their performances representing children in these cases with the performance of a control group of lawyers who had no special training.

The study found that the demonstration group of trained personnel approached their representation of children differently than did the control group of attorneys who received no special training. The demonstration groups spent more time on their cases, talked to more people, relied on more pieces of information, took more steps to mediate the court dispute, saw their role as more important to the ultimate outcome of the case, and were more critical of the court process and the other actors in the process. The demonstration groups were significantly more likely to engage in follow-up activities between hearings. Although the demonstration groups differed significantly from the control group on many measures of the process of representing the children, there were very few significant differences among the three demonstration groups—indicating that the law students, lay volunteers, and trained lawyers performed very similarly in their representation of the children.

The study's data indicate that the differences in the process of representing the children resulted in significant differences in case outcomes. Eight different measures of outcome were developed, relying on the court records of each case. According to the data, the court process was accelerated for cases handled by the demonstration groups. Demonstration cases were resolved in fewer days, with fewer court hearings. More demonstration cases were diverted from the court process at the first hearing (i.e., the case was dismissed) but once a child was made a ward of the court, there were significantly fewer dismissals among the demonstration groups compared with the control. Demonstration cases resulted in more specific placement orders, more visitation orders and more treatment/assessment orders.

While many significant differences were found between the control and demonstration groups in case outcome as well as case process, there were no significant differences among the the demonstration groups of law students, lay volunteers, and trained attorneys on the outcome measures. ⊠



Donald Duquette

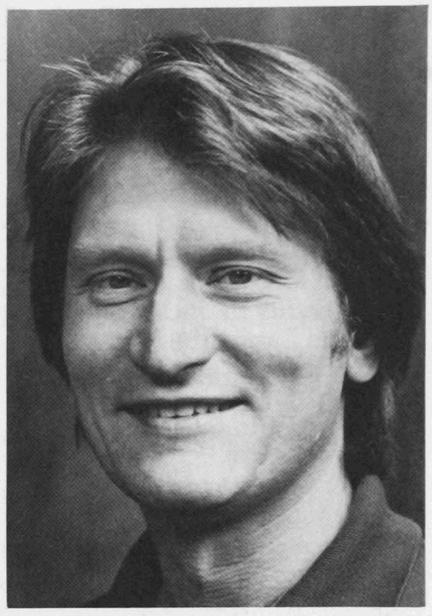
What is the good?

Regan receives Guggenheim to pursue philosophical studies

A respected legal scholar who is also an important moral philosopher, Donald H. Regan has been awarded a Guggenheim Fellowship for the year 1985-86. Regan, who holds joint appointments in the Law School and the philosophy department, describes himself as a consequentialist in his philosophical views about ethics and politics. "I believe that in the final analysis, the rightness or wrongness of acts or of social institutions is to be judged by the goodness or badness of their consequences," he explains. His first book, *Utilitarianism and Co-operation*, won the prestigious Franklin J. Matchette Prize of the American Philosophical Association for 1979-80. In it he explored strategies for promoting the good by asking what criteria ought to be used in judging individual acts.

Regan's current work focuses on the question of what ends moral action should promote. His view, which is highly eccentric by present standards, has roots in Plato, Aristotle, Kant, and G. E. Moore. "The question what is the good turns out to be effectively equivalent to the question what sorts of activity by rational and moral agents are intrinsically valuable," he explains. "And the activities which are in fact intrinsically valuable can be subsumed under the general headings of knowledgeable appreciation of the natural world and unifying relationships between people."

A 1963 graduate of Harvard in mathematics, Regan received his LL.B. from the University of Virginia in 1966. He received a B. Phil. in economics from Oxford in 1968, and began teaching at the Law School that same year. While teaching courses in the Law School, he was enrolled as a student in the philosophy department which awarded him the Ph.D. in 1980. ◘



Donald Regan

John P. Dawson

Distinguished U-M alumnus and former teacher dies

by George E. Palmer

Jack Dawson died the other day after a long and distinguished career as a law teacher. He was a member of the Michigan Law faculty from 1927 to 1957, when he left to join the faculty of the Harvard Law School, from which he retired in 1973. But he remained active as a teacher, for he continued to teach until 1981 at the Law School of Boston University and to publish important articles on contracts and restitution.

Through all these years he maintained close ties to Ann Arbor and the University of Michigan Law School. In addition to occasional service as a visiting professor, he gave the Cooley Lectures in 1959, out of which grew his book, *The Oracles of the Law*, published by the Law School nine years later.

In the 1930s, much of Jack's writing was concerned with the effect of circumstances that distorted the agreed exchange under a contract, such as fraud (31 Mich. L. Rev. 591, 875, 1933), inflation (33 Mich. L. Rev. 171, 706, 852, 1935), mistake (20 Minn. L. Rev. 481, 1936), and duress (11 Tulane L. Rev. 345, 12 *id.* 42, 1937). His writings disclosed a bent for comparing our law with foreign law; thus, his study of the effects of inflation dealt with the period 1861-1879 in the United States and the period 1914-1924 in Germany. (Frank Cooper was co-author of the United States study.) And his 1937 study of duress, which was concerned with the laws of France and Germany, was followed by his seminal article on the Anglo-American law of economic duress, in 45 Mich. L. Rev. 253 (1947), as well as his study of

duress through civil litigation in 45 Mich L. Rev. 571, 679 (1947). (The completion of these articles was delayed for many years because of his government service during the Second World War.)

Soon after his arrival on the Michigan faculty Jack began to teach a course in restitution, although for several years it was called "Equity III, including Quasi-Contracts," and this led to the publication in 1939 of his casebook on restitution. This was by far the most successful integration of law and equity up to that time. Quasi-contract and constructive trust were brought together and their common elements explored to an extent never before achieved.

John P. Dawson

Walter Wheeler Cook had pointed the way in a 1924 casebook, but the effort of the Restatement of Restitution in 1937 was disappointingly inadequate. The publication of Jack's casebook was an event of major importance in the development of the American law of restitution. (I refer to this as Jack's casebook because it was his work, a fact I learned only from Edgar Durfee, who told me that his contribution was one footnote. It was in character that Jack never mentioned this to me, although we both taught from the casebook for many years. Their original plan was for Edgar to prepare a first volume on equity, followed by the volume on restitution. That is why the casebook has the puzzling title, "Durfee and Dawson, Cases on Remedies II, Restitution at Law and in Equity," puzzling because volume I had not been published and never was published as planned. Edgar had prepared mimeographed materials for this volume, they were put to classroom use in this form for many years, but a serious illness interrupted his work and by the time he might have produced a hard-cover edition, the Law School had eliminated separate courses in equity. I should add that, while the casebook was Jack's work, his intellectual debt to Edgar Durfee was very great, as he acknowledged many times.)

Jack was one of the finest legal scholars of his time; in private law he had few if any equals. His interests ranged widely and every area of law that he entered he also mastered: equity, contracts, English legal history, comparative law, and above all, restitution. I first came to know him well when for about a year we worked together in the Office of Price Administration in Washington during the Second World War. When I came onto the Michigan faculty shortly after the end of that war I soon began to develop an interest in restitution. Jack helped me immeasurably, especially by offering perspective, for this was one of his great gifts: he was a generalist who also had worked carefully and accurately through the details of the matters he constantly sought to put in perspective. His Rosenthal Lectures of 1950, published as *Unjust Enrichment, A Comparative Analysis* (1951), gave a needed perspective on the American law of restitution. They also exemplified his belief that writings on comparative law are most useful when they compare the workings of different legal systems dealing with the same set of problems. This continued to characterize many of his articles as well as his later book: *A History of Lay Judges* (1960), *The Oracles of the Law* (1968), and *Gifts and Promises, A Comparative Study* (1980).

My knowledge of Jack as a law teacher is second-hand, but the reports bear out what I would expect, that he was superb. Given his knowledge, his warmth and his proper mixture of compassion and tough-mindedness, he surely left a mark on generations of law students.

Jack had a genius for friendship, which must somehow be a reflection of his virtues as a human being. His was a life that helped to define what life should be. ⊠

Professor Emeritus George E. Palmer received the J.D. from Michigan in 1932 and the LL.M. from Columbia in 1940. After several years in private practice and a period with the Department of Justice, Palmer taught at the University of Kansas. He taught at the Law School from 1946 until his retirement in 1978. He is the author of Mistake and Unjust Enrichment, Cases on Trusts and Succession, Cases on Restitution *(with Dawson), and* Law of Restitution.

The low-down on Capitol Hill

Congressman Conable is DeRoy Fellow

From 1964 to 1984 Barber B. Conable, Jr. brought to the deliberations of the United States House of Representatives the traditional Republican values cherished by inhabitants of the small towns of western New York State. During most of that 20-year period he served on the Ways and Means Committee and was the ranking minority member of that powerful body for his last eight years in office.

In September, Conable, who retired from public office last year, visited the Law School for two tightly scheduled days to share some of his insights on the machinations of Capitol Hill law-making and law-makers. Conable's visit was supported by the most recent in a series of DeRoy Fellowships initiated in 1980 to bring public officials and renowned lawyers to the School. The fellowship is supported by an endowment established by the trustees of the Helen L. DeRoy Foundation: Leonard H. Weiner (J.D. '35), chairman of the board; Gilbert Michel; and Arthur D. Rodecker.

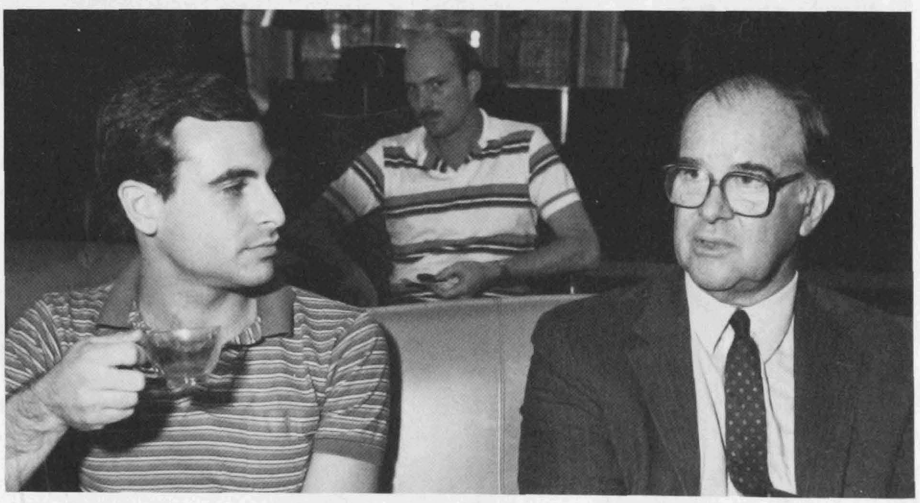
Conable, respected for his ability, integrity, and high standards by members of both political parties, first ran for public office in 1962, when he won election to the New York State Senate. A graduate of Cornell University and the Cornell Law School, Conable had practiced law for over a decade in upstate New York, served two tours of duty with the Marine Corps, and taken an active role in local Republican politics before running for office.

Since retiring from public office, Conable has maintained a schedule at least as full as the one he followed in Washington. He is now a part-time professor of political science at the University of Rochester, an editorial writer for *U.S. News and World Report*, senior fellow at the American Enterprise Institute in Washington, and a member of the board of directors of the New York Stock Exchange as well as of several multinational corporations and foundations. When asked why he chose to retire from public office, he replied, "I'd been there 20 years—that's long enough."

During his visit at the Law School, Conable visited classes on partnership tax, the Congress, legislation, international trade, and others. He also met informally with students and faculty for meals each day. A loquacious, articulate, and colorful speaker, Conable described to the legislation class in rich, witty detail, embellished with a wealth of anecdotal material, the context in which the widely-discussed tax reform bill would eventually be written. In each class and informal session, he displayed a wealth of knowledge about both the technical and the personal aspects of legislation. He explained later, "Students tend to find the Congress inscrutable. The whole process is affected by the people who are engaged in it, so I try to give the students some understanding of these people—the individual legislators and their idiosyncracies."

Referring to himself as "a loyal party hack," Conable nevertheless spoke with irreverence of several Republican leaders, including President Reagan, whom he frequently referred to as "the high priest." Conable criticized Reagan for playing the role of politician rather than statesman, by "following the old FDR concept of never ceasing to campaign."

When asked his observations of students at the Law School, Conable replied, "There are obviously students with political stirrings here. They're idealistic, and less skeptical than the students of the past." Today's students, he observed, are willing to draw as much as they can from the opportunity to meet a public official, rather than setting up an adversary relationship. ◘

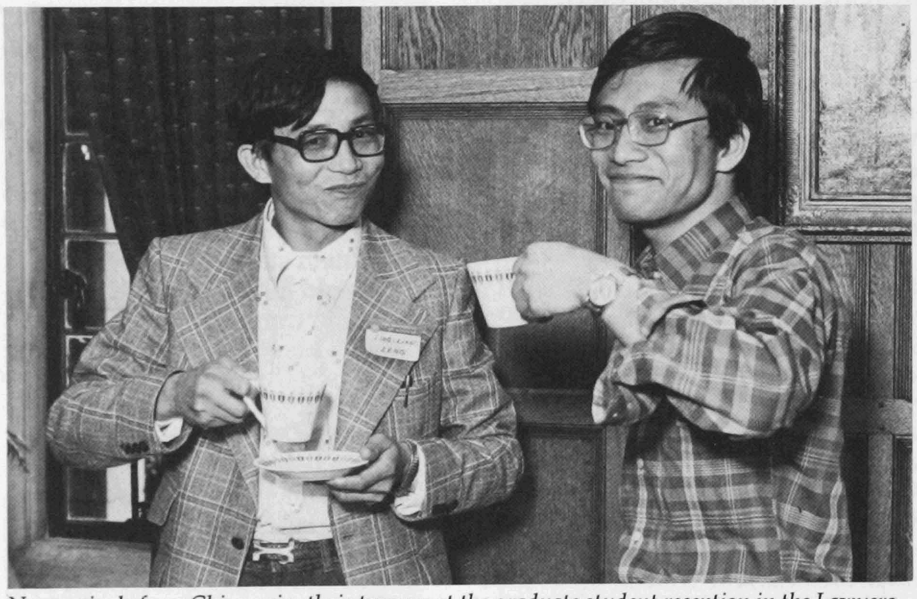


DeRoy Fellow Barber Conable met informally with students in the Lawyers Club lounge during his visit here.

Demystifying law school

Orientation answers questions for newcomers

Coffee, tea, and doughnuts; a gracious luncheon at the Michigan League; guided tours of the Law Quad and downtown Ann Arbor; and heartfelt advice from upperclassmen comprised the agenda of the class of '88 during their first two days of law school.



New arrivals from China raise their teacups at the graduate student reception in the Lawyers Club.

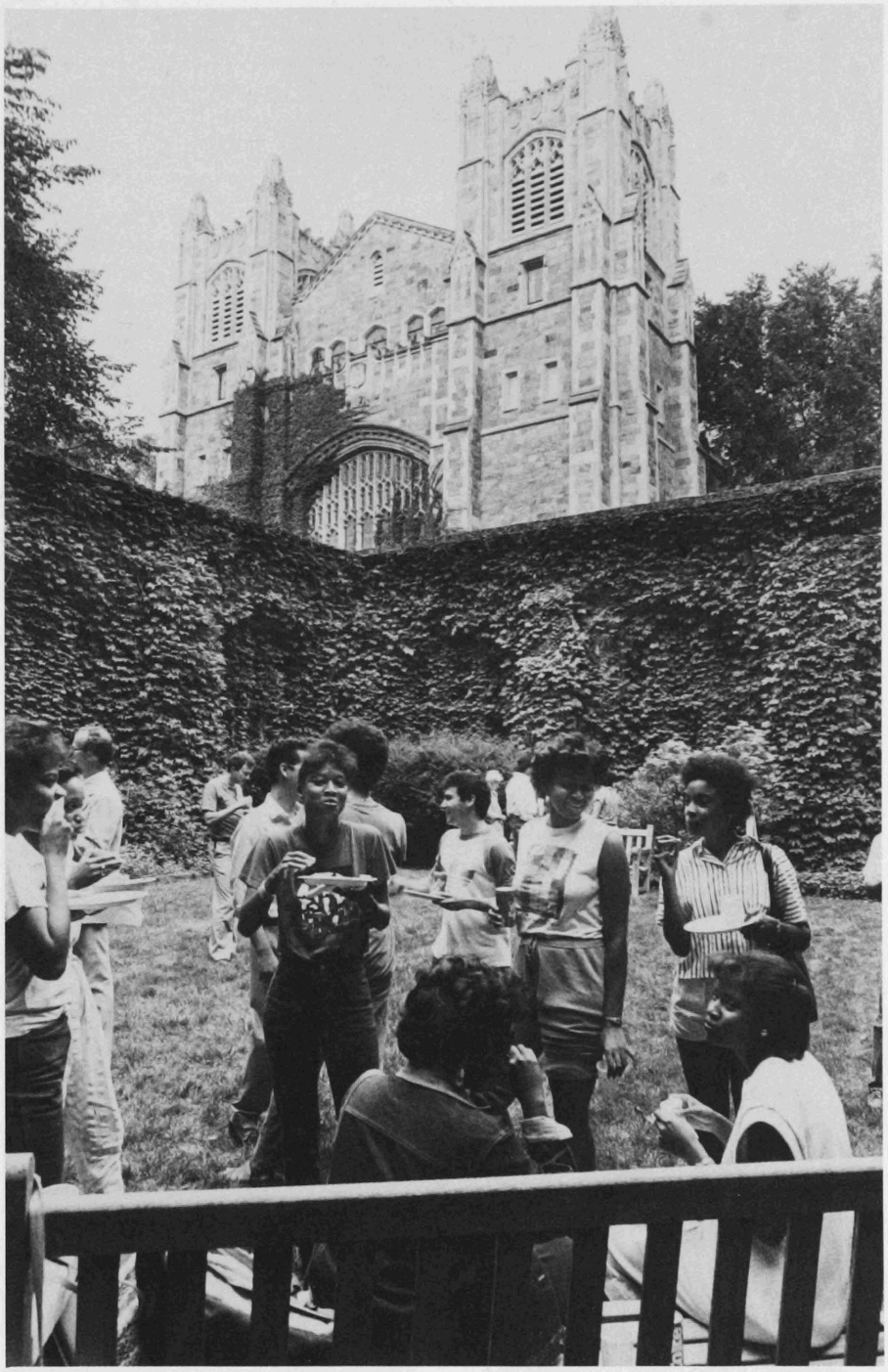
Name tags help new graduate students get acquainted.

Graduate students, coming to Michigan from places as diverse as Thailand, Italy, Japan, and Chile, were led by leaders trained to anticipate some of the problems they might encounter in adjusting to a new culture. A special reception for them and their families was held in the Lawyers Club lounge.

One of the primary purposes of the program, explained orientation leader and third-year student Thomas Bean, is to dispel and reaffirm various myths of law school. "One myth which is *reaffirmed* is that, as law students, they will be working harder than they ever have in their lives," he said. "A myth which is *dispelled* is that people at Michigan are so competitive, they'll stab you in the back to prevent you from doing well. I emphasize that this is a *myth*. Students here are very good, very competitive, but they're also decent human beings."

Orientation also serves to familiarize the new students with the

Visiting Professor Richard F. Babcock, guest speaker at the orientation lunch, recounted "war stories" compiled during his three decades as a legal consultant in land use, planning, and housing.



Minority students were treated to a pizza picnic in the Hutchins Hall courtyard after being welcomed by Professor and former Judge Wade H. McCree, Jr.

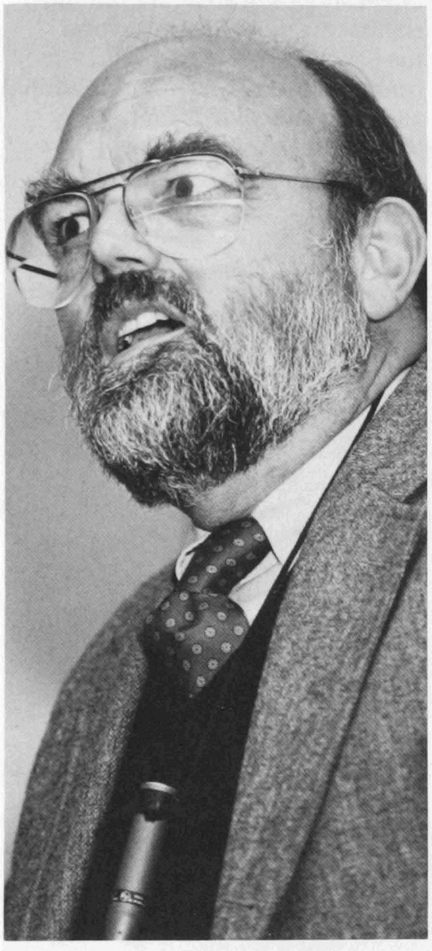
"nuts and bolts" operations of the School's administration, in Bean's words, "to tell them, for example, who Dean Eklund is, how exams are given, how to find tutoring." Tours of the State Street and Main Street shopping areas are reminders that the world exists beyond the Law Quad, and that Ann Arbor contains a rich variety of recreational and cultural activities for healthy diversion.

The small size of the orientation groups (the average size is 16) gives the new students a chance to learn the names of some of their peers and upperclassmen so they can recognize a few faces in the crowd by the time classes begin. ⚄

New students and faculty mix at lunch in the Michigan League.

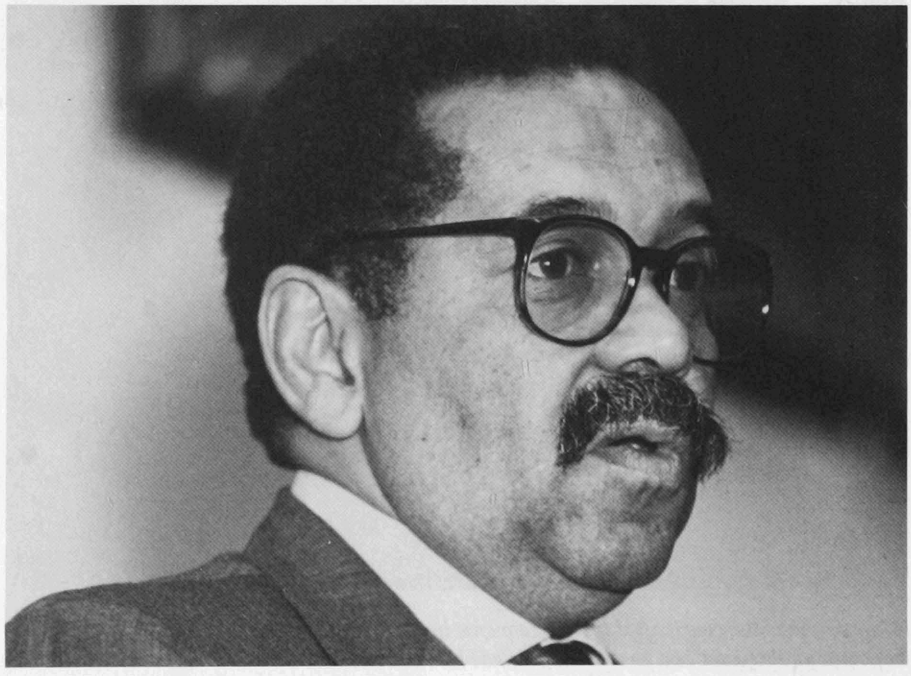
Graduate progeny provide entertainment at their parents' reception in the Lawyers Club.

Voices of experience



John Ehrlichman, the former assistant to President Richard Nixon who was convicted of obstruction of justice in the Watergate affair, addressed an audience at the Law School sponsored by the U-M Union Activities Center. Ehrlichman encouraged his listeners to aid criminal defendants and to be responsive to their clients at all stages of the trial process. Looking back on his own involvement in the Watergate affair, he urged students, whether they went on to private practice or to government service, to listen to their instincts. "Don't let the perks and the glory and the blandishments make you deaf," he said.

Rex Lee, former Solicitor General of the United States, described the workings of the Solicitor General's office as "the world's most interesting law firm." Lee noted that in any given year "this one little law firm is a participant in both briefing and oral argument in slightly over half of the Supreme Court's cases."



Clarence Pendleton, the chairman of the U.S. Commission on Civil Rights, addressed a full house in Room 100 when he spoke at the invitation of the Federalist Society, a newly-formed conservative student group. Pendleton's talk, "Does Racism Still Exist in America?" sparked a spirited discussion from the audience.

Good news

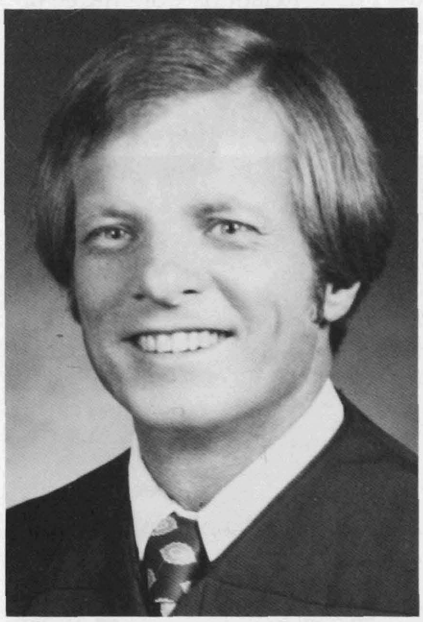
Alumni reap a bounty of honors, awards, appointments

After nearly 10 years of distinguished service as U.S. District Judge for the Eastern District of Michigan, **Ralph B. Guy, Jr.** has been appointed to the U.S. Court of Appeals for the Sixth Circuit. Guy, a 1953 Law School graduate, and the son of retired Dearborn District Judge Ralph Guy, Sr., was quoted in the *Detroit Free Press* as saying, "I've said right along this was something I've always wanted. I've always been interested in appellate work."

Judge Guy has had extensive experience in the public sector, having served as U.S. attorney for the Eastern District of Michigan for six years and chief assistant U.S. attorney for two years. From 1958 to 1969 he was corporation counsel for the city of Dearborn. During that same time he served on the Wayne County Board of Supervisors.

He has been an active member of the State Bar of Michigan, having served as secretary in 1983-84, on the Board of Commissioners from 1975 to the present, and on the Representative Assembly from 1972-75. He has also filled the top leadership position in the Detroit Chapter of the Federal Bar Association, Dearborn Bar Association, University of Michigan Alumni Club of Dearborn, Local Government Section of the American Bar Association, and Public Corporation Section of the State Bar.

Judge Guy currently serves on the board of directors and the executive council of the Federal Judges Association. He was president of the District Judges Association for the Sixth Circuit from 1984-85, and served on the Sixth Circuit Judicial Council. He is a member of the faculty for the National Institute of Trial Advocacy, is on the Advocacy Institute of the Department of Justice, and is a member of the Michigan Supreme Court Committee on Rules of Criminal Procedure.



Ralph B. Guy, Jr.

Judge Guy's appointment fills a position created when Congress, in 1984, added four seats to the Sixth Circuit appellate bench, which reviews cases from federal courts in Michigan, Ohio, Tennessee, and Kentucky. In assuming his new position, Judge Guy joins three other distinguished Law School alumni on the Sixth Circuit Court of Appeals bench: Judge Cornelia G. Kennedy (J.D. '47), Judge Leroy J. Contie, Jr. (J.D. '48), and Judge Albert J. Engel (J.D. '50).

Claude M. Pearson, J.D. '48, was one of two 1985 recipients of the Washington State Bar Association's "Award of Merit" in recognition of service to the public and to the profession. The Award of Merit is the highest honor given by the Association and is not necessarily given every year.

After graduating from the Law School, Mr. Pearson became a sole practitioner in Tacoma, Washington, where he is now the senior partner of a 24-member law firm, Davies Pearson, P.C. He has a long history of community involvement, having served as president of the United Way of Tacoma-Pierce County, chairman of the board of Epworth Methodist Church, and on a number of other boards and commissions. He has also served as president of the Michigan Alumni Club of Seattle and as first vice-president of the National Alumni Association.

Claude M. Pearson

Richardson W. Nahstoll, J.D. '46, a Portland, Oregon attorney, has been designated the 1985 recipient of the Robert J. Kutak Award by the Section of Legal Education and Admissions to the Bar of the American Bar Association. This award is made in memory of a distinguished Omaha lawyer, champion of legal reform, and advocate for legal education. Mr. Kutak was a member of the Council of the Section of Legal Education and Admissions to the Bar of the American Bar Association at the time of his death.

The award is presented for outstanding contributions to the improvement of legal education. Mr. Nahstoll served as president of the Oregon Bar Association and as chairman of the Section of Legal Education and Admissions to the Bar of the American Bar Association and as chairman of its Accreditation Committee. He has also served as a member of the law school visiting committees of the University of Michigan, University of Oregon, and Lewis & Clark College. In 1983-84, Mr. Nahstoll served as a distinguished practitioner-in-residence at Washington & Lee University School of Law.

Richardson W. Nahstoll

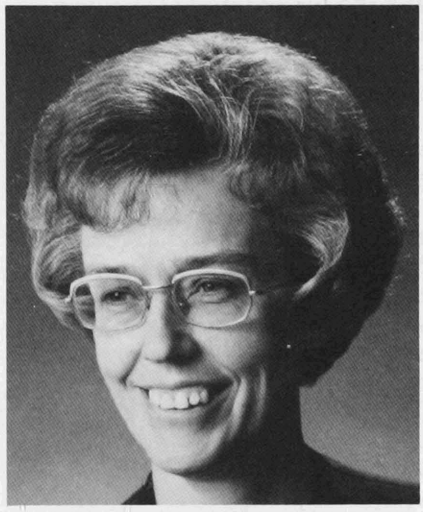
Herbert L. Meschke, J.D. '53, was recently appointed to the North Dakota Supreme Court. Justice Meschke, a native of Belfield, North Dakota, previous to his appointment, had been in practice with the law firm of Pringle and Herigstad at Minot, North Dakota.

He has been a member of the American Bar Association for nearly three decades, and a contributing member of the American Judicature Society for several years. From 1955 to 1956, Justice Meschke served as the chairman of the Public Relations Committee of the State Bar Association of North Dakota, and in 1965-66 he chaired its Continuing Legal Education Committee.

Herbert L. Meschke

In 1964, Justice Meschke was elected as one of six state representatives on the Democratic-NPL ticket from Ward County. In the 1965 North Dakota legislative session, he served on the Judiciary and Natural Resources Committees of the House of Representatives. In 1966, he was elected as one of three state senators from the Minot area district on the Democratic-NPL ticket. In the 1967 and 1969 North Dakota Legislative sessions, he served as Senate Minority Leader for the Democratic-NPL party.

Cornelia G. Kennedy, circuit judge, U.S. Court of Appeals for the Sixth Circuit, has been appointed by President Reagan to the Commission on the Bicentennial of the United States Constitution. The Commission is charged with promoting and coordinating activities to commemorate the Bicentennial of the Constitution.



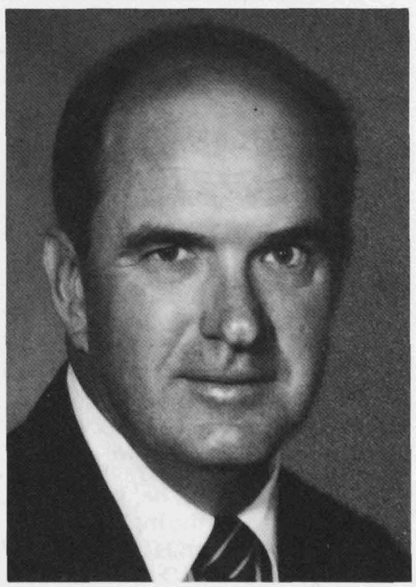
Cornelia G. Kennedy

Judge Kennedy (J.D. '47, A.B. '45) served as U.S. district judge for the Eastern District of Michigan from 1970 until her appointment to her present post in September, 1970. She was a Michigan state circuit court judge before moving to the federal system. She has served on the Judicial Conference Advisory Committee on Judicial Activities, the Advisory Committee on Codes of Conduct, and the Judicial Fellows Commission. She has been a member of the

Board of the Federal Judicial Center since 1981. She is the sister of Judge Margaret G. Schaeffer, a 1945 alumna of the Law School and a judge of the 47th District Court for the State of Michigan.

Francis X. Beytagh, Jr., a 1963 Michigan graduate, has been appointed Dean of the Ohio State University College of Law. Beytagh moves to his new position from the University of Houston College of Law, where he was Cullen Professor of Law in 1984-85. Before teaching at Houston, Beytagh had taught and held the deanship at the University of Toledo College of Law from 1976 to 1983. He has also taught at the University of Notre Dame and has been a visiting professor at the University of Virginia Law School. During the fall and winter of 1983-84, Beytagh visited at the U-M, where he taught administrative law, constitutional law, and two sections of lawyers and clients.

Beytagh is the co-author, along with the late Thomas Kauper, of *Constitutional Law: Cases and Materials*. He has also written numerous articles on the Burger and Warren Courts, freedom of the press, legal education, and judicial review in selective service cases.



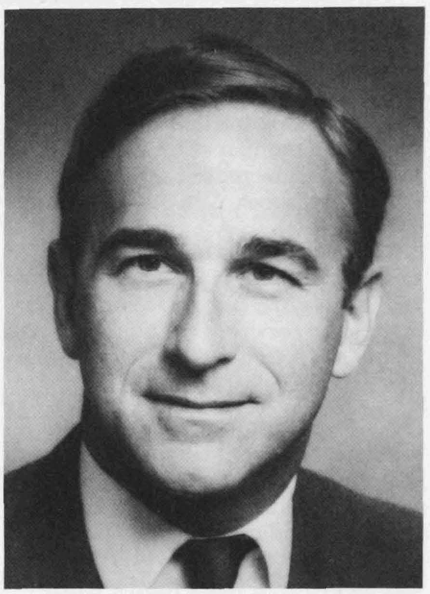
Francis X. Beytagh, Jr.

After graduating first in his class from the Law School, where he had been editor-in-chief of the *Law Review*, Beytagh served as senior law clerk to Chief Justice Earl Warren. He later worked as an assistant to the solicitor general in the Department of Justice.

When jokingly asked whether he felt a conflict of loyalty between his law school alma mater and football arch-rival Ohio State, Beytagh pointed out that he had received his undergraduate degree from the University of Notre Dame. He told **LQN**, "I'll probably cheer for the people who provide my salary." He added, "The fact that OSU president Edward Jennings and athletic director Rick Bay also have degrees from the U-M indicates that Ohioans generally recognize quality, and that's why they turn to Michigan so frequently to fill their top positions."

John M. Walker, Jr., J.D. '66, has been sworn in as U.S. District Judge for the Southern District of New York. From 1981 to 1985, Judge Walker was Assistant Secretary of the Treasury (Enforcement and Operations). In this capacity, he was responsible for Treasury policy in law enforcement and trade matters and for the management and direction of the following Treasury Bureaus: U.S. Customs Service; U.S. Secret Service; Federal Law Enforcement Training Center; Bureau of Alcohol, Tobacco, and Firearms; and the Office of Foreign Assets Control.

A native of New York City, Judge Walker received a bachelor's degree from Yale University and served in the Marine Corps Reserve before enrolling in law school. After receiving the J.D., he was awarded a two-year Africa-Asia Public Service Fellowship, under which he served in Africa as a State Counsel to the Republic of Botswana.



John M. Walker, Jr.

From 1970 to 1975, after a period of private law practice in New York City, Walker served as an assistant U.S. attorney for the Southern District of New York in the Criminal Division, concentrating on narcotics and business fraud investigations and prosecutions. From 1975 to 1981, he was associated with and a partner of Carter, Ledyard & Milburn, a New York City law firm, where he specialized in litigation. ⊠

Professor James Martin dies

James A. Martin, professor at the Law School since 1970, died on December 10, 1985 after a long illness. He was 41. News of his death came just as the present issue of *Law Quadrangle Notes* was going to press. A detailed account of his career will appear in a subsequent issue. ⊠

Class notes

'28 **Milton D. Green** has written *It's Legal to Laugh*, a small volume of courtroom anecdotes, unique cases, profiles of colorful leaders of the bar, and "behind the scenes" incidents relating to the legal profession. Better known for his widely used casebook, *Basic Civil Procedure*, Green, who for 50 years taught at a number of leading law schools, is now retired and living in Lake San Marcos, Cal.

'34 **Byron F. Novitsky**, recently elected president of St. Joseph Hospital, Fort Wayne, Ind., was given a distinguished service recognition award by the Allen County, Ind. Bar Association for community service.

'38 **W. W. Lessley**, for the past five years has served as chief water judge of the Montana Water Courts; this was after 33 years as a senior district judge in the 18th Judicial District. The task of the Montana Water Courts is to adjudicate all pre-1973 water rights, which total 204,000.

'40 **Roy L. Steinheimer, Jr.** has been named the Robert E. R. Huntley Professor of Law at Washington & Lee University School of Law, where he served as dean from 1968 to 1982. Steinheimer was a member of the Michigan Law School faculty from 1950 to 1968.

'49 **Joseph Pilkington**, a Toledo attorney, has been elected to the board of directors of First Federal Savings of Toledo.

'50 **Clinton R. Ashford**, a Honolulu attorney, has been re-elected to the board of directors of the American Judicature Society, a national organization for improvement of the courts.

'51 **William W. Milligan**, a former Ohio state legislator and assistant attorney general, has received the American Judicature Society's Herbert Harley Award in recognition of his service in improving the administration of justice in Ohio.

Alan C. Boyd, associate general counsel of Owens-Illinois, Inc., has been elected secretary of the company.

'52 **William A. Clark** has been appointed U.S. bankruptcy judge at Dayton, Ohio.

Warren Elliott, a Washington attorney, has been appointed chairman-elect of the Committee on Employee Benefits of the American Bar Association's Tort and Insurance Practice Section (TIPS).

'55 **Robert B. Fiske, Jr.**, a New York City attorney, has been re-elected to the board of directors of the American Judicature Society. Mr. Fiske served as U.S. attorney for the Southern District of N.Y. from 1976 to 1980.

'57 **John F. Foley** has been appointed by Governor Blanchard to the post of circuit judge in Kalamazoo County.

Friedrich K. Juenger has received the 1985 Distinguished Teaching Award for the University of California-Davis School of Law.

'58 **Dean S. Lewis**, a Kalamazoo attorney, has been re-elected to the board of directors of the American Judicature Society.

'59 **Lawrence A. Jegen III** has been named Most Outstanding Law Professor at Indiana University.

Robert C. Weinbaum has been promoted from assistant to associate general counsel of the General Motors Corporation.

'60 **Charles R. Sharp**, another member of the General Motors legal staff, has also been promoted from assistant to associate general counsel.

Dean J. Shipman has been appointed by Governor Blanchard to the 47th Judicial Circuit Court.

'61 **Richard E. McEachen** has been named executive vice-president at Centerre Bank of Kansas City, Mo., where he will be in charge of the trust division.

James Hourihan has been appointed chairman of the Committee on Toxic and Hazardous Substances and Environmental Law of the American Bar Association's Tort and Insurance Practice Section (TIPS).

Frederic R. Merrill is serving as acting dean of the University of Oregon Law School.

'62 **Walter W. Naumer, Jr,** vice-president of the DuQuoin Packing Co., DuQuoin, Ill., has been elected to the Southern Illinois University Foundation board of trustees.

'63 **Norman Otto Stockmeyer, Jr.** has been selected Outstanding Professor of the Year 1985-86 at Thomas M. Cooley Law School, Lansing, Mi., by Delta Theta Phi Law Fraternity International.

'64 **Paul M. Ostergard** has been elected president of the General Electric Foundation. The foundation, together with the G.E. Company, contributes some $36 million annually to higher education, human services, and cultural and civic activities.

'66 **Alan A. May**, a Detroit lawyer, has been appointed to the Michigan Civil Service Commission by Governor James Blanchard for a six-year term.

W. Sabin Phelps has been appointed general counsel of the international office of The Nature Conservancy.

'67 **Joyce Q. Lower** has been re-elected for a second term as president of the Metropolitan Board of Directors of the Young Women's Christian Association of Metropolitan Detroit.

Robert Gilbert, a Detroit attorney who specializes in aquatic injury cases, several years ago formed the Aquatic Injury Safety Group (AISG). The organization hopes to reduce the number of diving-related injuries through public awareness campaigns and through legislation requiring pool companies to provide signs warning of the danger of diving into shallow water.

Christopher B. Cohen has been appointed as one of the seven commissioners to govern the Illinois Medical Center Commission.

John A. Sebert, Jr. has been appointed associate dean for academic affairs and administration at the University of Tennessee College of Law.

'68 **R. George Economy**, an Okemos, Mi. attorney, has been appointed judge of the Ingham County Probate Court.

Robert J. DeGrand, an Escanaba, Mi. attorney, has been appointed by Governor Blanchard to the 47th Judicial Circuit Court, which serves Delta County.

'71 **Donald Tucker** was appointed to the Michigan State Housing Development Authority (MSHDA) by Governor Blanchard, and was elected chairperson of the Authority by its members. MSHDA was established by the state legislature in 1966 to address the housing needs of the state's low and moderate income families, elderly persons, and handicappers.

'72 **Lawrence A. Rogers** has been promoted to vice-president and general counsel for American Capital Corporation in Houston, Texas. American Capital Corporation and its subsidiary companies comprise one of the nation's oldest and largest mutual fund and investment counseling organizations with more than $6 billion in assets currently under management.

'73 **Frank W. Jackson**, Detroit's director of litigation, and president of the board of governors of the U-M Lawyers Club, has been promoted to major in the Army Reserve.

'74 **Craig A. Wolson** has assumed the positions of vice-president, secretary, and general counsel of the J. D. Mattus Company, Inc., Greenwich, Connecticut.

'75 **Steven Wechsler** has been appointed associate dean at Syracuse University College of Law.

Ralph J. Gerson, a Washington, D.C. attorney, has been appointed by Guardian Industries Corporation as vice-president for governmental and international affairs.

'78 **Stephen L. Howard**, a Providence, R.I. attorney, has become vice-president and general counsel of Cookson America Inc., the North American division of the world-wide Cookson Group plc, a manufacturer of specialty metals and industrial materials.

'80 **James D. Holzhauer**, a former Washington, D.C. attorney, is now an assistant professor at the University of Chicago Law School.

Robert M. Kalec has joined the Controlled Substance Unit of the U.S. Attorney's Office as an asistant U.S. attorney for the Eastern District of Michigan.

'81 **Michael J. Grace** has joined the Internal Revenue Service, Office of Chief Counsel, Legislation and Regulations Division, in Washington, D.C., as an attorney-adviser, where he will be drafting amendments and regulations.

'82 **Betsy Berryman Baker** has been appointed to serve as assistant dean for admissions, placement, and administration, and to serve as director of legal writing at the University of Minnesota Law School.

Deaths

'14 **Seldon W. O'Brien,** July 31, 1985

'20 **Amos F. Paley,** September 12, 1985

'21 **George Bouchard,** March 16, 1985, in Laguna Hills, CA

'22 **Frederick H. Lauder,** April, 1985
J. Harper Moore, July 17, 1985, in Grand Rapids, MI
George C. Quinnell, July 21, 1985

'24 **John P. Dawson, Jr.,** October, 1985
Frederick C. Gielow, Sr., May 16, 1985

'25 **Fred R. Allaben,** June 16, 1985
Thomas J. Lynch, October 30, 1984, in Chevy Chase, MD

'26 **Albert Adams,** March 25, 1985
Harry H. Platt, June 15, 1985, in Oakland, CA

'27 **Joseph H. Parsons,** June 7, 1985, in Detroit, MI
James R. Ramsey, April 2, 1985

'28 **R. William Rogers,** February, 1985

'29 **Samuel R. DiFrancesco, Sr.,** September 12, 1985

'30 **Boice Gross,** October 16, 1984
Carmi Jay Yoakam, January 15, 1985
Verling C. Enteman, September, 1985, in Washington, NJ

'31 **Leslie David Bloom,** August 26, 1985, in Detroit, MI
Clarence W. Brownell, June 28, 1985
Paul F. Burke, September 26, 1984

'32 **Harold G. Capron,** January 7, 1985
Watson Clay, May 24, 1985, in Frankfort, KY
Harvey G. Straub, September 10, 1985

'33 **Frank L. Amprim,** April 6, 1985

'35 **Wendell B. Barnes,** June 11, 1985, in Walnut Creek, CA
R. L. Browning, March 24, 1985
Saul Robins, August 24, 1985, in Southfield, MI
Albert H. Saperstein, May 10, 1985, in North Miami Beach, FL

'36 **William J. Johnson,** February 28, 1985

'38 **J. Edward Hutchinson,** July 22, 1985, in Naples, FL

'39 **Richard J. Blanchard**
James C. Briegel, September 18, 1985
Jack F. Smith, December 20, 1981, in Lapeer, MI
Francis M. Wistert, April, 1985, in Painseville, OH

'41 **Calvin B. Chamberlain,** July 9, 1985
John S. Mechem, July 3, 1985

'47 **Samuel B. Bass,** October 12, 1985

'50 **Robert B. Willemin,** July 25, 1985, in Benton Harbor, MI

'51 **Ivan E. Barris,** October 10, 1985, in Bloomfield Hills, MI
Laurence A. Wiley, June 24, 1985

'52 **Clair W. Pike,** September 23, 1985
Margaret Rogers, May 3, 1985

'57 **William J. P. Collins,** October, 1985
Harold O. MacLean, Jr., November 27, 1984, in San Francisco, CA

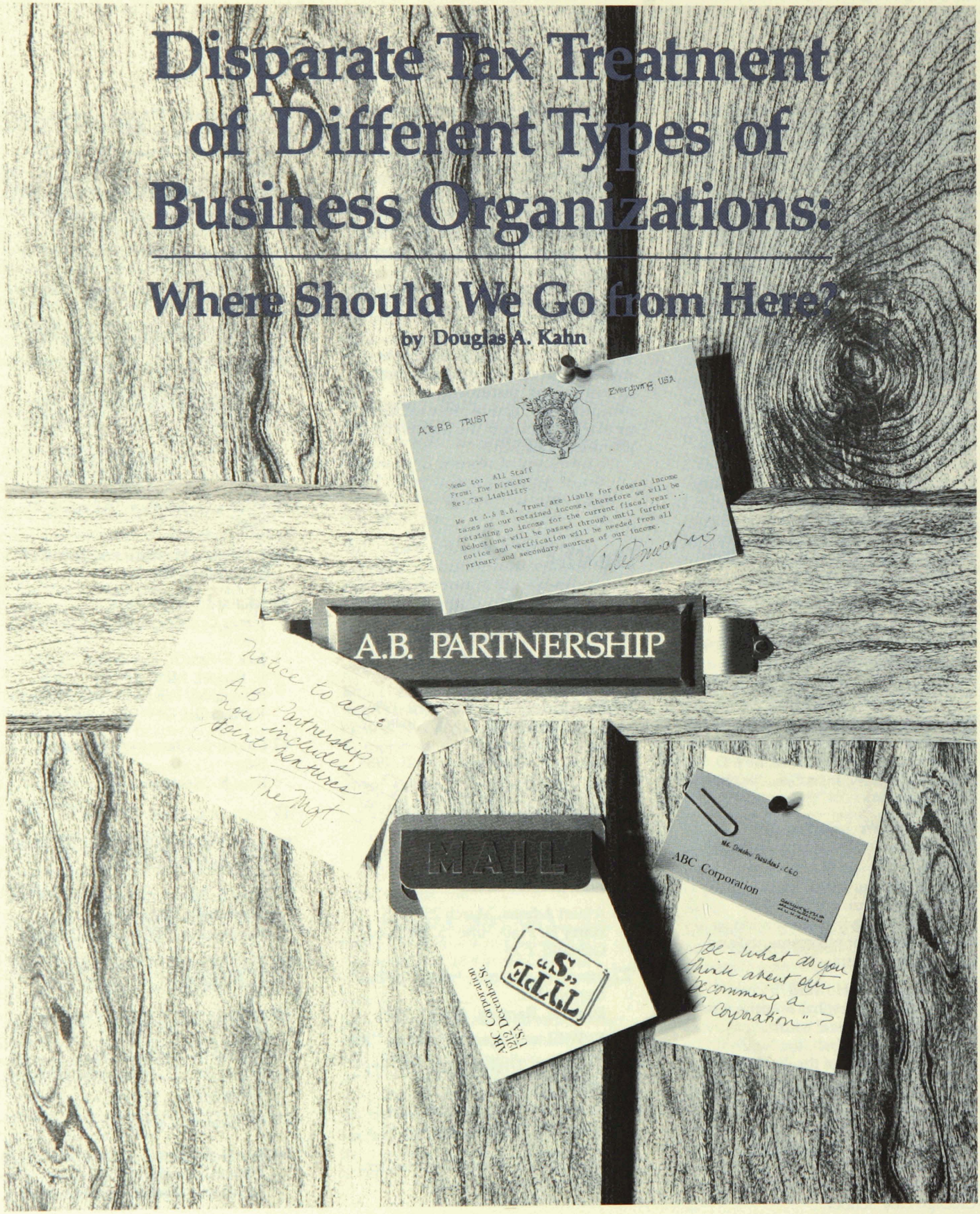
'59 **William H. Lewis,** June 3, 1985

'64 **John J. Hensel,** September 27, 1985, in Lansing, MI
Sanders J. Mestel, April 28, 1985

Disparate Tax Treatment of Different Types of Business Organizations:

Where Should We Go from Here?

by Douglas A. Kahn



If several persons wish to join together in a common enterprise in order to pool their capital or labor or some of each, they may choose among a variety of available organizational structures that will serve that purpose. The most common entity forms are partnerships (including joint ventures), corporations, and trusts. While, in its typical structure, each of those entity forms has its own distinct characteristics, the structure of such organizations often is modified by agreement so as to adopt attributes of another type of entity. Because of this, the substantive distinction between entity types is blurred.

However, tax law's treatment of these entities is dissimilar in many important respects. For example, partnerships pay no federal income taxes. In this respect, the partnership serves as a conduit in that all of its income, losses, deductions, credits, and other tax attributes are passed through to its partners who report those items on their own tax returns. A corporation, on the other hand, is subject to a federal income tax. The typical domestic corporation is taxed on its income regardless of whether it retains that income or distributes its earnings to its shareholders by way of dividends. Corporate income is sometimes said to be subjected to a double tax—once when earned by the corporation and again when distributed to its shareholders. Certain closely held corporations are permitted to elect under Subchapter S to be excused from income tax liability on most (or perhaps all) of their income and to have most (or perhaps all) of their income, deductions, credits, and other tax items pass through to the corporation's shareholders in a manner that is similar to the pass-through treatment provided for partnerships and partners. Such electing corporations are referred to as "S Corporations." Corporations which are not S corporations are sometimes referred to as "C Corporations." Unlike a partnership, an S corporation is subjected to federal income lax liability in certain narrow circumstances, but for the most part, an S corporation will pay no federal income taxes.

A trust is liable for federal income taxes on its retained income, but to the extent that the trust makes (or is required to make) a current distribution of its income to its beneficiaries, such income will be taxed in the hands of the beneficiaries rather than the trust. Thus, a required or actual distribution by a trust will cause all or some of its income to be passed through to its beneficiaries, but the remaining trust income is taxed to the trust itself. Credits generally pass through to the beneficiaries. Deductions sometimes pass through and sometimes are available only to the trust.

The foregoing cursory description of entities and their tax treatment raises several fundamental questions. Should the tax treatment of all entities be the same or should there be disparate treatment? If there is to be disparate treatment, should the treatment depend upon the traditional classification of entities as corporations, partnerships, or trusts? If so, should the tax law's characterization of an organization rest on its characterization for local law purposes or should characterization be determined according to a federally established standard? Alternatively, should the tax characterization of an organization turn exclusively on an election by the members of the organization?

The tax law's current response to those questions is to characterize organizations according to federally created standards and to treat each entity type differently. Thus, an organization that is treated as a partnership for state law purposes may be treated as an association taxable as a corporation for tax purposes. The standards employed in determining the tax classification of entities were established in the Supreme Court's 1935 decision in *Morrissey v. Commissioner*, and they are sometimes referred to as the *Morrissey* standards.

. . . an organization that is treated as a partnership for state law purposes may be treated as an association taxable as a corporation for tax purposes.

The history of the government's application of the *Morrissey* standards to partnerships is instructive in that there were dramatic shifts in the government's position as the benefits and detriments to taxpayers of corporate tax treatment waxed and waned. Initially, the government sought to impose corporate tax treatment on partnerships to the extent that it could do so under the *Morrissey* standards. The government's purpose was to maximize the reach of the double tax imposition that applies to corporate entities but not to partnerships. However, there are tax advantages to corporate treatment that mitigate or even offset the double tax cost.

Until recently, one of the tax advantages of corporate classification was a more liberal statutory deferred compensation treatment for shareholder-employees of a closely held corporation than was available to members of a partnership. Beginning with the early 1950s, many closely held organizations were incorporated for that purpose. Since, at that time, state laws prohibited professionals from incorporating, some professional partnerships successfully sought to be classified under the *Morrissey* standards as associations that are treated as corporations for tax purposes. To combat that effort, in 1960, the government promulgated regulations which adopted the *Morrissey* standards but construed them in such manner as to make it difficult for a partnership to be treated as a corporation. Many states responded to the 1960 regulations by authorizing professionals to incorporate, and so was born the "professional corporation." The government then promulgated a regulation which set forth standards for corporate characterization that were designed to exclude professional corporations. After a number of courts held this "anti-professional corporation" regulatory provision to be invalid, the government revoked it in 1977.

Subsequently, the statutory provisions for deferred compensation were altered by Congress so that there is little difference between the provisions for self-employed participants and those for employees. That change removed one of the major incentives for corporate characterization.

The focus of the characterization dispute shifted once again. With deferred compensation plans no longer a significant consideration, the government turned its attention to the area of tax shelters. Tax sheltered investments are designed to provide sheltered income for the investors or generate deductions or credits that the investors can use to shelter outside income. A corporation typically is not a useful entity for the conduct of a tax sheltered operation since the tax benefits generated by the corporation will not pass through to its shareholders. In some cases, an S corporation can be useful, but the requirements for qualifying as an S corporation are such that few tax shelter operations could qualify. Consequently, a partnership, especially a limited partnership, form has been the most popular entity for conducting such investments.

. . . the government has returned to its pre-professional association position of seeking to impose corporate characterization to the broadest extent possible.

The government had sought through legislative proposals and through litigation to eliminate tax shelters or to minimize the tax benefits which such investments are designed to obtain. To the same aim, the government has sought to prevent investors from securing such tax benefits by recharacterizing the partnership or trust which conducts the sheltering activity as a corporation for tax purposes. Thus, the government has returned to its pre-professional association position of seeking to impose corporate characterization to the broadest extent possible. As to partnerships, the government's litigating efforts were thwarted by the regulations it adopted in 1960, which are designed to make corporate characterization more difficult to obtain and therefore to impose. In its 1976 decision in *Philip G. Larsen*, the Tax Court established criteria that make it extremely difficult to reclassify a partnership as a corporation, and the Commissioner was constrained to adopt the *Larsen* position. As a result, relatively few limited partnerships are at risk of being reclassified, and general partnerships are virtually immune.

Trusts are also vulnerable to reclassification for tax purposes. In fact, the *Morrissey* case itself involved the classification of a trust as an association taxable as a corporation. The government has recently promulgated proposed regulations and rulings that would reclassify certain types of trusts, but, these rules have not yet been tested in court.

In general, incorporated organizations have withstood any effort to reclassify them as partnerships or other unincorporated entities. However, problems similar to characterization have plagued corporate entities. In some circumstances, persons who wished to do business as a partnership or as a sole proprietor have had to incorporate an activity to satisfy (or to avoid) some state law requirement. The most common illustration of this is where a real estate operation incorporates to obtain a construction loan and permanent financing. State usury laws do not apply to corporate borrowers. If the permissible rate under the usury law is lower than prevailing commercial rates, the lender will only make the loan to a corporate borrower. To comply with the lender's demand, the land is placed in a newly formed corporation which then borrows the funds needed for construction. In such cases, the charter of the corporate borrower may describe it as a "dummy" that was created solely to borrow the funds needed for construction. The corporation will be liquidated as soon as construction is completed and the permanent financing is obtained. The shareholders have then attempted to treat the incorporated entity as a sham so that the entity will be ignored for tax purposes and the organization treated as a partnership or sole proprietorship. With few exceptions, shareholders have been unsuccessful in such attempts, and the courts have sustained the viability of the corporate entity. To obtain partnership treatment in such cases, the shareholders will have to liquidate the corporation which may cause them to incur substantial tax liability especially if the corporation is deemed to be a collapsible corporation.

Faced with the Commissioner's and the courts' unwillingness to treat such real estate corporations as shams, shareholders tried a different approach. They formed a corporation to serve as an agent for the shareholders, and they transferred title to the realty to the corporation in its agency capacity. By so structuring the transaction, they hoped to permit the corporation to borrow the needed funds without saddling the operation with corporate tax treatment. It is a matter of state law whether such an arrangement will successfully evade usury law restrictions.

The Commissioner generally challenges the validity of such agency relationships and contends that the corporation is to be treated as the owner of the realty which it purportedly holds as agent for the transferors. The criteria for determining whether the agency relationship is valid were set forth in the Supreme Court's decision in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949). *National Carbide* established six standards or criteria of which the fifth has proven to be the most important. The fifth standard requires that a corporation's agency relationship with its principals not be dependent on their shareholder status for the agency relationship to be treated as valid. Although the Tax Court disagrees, several courts of appeals (the Fourth and Fifth Circuits) have held that the fifth standard must be satisfied to obtain agency status regardless of whether the other five *National Carbide* standards are met. The Fourth and Fifth Circuits have construed that fifth standard so strictly as to

make it difficult for a corporation to qualify as an agent of its shareholders. However, if the transferors of the realty to the corporate agent are not the shareholders of the corporation, or if the shareholders own only a portion of the equity interests in the transferred property, the validity of the agency relationship likely will be recognized. E.g., *Moncrief v. United States*, 730 F.2d 276 (5th Cir. 1984). So, if a law firm were to form a corporation which serves as an agent of the firm's clients, it appears that the firm could borrow the needed funds and construct the property without subjecting its principles to corporate tax treatment.

The various tests employed to determine the characterization of an organization are designed to measure the extent to which an organization's attributes more closely resemble those of one type of entity rather than another. Thus, if the characteristics of an organization that is classified as a limited partnership under state law more closely resemble the attributes of a typical corporation, the organization will be treated as an association taxable as a corporation. Given that purpose, there are reasons to question whether the *Morrissey* standards are appropriate criteria especially in light of the diversity of forms that

The various tests employed to determine the characterization of an organization are designed to measure the extent to which an organization's attributes more closely resemble those of one type of entity rather than another.

are now employed for each of such entities. But a more fundamental issue is whether the reclassification of entities is justified as a matter of tax policy. In other words, there may be no good reason for tax law to classify an entity as anything other than the classification chosen by the taxpayers regardless of the entity's characteristics.

First, let us consider whether there is any justification for reclassifying a limited partnership as a corporation. The corporate income that is distributed to a shareholder typically is subjected to double taxation—once in the hands of the corporation and again when it is distributed to a shareholder. There is substantial support for the view that this double taxation of corporate income is undesirable both for reasons of economic policy and of equity. If it were administratively feasible, it would be desirable to integrate the corporation's income with the individual shareholder's personal income and apply a single tax. The Subchapter S provisions demonstrate that in circumstances where the administration of an integrated tax system is manageable, Congress has permitted an election to integrate. The principal differences between the Subchapter S provisions and the provisions of Subchapter K (the partnership provisions) are those provisions of Subchapter S that are designed to prevent a perceived abuse where the S election is made by a corporation that had previously been operating as a C corporation. Congress feared that otherwise the shareholders could obtain the future income of the organization free of a corporate tax without first having to liquidate the corporation and cause the shareholders to recognize gain thereby. The provisions in Subchapter S that deal with this problem apply only to capital gains and to passive investment income.

So long as the allocation of partnership income among the various partners is administratively manageable, there is no reason to impose a double tax on partnership income. The integration of such income with that of the partners, as is done by Subchapter K, is unobjectionable. Since a corporate organization cannot be converted to a partnership without liquidating the corporation, the special Subchapter S problems concerning capital gains and passive investment income do not arise in the partnership area.

The major concerns over the classification of limited partnerships arise because of a partnership's capacity to pass through to its partners favorable tax attributes such as artificially created tax losses and tax credits. The partnership is the favored entity of the infamous tax sheltered investments. Tax shelters are spawned by tax preferences that typically are deliberately created by Congress for some economic or social purpose—e.g., highly accelerated depreciation and investment tax credits. If these preferences are designed to encourage certain types of investments, it would seem appropriate to permit the investments to be made by a group of people joining together as well as by a single investor. Indeed, there has been no objection to a general partnership's engaging in a tax sheltered investment. The attack has been directed at limited partnerships because limited partners have no liability to contribute additional amounts to the partnership or to pay its creditors.

A major objection has been raised to providing a person tax benefits, such as depreciation deductions, in an amount that exceeds the aggregate contributions of that person to the enterprise plus the total liability of that person for additional contributions. This situation can arise as a consequence of the "basis" rules that comprise the so-called *Crane* doctrine for the treatment of nonrecourse debt. The problem caused by nonrecourse debt is not peculiar to limited partnerships; it can arise where any party, even a single individual, acquires property subject to a debt for which the acquiring party is not personally liable. There is no reason to deprive a limited partner of the tax benefits that flow from the partnership's basis in property acquired through a nonrecourse debt. No property owner—general partner or sole investor—has any greater liability for the repayment of a nonrecourse debt than does a limited partner. Current law recognizes this, and treats a limited partner the same as a general partner in determining the bases that they acquire in their partnership interests as a result of the partnership's nonrecourse debt.

That is not to say that the current treatment of non-

recourse debts is correct. It is merely that there is no reason to distinguish limited partnerships from other investors in dealing with such debts. There are some who believe that the *Crane* rule should be modified or even repudiated. Regardless of the merits of that contention, the problem arises out of the *Crane* doctrine, and it is that doctrine that should be addressed directly rather than making a piecemeal attack on it by reclassifying some partnerships as corporations.

Another means of dealing with the nonrecourse debt problem is the imposition of "at risk" rules such as those imposed by §465 and §46(c)(8) of the Code. Currently those rules are insufficient because there are several areas where they do not apply—notably, real estate investments. The pending tax reform bill (H.R. 3838) would cure that problem by expanding the scope of the at risk rules so that they apply to many (but not all) real estate holdings. The bill also would repeal the investment tax credit and reduce the permissible rate of depreciation.

. . . an ideal tax structure would integrate all business income with the personal income of the individuals who have the beneficial interest in the organization

The partnership's recourse debts do not open any doors to avenues for tax abuse. A limited partner enjoys limited liability as to the partnership's recourse debts. A partner can deduct his share of partnership losses only to the extent of his outside basis in his partnership interest (§704(d)), and a limited partner gets no addition to his outside basis because of a partnership's recourse debts. Consequently, a limited partner's exemption from liability precludes him from obtaining any tax benefit from such debts, and no tax abuse can occur because of such debts.

In sum, there is no justification for the Commissioner or the courts to challenge the classification of a partnership. The Commissioner has used reclassification as an oblique attack against tax provisions that the Commissioner deems undesirable where a frontal attack on such treatment does not seem promising. While the Commissioner's behavior is understandable, it would be more efficient and equitable to require either the courts or the legislature to face the underlying problem directly rather than to dilute its significance through the reclassifying of a relatively few organizations.

Similarly, it is inappropriate to impose extraordinary requirements for a corporation to qualify as an agent of its shareholders. The Tax Court has come to that conclusion, but the Commissioner rejects it, and he has the support of the Fourth and Fifth Circuits. It is especially inappropriate to impose such requirements where knowledgeable parties easily sidestep this obstacle by having a corporation which is formed and controlled by the shareholders' lawyers hold the property as the transferors' agent and obtain the needed financing.

For the same reasons, the characterization of a trust should not be challenged regardless of whether the beneficiaries have different types of interests in the trust. One problem here is that persons might be able to create a trust to which they each contribute their stock holdings in order to diversify their portfolio without recognizing a gain as would be required by §351(e)(1) or §721(b) if the transfers were made to a corporation or to a partnership. But, that problem exists for fixed investment trusts that the regulations acknowledge cannot be reclassified. [Treas. Reg. §301.7701-4(c)]. If this is a problem, it should be dealt with by amending Subchapter J rather than by attempting to reclassify some trusts.

Another reclassification issue arises where two or more persons acquire property as co-tenants and divide the income from the property among themselves. In some circumstances, the Service will seek to impose partnership status on that activity, which classification can have detrimental consequences to one or more of the parties. The only justification for imposing partnership status is to facilitate administration of the tax laws. It would seem that reclassification as a partnership should not be imposed unless the nature of the cooperative activity is such that it would be cumbersome to deal with it as representing an aggregate of interests rather than as a separate entity. However, in determining whether a tenancy in common should be reclassified, neither the courts nor the Service has addressed that question and instead they seek to resolve this issue according to mechanical standards that do not appear to be particularly relevant.

On the other hand, where several persons attempt to characterize an employment or loan arrangement as a partnership, the government has a legitimate interest in ignoring their formal characterization. This is to prevent the transmutation of compensation for services or for the use of funds, which would be ordinary income to the recipient, into a "partnership distribution" which may permit a deferral of income or capital gains treatment. Precluding partnership treatment is one means of preventing such abuses.

Two questions more fundamental than entity reclassification are whether there is any justification for having two different tax schemes for business organizations (i.e., a double tax system and a pass-through tax system) and, if so, whether the choice of the applicable system should depend upon whether the organization is a corporation or a partnership. Regarding the first question, as previously noted, an ideal tax structure would integrate all business income with the personal income of the individuals who have the beneficial interest in the organization. The major objection to a fully integrated system (i.e., a pass-through tax structure) is that the forms of equitable ownership of a corporation can be extremely complex. For example, different classes of corporate stock can provide different income rights, and there can be multiple tiers of corporate engagement in investments. A corporate tax system addresses this complexity.

For many years, the partnership form typically was employed in uncomplicated circumstances so the pass-through system operated quite well for those organiza-

tions. The provision of different tax treatment for partnerships is arbitrary in that it excludes those corporate enterprises that have uncomplicated forms of shareholder ownership and includes partnerships that have complex structures. The adoption of an arbitrary line of distinction is justified as a means of avoiding the administrative chaos that would follow from a rule requiring ad hoc determinations of the degree of an organization's complexity. The prejudice to small corporations is alleviated by the availability of the Subchapter S election.

Currently, the forms of ownership of partnership interests of some large limited partnerships have become as complex as those of many large corporations. The question arises whether such partnerships should be given pass-through treatment. The Treasury addressed this issue in its first Tax Reform proposal (Treasury I) when it proposed to treat a limited partnership with more than 35 partners as a corporation. This proposal was dropped by Treasury when it promulgated its revised version (Treasury II), sometimes referred to as the President's proposal.

The number of persons who own an interest in an organization should not be a factor in its classification. In that regard, the 35 shareholder limit on S corporations should be re-examined. Since the audit process focuses on the organization itself, there is no administrative difficulty in applying pass-through treatment to any number of persons provided that they are identified at the entity level.

Another question is whether the tax treatment of an organization should be determined by criteria that measure the relative difficulty of administering a pass-through system rather than by whether the organization is incorporated. Thus, an uncomplicated ownership form would have pass-through treatment, and a complicated ownership form would have a tax imposed at the entity level. Such a system would be extremely difficult to administer especially since the ownership of an organization can change from time to time and may thereby become more or less complex. The corporate-partnership division is a relatively easy one to administer and may well be preferable, provided that the typical corporation or partnership fits the complex or simple ownership pattern and provided that provision is made for those organizations which do not fall within the expected degree of complexity or simplicity. The Subchapter S election is a good device for dealing with these problems for incorporated organizations. It is elective so that an incorporated organization which does not wish to be subjected to the complexity of the pass-through system (and of the possible involuntary termination of pass-through treatment) need not have it imposed. While the Subchapter S provisions were liberalized in 1982, they might be further expanded.

As to the partnership, the pass-through system should be retained so long as the typical partnership has an uncomplicated ownership structure. As to those partnerships with complex structures, if they impose a significant administrative burden on the Service to apply pass-through treatment, then criteria should be established (by legislative action) to impose corporate tax treatment for such partnerships. But, if this is necessary, the distinction should be based on factors that are easy to ascertain even if the result is an arbitrary line of demarcation. The criteria that are adopted should be aimed at identifying organizations having a complicated form of ownership for which it is difficult to administer a pass-through tax system. For example, tiered partnership ownerships might present such a problem. To date, however, the Service appears able to administer Subchapter K even as to the more complex partnership forms. If so, the pass-through system should be retained for all partnerships, and the restrictions on qualifications for Subchapter S treatment should be re-examined in light of the experience with administering the more complicated forms of partnership structures. ◘

Douglas A. Kahn is a graduate of the University of North Carolina and of the George Washington University Law School. He practiced in Washington, D.C., and served as a trial attorney with both the Civil and Tax Divisions of the Department of Justice. He has written widely on the subject of federal taxation. Professor Kahn has co-authored two casebooks that are used in tax courses in a number of law schools, and has authored several text books on taxation. He began his academic career at Michigan in 1964 and is now the Paul G. Kauper Professor of Law.

DEFENSIVE SELF-TENDER OFFERS

by Michael Rosenzweig

Adapted with permission from the forthcoming article, "Defensive Stock Repurchases," Harvard Law Review, Volume 99, by Michael Bradley, Associate Professor of Finance, University of Michigan, Graduate School of Business Administration, and Michael Rosenzweig, Associate Professor of Law, University of Michigan Law School (which article is hereinafter referred to as Bradley & Rosenzweig). For the most part, documentation is not provided in this adaptation, as full citations may be found in the aforementioned article.

Target companies employ a variety of defensive tactics in an effort to thwart hostile bidders. In recent years, targets have resorted with increasing frequency to repurchases of their own stock to defeat hostile tender offers. This tactic may serve several strategic purposes. First, such repurchases may increase the percentage of the target's stock that is owned by management or management loyalists who are unlikely to tender, thereby enhancing the probability that the bid will fail. Second, a repurchase may raise the price of the target's stock above the tender offer price, forcing the bidder to confront the unwelcome dilemma of having to increase its offer or abandon the fight. Third, the repurchased stock may come from the bidder itself, which may agree as a condition of the sale to terminate its effort to win control of the target.

We may refer to all target stock repurchases that are undertaken to defeat a hostile takeover bid as "defensive stock repurchases." While target managers often effect such repurchases in the open market at prevailing market prices, many recent repurchases have been structured as cash tender offers, in part because managers believe that such a "self-tender offer" will attract the target's stock more quickly than an open market purchase program.[1]

Because they believe that management resistance to premium tender offers diminishes shareholder welfare, some commentators would bar target managers from fighting takeover bids with stock repurchases. I disagree. I believe that defensive stock repurchases should be permitted, so long as they are regulated to preserve a competitive balance among takeover contestants. This view derives from a theory of tender offer regulation based on the notion that there is a competitive market for corporate control, in which management teams (including the target's management) contend for control over the target's assets. This theory suggests that a fair competition among these management teams helps provide an efficient allocation of corporate resources. Thus, I conclude that tender offer regulation should be fashioned so as to avoid conferring a competitive advantage on one contestant or another, which is also consistent with Congress's goals in regulating takeover activity. Under this view, defensive self-tender offers[2] should be permitted (subject to certain conditions) in order to afford incumbent management a more equal opportunity to compete for control of the target.

I. A Proposed Theory of Tender Offer Regulation

Rather than offer either a general analysis of hostile takeovers or a broad critique of existing tender offer regulations, this article focuses on a particular aspect of those regulations, maintaining that if we choose to regulate hostile tender offers, we should endeavor to treat target and bidding managers evenhandedly, in order to facilitate allocation of corporate resources to their highest-valued uses.

There is a good deal of controversy among commentators regarding the reasons for hostile takeovers and the motivations of bidders, which naturally leads to disagreements about how to regulate target management defensive responses. On one hand, there are those who believe that tender offers are often used by so-called "corporate raiders" to expropriate the wealth of target shareholders. These commentators argue that bidders frequently exploit target shareholders by acquiring target firms for less than their pre-offer value or purchasing target shares at prices that fail to reflect the true value of the target's resources; they often support the use of legal rules to protect target shareholders from such exploitation, including rules that provide target managers with considerable latitude in defeating unwanted takeover bids. Members of this camp presumably would permit target managers to use either an open market stock repurchase program or a self-tender offer to thwart a hostile bid. Indeed, the extreme form of this view would be to give target management veto power over all takeover bids.

Some believe, on the other hand, that tender offers are frequently used by bidding firms to remove inefficient or self-dealing target managers. These commentators argue that takeover premiums often reflect mismanagement of the target firm and the bidder's belief that it can manage the firm more efficiently; they view target management resistance with suspicion, and commonly argue for greater restrictions on target managers' responses to unwanted takeover bids. Presumably, members of this camp would preclude target managers from pursuing *either* an open market repurchase program or a self-tender offer in the wake of a hostile bid. Some have even advocated a rule requiring target managers to remain passive in the face of an interfirm bid.

Existing empirical evidence appears to refute the "corporate raider" theory. Thus, studies reveal that target shareholders typically realize significant capital gains as a result of interfirm bids. More important, these studies show that the average post-execution market price of the target shares *not* purchased by the

acquiring firm is significantly greater than the average pre-offer price of these shares. In other words, even non-participating target shareholders earn significant positive returns as a result of a successful tender offer for their firm.

At the same time, neither does the evidence confirm the "inefficient or self-dealing management" hypothesis, for it says nothing about the *source* of the capital gains that accrue to target shareholders. To be sure, these gains may stem from the ouster of inefficient or self-dealing target managers, but they may also result from economies of scale, the combination of complementary resources, the redeployment of assets to more profitable uses, the exploitation of market power, or any number of value-creating mechanisms that fall under the general rubric of "corporate synergies." The evidence does not and cannot discriminate among these alternative explanations for the gains from tender offers. Indeed, there may be no "general theory" that explains tender offers; the sources of the synergies that are created through tender offers may well vary from case to case.

. . . defensive stock repurchases should be permitted, so long as they are regulated to preserve a competitive balance among takeover contestants.

Thus, the "synergy" theory of tender offers admits the inefficient or self-dealing management hypothesis as a particular explanation (among many) for tender offer gains, but does not assume that target managers are *generally* inefficient or self-dealing. Instead, under the general synergy theory, the tender offer is viewed as a transaction in the market for corporate control: a contest between the managers of the bidding and target firms for the right to control allocation of the target's resources. From this perspective, the transaction need not involve either corporate raiders *or* inefficient or self-dealing target managers.

I find the general synergy theory to be an attractive explanation of takeover activity, for it is consistent with existing empirical evidence and also allows one to reject the counterintuitive notion that target managers are *commonly* inefficient or dishonest. Thus, I view the hostile tender offer as a competition among rival management teams for the right to control the target's resources.

The social welfare implications of this view follow from the general theory that a competitive market is sufficient to ensure that resources will be put to their highest-valued uses. In other words, fair competition among rival management teams can prevent acquiring firms from effecting value-decreasing takeovers (*i.e.*, acquisitions for less than the target's pre-offer value) and keep target managers from defeating value-increasing acquisitions (*i.e.*, acquisitions at a price exceeding the target's pre-offer value). If there is to be regulation of tender offers, the law should treat target and bidding managers evenhandedly; that is, tender offer regulation should avoid conferring an advantage on either managerial team in the contest for control of the target's assets. From this perspective, permitting self-tender offers, subject to certain conditions discussed below, tends to "even the playing field," or put target management and the managers of the bidding firm in more equivalent positions.[3]

This view is also consistent with Congress's goals in regulating tender offers. In adopting the Williams Act, Congress wished to effect a neutral balance between target managers and outside bidders, interfering as little as possible with the market for corporate control.[4] To be sure, Congress did not articulate this view as part of a broader desire to facilitate allocation of the target's resources to their highest-valued uses. But the argument that target management and hostile bidders should be governed by the same rules in competing for control of the target because that advances an efficient allocation of the target's resources is certainly consistent with the congressional goal of neutrality.

. . . if we choose to regulate hostile tender offers, we should endeavor to treat target and bidding managers even handedly, in order to facilitate allocation of corporate resources to their highest-valued uses.

II. An Economic Justification for Defensive Self-Tender Offers

A. *Protection Against Corporate Raiders*

The defensive self-tender offer is an important safeguard against would-be corporate raiders. To see this argument, consider an interfirm tender offer in which the recognized objective of the bidding firm is to secure 51% of the target shares for a price that is just above market, liquidate the firm and expropriate the wealth of the remaining minority interest. In the absence of an alternative offer, the wealth-maximizing response of each target shareholder to this bid is to tender his shares. If the offer is unsuccessful, his wealth will remain the same whether he tenders or not. But if the offer is successful, the effect on his wealth will depend on his tendering decision: if he does not tender, his entire interest in the target will be worthless; if he tenders he will receive (assuming pro rationing) at least 51% of the pre-offer market value of his holdings. Since the decision of any one target shareholder cannot affect

the outcome of the offer, the rational response of each is to tender his shares to the bidding firm. Consequently, if target shareholders are a homogeneous group,[5] this individual optimizing behavior will insure the success of the outstanding offer even though the acquisition will decrease the aggregate wealth of the initial target shareholders.

One solution to this apparent "prisoner's dilemma" is to allow the target managers to engage in a self-tender offer. As long as the total value of the outstanding interfirm tender offer is less than the total pre-offer value of the target shares, target managers can always fashion a self-tender offer that dominates the takeover bid. In the current example, target managers can respond to the takeover bid by making a self-tender offer for 51% of the firm's stock at a significant premium above market. At the maximum, the target managers can offer up to a 96% premium for 51% of the target shares.[6] Note also that so long as the repurchase is effected on a pro rata basis, the premium paid for the repurchased shares is a matter of indifference to the target shareholders. Regardless of the magnitude of the premium, pro rata execution insures that the wealth of tendering shareholders will remain at pre-offer levels.[7]

The preceding analysis suggests that the self-tender offer can be used by target managers to defeat a value-decreasing interfirm tender offer. Clearly, however, this capital market transaction is not the only protection target shareholders have from corporate raiders. Legal rules governing fiduciary responsibilities to minority shareholders and the appraisal remedy also restrict corporate raiding. In addition, competition among corporate raiders works for the protection of target shareholders: ignoring differential abilities in expropriating wealth and the costs of making an offer, competition to become the successful raider should (in theory) bid up the value of the controlling block to the market value of 100% of the firm's securities. In the current example, competition among would-be raiders would force the winning bidder to pay a 96% premium (*i.e.*, 1/F) for a controlling interest.

Thus, there are forces operating in the market for corporate control other than the self-tender offer that serve to protect target shareholders from corporate raiders. But these may not, by themselves, offer sufficient protection. First, legal rules may be inadequate to police effectively against corporate raids. This is so not only because of the acknowledged difficulties of invoking the appraisal remedy and getting "fair value" given the variety of valuation techniques employed by the courts, but also because corporate raids less extreme than the example given earlier may be difficult to detect and police.

Second, the raid on the target firm's assets may not take the form of an explicit, lower back-end price in a two-tier tender offer, but result from a decision by the acquirer not to "cash out" the minority shareholders. In other words, there may be no explicit, lower-back-end freeze out merger subject to the appraisal remedy, but simply a partial tender offer, with the bidder then exploiting the subsidiary through internal transactions. It is true that legal rules governing the fiduciary responsibilities of majority shareholders may limit the extent to which the acquiring firm can "move" assets out of the target. But one must also recognize the difficulties courts have in constraining such activities, even where they are willing to endorse such shareholder fiduciary obligations.

Existing empirical evidence appears to refute the "corporate raider" theory. Thus, studies reveal that target shareholders typically realize significant capital gains as a result of interfirm bids.

Finally, one should not assume that competition among potential raiders is sufficient to protect target shareholders from a value-decreasing takeover bid. In most competitive markets, rents are competed away over time, so that actors have an incentive to compete in order to capture these rents in the short term. But in the market for corporate control, competition for targets usually consists of merely a series of revised bids. That is, a potential competitor may capture *no* rents from competing, because it may be outbid before it actually purchases any target shares. Since the ultimate outcome of such a competition may be to dissipate all potential gains from acquiring control of the target without allowing any competitor (even the winner) to reap any of these gains, the ability of any one competitor to capture rents is considerably more uncertain and the incentive of another firm to outbid a raider may be significantly reduced. In view of these concerns, why not give target managers the responsibility and wherewithal to defeat a raiding bid, particularly if (as argued below) there are no social costs in doing so?

B. *The Potential Social Costs of Defensive Self-Tender Offers*

It is important to show that permitting defensive self-tenders would not enable target managers to defeat desirable value-increasing acquisitions. I shall attempt to do so by advancing a hypothetical numerical example.

Assume that we have an all-equity firm valued at $8,000 with 200 shares outstanding, each trading at $40. Assume further that a bidding firm has made a tender offer for 100 of the firm's shares at $60 per share. The bidding firm has stated that if the offer is successful, it will use its majority position in the target to force a redemption of the remaining 100 shares at their current market price of $40 per share.

Now imagine that the target managers attempt to defeat the takeover bid through a self-tender offer for 120 of the firm's shares at $60 per share. Such a premium

repurchase has a predictable effect on the post-offer price of the target shares. Specifically, a premium repurchase is economically equivalent to a "front-end loaded, two-tier offer." The front end is the repurchase premium and the necessarily lower back end is the post-acquisition market price per share.[8] In the present example—with a pre-acquisition market price of $40 per share, a repurchase price of $60 per share, and a fraction of shares purchased of .6—a dilution of $30 per share results. (That is, the post-acquisition market price per share will be $10.)

As suggested earlier, a front-end loaded, two-tier tender offer, even if in the form of a self-tender offer, has the potential for placing target shareholders in a situation not unlike the classic prisoner's dilemma of game theory. In an attempt to avoid the inevitable dilution that would occur if the self-tender offer succeeded, target shareholders would be induced to reject the interfirm offer and accept the self-tender offer, even though the former is of greater value.

The solution to this apparent prisoner's dilemma is a revised offer by the initial bidding firm. In order to defeat the two-tier bid made by the target managers, the bidding firm must respond with its own two-tier bid. The optimal bidding strategy is to maximize the difference between the front end and the back end of the offer. Specifically, if target shareholders are faced with two front-end loaded two-tier bids, they will tender to the offer with the maximum difference between the front end and the back end.[9] Moreover, the management team that can put the target resources to their highest-valued use can also formulate a bid that maximizes the difference between the front and back ends.[10]

I find the general synergy theory to be an attractive explanation of takeover activity, for it is consistent with existing empirical evidence and also allows one to reject the counterintuitive notion that target managers are *commonly* inefficient or dishonest.

In the present example, the bidding firm need only *match* the repurchase offer in terms of the number of shares and the back-end price, and *compete* with the target managers on the front-end price. Since the bidding firm is willing to pay a total of $10,000 for the target firm, a back-end price of $10 for 80 shares implies that it would pay up to $9,200 in total for the 120 shares on the front end, or $76.67 per share. This translates into a premium of 92%. Clearly, such an interfirm offer would dominate the repurchase offer since the interfirm offer has a front-end premium of 92% and the repurchase offer has a front-end premium of only 50%, while both are for the same number of target shares and have the same back-end price.

Significantly, the amount that target managers can offer for target shares is limited by the target's pre-offer market value. In an efficient capital market, the pre-offer value of the target equity is an unbiased estimate of the value of these claims under current management (under the firm's current investment/production decisions). This value therefore places an upper bound on the amount creditors will offer to finance the repurchase. In the current example, target managers can only offer up to $8,000 (or $66.67 per share) for 60% of the firm's shares because presumably capital market agents would not pay more to finance the repurchase. If the target managers were to repurchase the 60% at $66.67 per share, the entire equity of the firm would be "cashed out."

If there is to be regulation of tender offers, the law should treat target and bidding managers evenhandedly; that is, tender offer regulation should avoid conferring an advantage on either managerial team in the contest for control of the target's assets.

The preceding analysis is general in its application. The management team that can put the target resources to their highest-valued use can *always* fashion a dominating two-tier bid. Thus, so long as the managers of the target and bidding firms are able to compete on an equal footing,[11] the team that can maximize the value of the target can also formulate a control-winning bid.

There are, however, two important qualifications to the foregoing discussion. First, if target managers can effect a self-tender offer for less than the interest being sought by the outside bidder, they will enjoy a clear advantage in the competition for target shares, enabling them to defeat even value-increasing bids. Second, target managers will enjoy a similar advantage if they can exclude the bidder from participating in a self-tender. I conclude by discussing each of these qualifications.

1. *Self-tenders for fewer shares than the bidder seeks.* Following the optimal bidding strategy described above (and recalling that the maximum price target managers can offer in a self-tender for F of its outstanding shares is P_o/F, where P_o is the pre-offer market price of target shares), the target managers in the current example could (in the extreme case) reduce the number of shares sought in the self-tender from 120 to *1* and increase the offer price from $60 per share to P_o/F, or

$8,000. Since the difference between the front-end and back-end prices would therefore be $8,000 for the defensive self-tender and $20 for the interfirm bid, target shareholders would tender to the target rather than the outside bidder.

While a defensive self-tender for one share is highly unlikely, this example illustrates the basic point that target managers will be able to defeat value-increasing bids if they are permitted to tender for fewer shares than the outside bidder wishes to purchase.

In the instant case, although the bidding firm is willing to pay up to $10,000 *to gain control of the target*, it obviously would not be willing to pay that amount for just one share or, more generally, for *less than a controlling interest*. In other words, a bidder willing to offer more than the current value of the target firm for a certain number of shares (usually a control block) will be unwilling to spend that amount for a smaller block. But if target managers can make a self-tender that offers up to the entire value of the firm for such a smaller block, they will defeat the outside bid. To overcome such a self-tender, the bidder must be prepared to purchase fewer shares than it originally wanted, in the usual case, a non-controlling interest, for a price that exceeds the target's total pre-offer value. By effecting a self-tender for fewer shares than the bidder seeks, therefore, target managers can defeat even a value-increasing bid.[12]

. . . defensive self-tenders [should] be permitted *only* if they seek the number of shares sought by the bidding firm.

In light of this possibility, I must qualify my proposal to allow defensive self-tenders by recommending that they be permitted *only* if they seek at least the number of shares sought by the bidding firm.[13] This would keep target and bidding managers on an equal footing, thereby facilitating the movement of corporate assets to their highest-valued uses.

2. *Discriminatory self-tenders.* The validity of my claim—that defensive self-tender offers can never be used to defeat value-increasing bids—also depends on a second important condition: the target must be barred from excluding certain target shareholders from participation in the offer. Consider, for instance, the following illustration (using numbers drawn from my previous example): A bidding firm purchases 25 of our target's outstanding 200 shares in the open market *before* announcing a tender offer to acquire an additional 75 shares at $50 per share (again with the stipulation that the bidder will "pick up" the remaining 100 shares at the pre-offer price of $40 per share if the offer is successful). Assume that the target's managers again attempt to defeat the bid by repurchasing the firm's shares, which, under my proposal, must be accomplished through a self-tender offer for at least the number of shares sought by the bidder. Let us imagine, however, that legal rules permit target managers to exclude the bidder from participation in the offer and that the self-tender therefore specifies that the bidder's 25 shares are not eligible for tendering.[14] Can target management use such a self-tender offer to defeat a value-increasing bid? Our example reveals plainly that it can.

Recall again that target managers can offer up to the pre-offer value of the target firm ($8,000 in our example) for the shares that it wishes to repurchase. Thus, if we assume that the target managers wish to repurchase, say, 75 shares, then the self-tender offer could be at a price as high as $106.66 per share. As demonstrated earlier, if the target managers were to repurchase the 75 shares at a price of $106.66, the effect would be to "cash out" the entire equity of the firm, with the result that the remaining 125 shares would be worthless. Shareholders other than the bidder, of course, would be permitted to participate in the offer on a pro rata basis, with each therefore receiving a "blended" price or total value of about $46 per share held (*i.e.*, a "blended premium" of approximately $6 per share); that is, if all 175 non-bidder-owned shares were tendered, 75 would be purchased at a price of $106.66 per share and 100, now worthless, would be returned to the target shareholders. But our bidder, barred from participating in the self-tender offer, would be left with 25 worthless shares; in effect, the bidder would have financed the $6 per share blended premium that is enjoyed by all other target shareholders with a capital loss equal to the total pre-offer value of its 25 shares. To put this somewhat differently, target managers would have expropriated $1,000 (25 shares x $40 per share) of the bidder's wealth in order to pay a premium of $6 per share on the 175 shares held by the other target shareholders.

The earlier analysis of optimal bidding strategy in a control contest demonstrates that, absent a revised offer by the bidder, the self-tender (with a difference between front and back ends of $106.66) would defeat the outside bid (with a difference between front and back ends of $10). It is still true, however, that the bidder will be able to defeat the self-tender by making a revised bid. Moreover, if the bidder does defeat the self-tender, then by hypothesis the bidder will not suffer the capital loss described above; obviously, the capital loss occurs only if the target in fact purchases shares other than the bidder's at a premium above the pre-offer market price. But allowing the target's managers to exclude the bidder from participating in the self-tender significantly alters the calculus for the revised bidding strategy, and might convince the bidder to abandon its value-increasing offer.

In order to fashion a winning revised bid, the bidder must offer at least $8,001 to the 175 shareholders. If the bidder follows the suggested optimal bidding strategy and competes with target management on the front-end price for 75 shares while matching the implicit

back-end price of zero for the remaining 125 shares, therefore, it will have to offer just over $106.66 per share for 75 shares, with the remaining shares effectively rendered worthless. Since the bidder in this case has already invested $1,000 in the target through the open market purchase of 25 shares, it follows that in order to win, it must spend a minimum total of $9,001.

This point may be stated more generally: if a bidder is precluded from tendering to a self-tender offer target shares that it may own, it must compete with an offer that, in effect, is partially financed with its own money. A winning bidder, therefore, must be willing to spend an aggregate amount that exceeds the pre-offer value of the target by at least the bidder's pre-offer investment in target shares. It follows that target managers can defeat all value-increasing offers by bidders who are not prepared to spend, in total acquisition costs, an amount that exceeds the pre-offer value of the target by at least the cost of any previous acquisitions of target stock by the bidder. More generally, a discriminatory self-tender can defeat all value-increasing bids that represent synergistic gains of less than the pre-offer value of the bidder's investment in the target's stock.

. . . a discriminatory self-tender can defeat all value-increasing bids that represent synergistic gains of less than the pre-offer value of the bidder's investment in the target's stock.

In the present example, a bid with total value of between $8,000 and $9,000 would be value-increasing; given, however, the bidder's pre-offer acquisition of 25 shares and legal rules that permit target management to exclude the bidder from participation in a self-tender offer, the bidder would face defeat unless it were willing to spend *more* than $9,000. Thus, the bidder's value-increasing bid of $50 for 75 shares, to be followed by a second-step merger at $40 per share, would be defeated.[15]

I therefore conclude that defensive self-tender offers should be permitted (a) only on a non-discriminatory basis, and (b) only if they seek at least the number of shares that the interfirm bidder wishes to purchase.[16] Self-tenders that either exclude or seek fewer shares than the bidder can be used to defeat value-increasing bids and, for that reason, should be barred.[17]

CONCLUSION

Defensive self-tender offers should be permitted in order to enable target managers to compete with hostile bidders for control of the target's resources. Self-tender offers help prevent "corporate raiding" and—so long as they are non-discriminatory and for at least the amount of stock being sought by the outside bidder—cannot be used by target managers to defeat value-increasing interfirm bids. ⊠

FOOTNOTES

[1] On the other hand, existing regulations of the Securities and Exchange Commission (sometimes hereinafter referred to as the SEC or the Commission) subject self-tender offers to special substantive rules and disclosure obligations that do not apply to other defensive stock repurchases. This dichotomous regulatory scheme creates significant incentives for target management to acquire stock in transactions (such as open market purchases) that may not be characterized as "tender offers." For a detailed discussion of these regulations and the phenomenon of defensive open market repurchases, *see* Bradley & Rosenzweig.

The SEC promulgated the federal tender offer rules pursuant to its authority under the Williams Act, which Congress adopted in 1968 to regulate tender offers and issuer stock repurchases.

[2] I use the term "defensive self-tender offer" to refer to a self-tender that is made by the target firm in response to an unwanted takeover bid, in an effort to thwart that bid.

[3] The rules governing self-tenders closely resemble those governing tender offers by outside bidders (so-called "interfirm bids"). For a detailed discussion of these regulations and proposed modifications that would "even the playing field" still further, *see* Bradley & Rosenzweig.

Note also that under existing regulations, *non*-tender-offer defensive stock repurchases give target managers an advantage over bidding firms in competing for control of the target's resources. Michael Bradley and I analyze this competitive advantage and suggest that it be eliminated. *Id.*

[4] For an extensive analysis of the legislative history of the Williams Act, *see* Bradley & Rosenzweig.

My claim, it should be emphasized, is that *if* there is to be regulation of takeover activity, it ought to be symmetric among all contestants, including the current target managers, lest those least hindered by regulation succeed in acquiring (or, in the case of incumbent management, preserving) control of the target with a lower-valued bid. I do not consider whether defensive stock repurchases *ought* to be regulated, nor do I discuss whether *nonregulation* of takeover activity would result in the optimal competitive balance. Rather, my analysis takes regulation of the tender offer process as given and proposes modifications of the present regulatory scheme that would eliminate certain competitive advantages that target managers currently enjoy.

Empirical evidence suggests that adoption of the Williams Act generally favored target managers by raising the costs of making bids and lowering the costs of defending against them. Apparently, the legislation itself was therefore decidedly unneutral, whatever Congress's stated intentions may have been. I do not claim that my proposed modifications would produce perfect regulatory neutrality. But adoption of my proposals would move the Williams Act scheme *closer* to the position of neutrality that Congress apparently favored.

[5] For an extensive discussion of the assumption of shareholder homogeneity, and the argument that recognizing the reality of shareholder heterogeneity would not materially affect our prediction of shareholder responses, *see* Bradley & Rosenzweig.

[6] Algebraically, the target managers can offer a repurchase premium [(Pt/Po)-1] of up to 1/F, where F is the fraction of target shares sought by the bidding firm and repurchased by the target firm, Pt is the self-tender offer price, and Po is the pre-offer price of target shares. For a discussion of why target managers are limited to offering an amount equal to the pre-offer value of the firm, *see below* pp.32.

[7] The wealth of non-tendering shareholders, of course, would be decreased. Nevertheless, this seems untroubling so long as the rules

governing self-tender offers ensure target shareholders a fair and realistic opportunity to tender. Arguably, SEC Rule 13e-4, which governs self-tender offers for publicly-held securities, guarantees such an opportunity. Thus, Rule 13e-4 provides for widely-disseminated notice of the self-tender, a minimum period during which the offer must remain open, and pro-rationing in the event of over-subscription.

[8] For a fuller discussion of this effect, *see* Bradley & Rosenzweig.

[9] It is important to understand that this is an optimal (winning) strategy *provided that* target shareholders are atomistic (*i.e.*, no one shareholder can affect the outcome of an offer) and agnostic (*i.e.*, no shareholder has any knowledge of what other shareholders will do). Given these assumptions, each shareholder will attempt to maximize his individual welfare, even though in the process collective welfare may be sacrificed. Obviously, if target shareholders could act collectively, maximizing the difference between the front end and the back end would not insure victory for a particular bidder, since the target shareholders would collectively analyze the *entire* value of each bid. That is, they would evaluate each bid in terms of the fraction of shares purchased at the offer price and the fraction purchased (or redeemed) at the back-end price. They would then tender collectively to the bidder that offered the highest-valued *total* bid, and they would be indifferent to the difference between the front end and the back end.

When target shareholders are forced to act individually, however, with no information other than market and offer prices, the tendering decision will turn on the difference between the front and back ends: the higher the front end is, the greater will be the premium realized if the offer is successful, which is an incentive to tender; the lower the back end is, the greater will be the (expected) cost of not tendering (*i.e.*, the cost of not participating) if the offer is successful. Both of these factors work to the advantage of the bidder that maximizes the difference between the front and back ends.

Of course, if (contrary to the assumption of homogenous shareholder expectations) shareholders base their decisions on predictions regarding the likely decisions of other shareholders or assign varying probabilities to different possible outcomes of competing bids, they may not tender to the management team that maximizes the difference between the front and back ends.

Ultimately, the extent to which target shareholders engage in "coordination games" or assign varying probabilities to different possible outcomes is an empirical question, as yet unanswered. There is, however, empirical evidence that is consistent with the assumption that target shareholders are atomistic and agnostic. Thus, Michael Bradley has successfully used a tender offer model based on this assumption to predict the market price of target shares during the pendency of an interfirm bid. The Bradley study also demonstrates that in *unsuccessful* offers, the post-offer price of target shares exceeds the rejected offer premiums. Both of these findings are consistent with the assumption that the tendering decision turns on a simple comparison of alternative premiums.

In addition, a recent study by the SEC's Office of the Chief Economist examined 69 successful partial and two-tier offers for New York and American Stock Exchange firms during the period 1981 through 1984, and showed that *all* were front-end loaded. These findings also suggest that target shareholders respond in the predicted fashion.

[10] Note that the availability of the appraisal remedy to target shareholders may effectively prevent an interfirm bidder from undertaking a second-step takeout merger at less than the pre-offer market price of target shares. In addition, fair-price provisions in the target's charter may have much the same effect. Neither constraint, of course, applies to self-tenders, where the back end is simply the post-execution market price of target shares. Accordingly, the appraisal remedy and (where applicable) fair-price charter provisions may place a floor under the back end for the interfirm bidder but not the target managers. If so, then self-tenders could readily be used to defeat value-increasing interfirm bids, since the target managers would enjoy a significant competitive advantage in fashioning their bid.

I would make two points with respect to this observation. First, the appraisal remedy and fair-price charter provisions in fact constrain bidders only to the extent that a take-out merger is likely. Some claim that a take-out is highly probable following a successful partial bid, but base that claim on the unproven assertion that bidder attempts to expropriate target wealth through self dealing cannot go undetected. If this assertion is incorrect, then appraisal and fair-price provisions may be much less significant limitations on the bidder's ability to lower the back end.

Second, it is not clear (at least to me) that appraisal and fair-price provisions should operate against the bidder where the target's managers have responded to an interfirm bid with a defensive self-tender offer. In other words, if (as I argue) we can rely on the defensive self-tender offer to protect target shareholders against expropriation of their wealth, then appraisal and fair-price provisions seem unnecessary and, given their role in possibly conferring a competitive advantage on target management, potentially quite costly. While this issue plainly requires careful thought and more extended treatment than I provide here, it may therefore make sense to nullify the appraisal remedy and the target's fair-price charter provisions once the target managers effect a defensive self-tender offer in response to an interfirm bid.

[11] I have argued, in favor of allowing defensive self-tender offers, that the tender offer process should be viewed as a competition among management teams and that the current management team should not be prevented from participating. One impact of my proposal, as compared with one that would bar all target management activity, would be to increase the likelihood of competitive bidding for the target. Commentators disagree sharply on whether competitive bidding is desirable. Some argue that competitive bidding dissipates the gains to the ultimately successful bidder, thereby reducing the incentive to make an initial bid. Others maintain that competitive bidding facilitates the movement of corporate resources to their highest-valued uses and believe that rules encouraging competitive bidding will not necessarily reduce the level of search for takeover targets. While I offer no new insights regarding this debate, I believe that permitting defensive self-tenders at worst reduces the incentive to search for *value-decreasing* acquisitions. If so, then that may be an acceptable cost of my proposal.

[12] After the target has repurchased the shares it seeks, however, the bidder can make a new offer that reflects the fewer shares outstanding and the reduced value of the target, thus continuing its quest for control. At the extreme, the bidder can wait until the target has bought all of its shares but one and then make a dominating offer for the remaining (controlling) share. Thus, defensive self-tenders for fewer shares than the bidder seeks cannot *by themselves* defeat value-increasing acquisition attempts. (This assumes, as I propose below, that the target may not exclude the bidder from any defensive self-tender offer.) They can, however, delay execution of a value-increasing takeover, increasing its expense and providing target management time to erect other barriers to a change of control. The competitive advantage thus afforded target managers is sufficient reason to bar such defensive self-tender offers.

[13] Under this proposal, four recent defensive self-tender offers would be illegal. In July, 1985, CBS responded to a hostile takeover bid by Ted Turner for 67 per cent of CBS's shares with a defensive self-tender seeking 21 per cent of its stock. In August, 1985, Revlon made a self-tender offer for 5 million of its 38.3 million common shares in an effort to fend off a bid by Pantry Pride for any or all Revlon shares. In October, 1985, Cluett Peabody responded to a tender offer by a group led by Paul Bilzerian for all of Cluett's outstanding shares with a defensive self-tender seeking slightly less than 25 per cent of its stock. And in December, 1985, Union Carbide responded to an all-cash, any-or-all bid by GAF with a defensive self-tender for 35 per cent (later increased to 55 per cent) of its common stock.

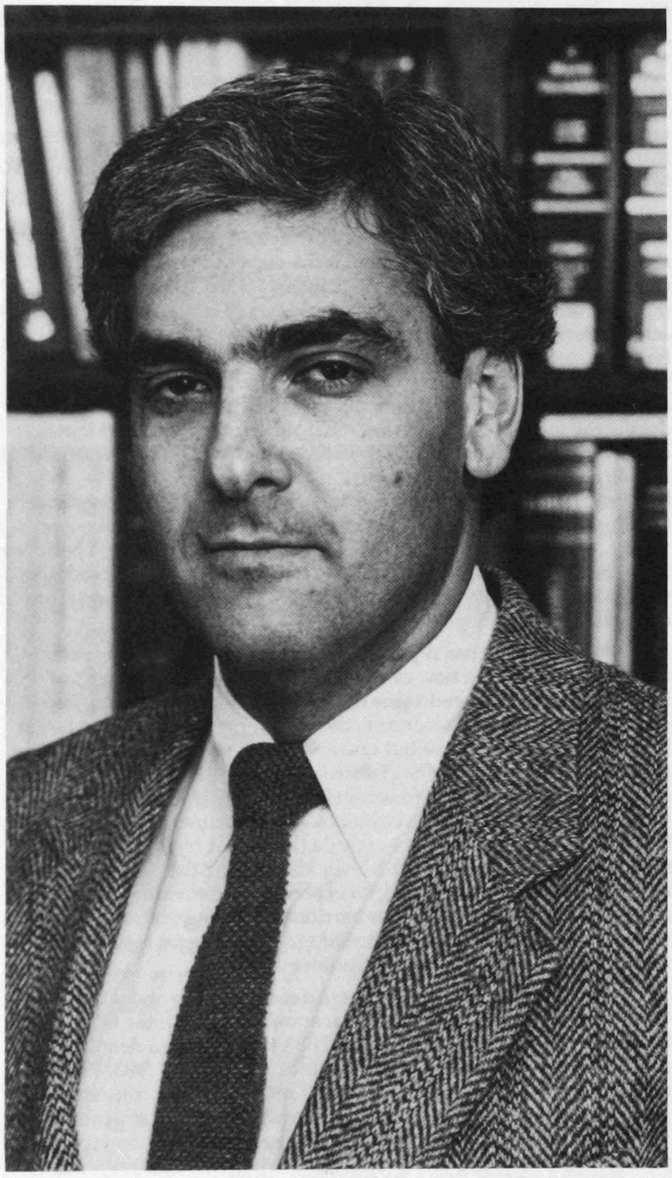
The defensive-self tender recently effected by Unocal Corporation to defeat a takeover attempt by T. Boone Pickens, Jr., discussed below, would also be barred by the rule I propose.

[14] This example essentially describes the recent takeover bid by T. Boone Pickens, Jr. for control of Unocal Corporation, and Unocal's self-tender offer made in response thereto.

[15] In the Unocal–Pickens contest, Pickens agreed to abandon his value-increasing bid almost immediately after the Delaware Supreme Court upheld the condition of the Unocal self-tender offer barring Pickens from tendering any of his Unocal stock.

[16] The SEC recently proposed amendments to Rule 13e-4 that, among other things, would bar discriminatory self-tender offers. These proposals are discussed in Bradley & Rosenzweig.

[17] For the argument that this conclusion is also mandated by the Williams Act, *see* Bradley & Rosenzweig.



Michael Rosenzweig is a graduate of the University of Michigan and of the Columbia University School of Law. After a clerkship with Judge Paul R. Hays of the United States Court of Appeals for the Second Circuit, he practiced in Atlanta, Georgia. He began his academic career at Michigan in 1979. His teaching and research interests are primarily in the areas of corporate and securities law.

Law Quadrangle Notes

Second Class Postage
Paid at Ann Arbor, Michigan

The University of Michigan Law School / Ann Arbor, Michigan