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S.1323 – THE MURKY ISSUE OF CORPORATE TAKEOVER LAWS

INTRODUCTION

The full Senate has begun debating S. 1323, the "Tender Offer Disclosure and Fairness Act of 1987." This bill would increase federal regulation of corporate takeovers. Before voting on such legislation, Congress should address and answer a central question: Is federal law or state law paramount in this area? The answer is as complex as the issue of takeovers. Both federal and state laws, it can be argued, legitimately apply to corporate takeovers. It therefore would be wise for Congress to recognize that:

1) States must retain the primary responsibility for setting the legal framework for corporate takeovers.

2) The federal government retains the primary responsibility for protecting the ownership rights of shareholders when management seeks to use state law to block the desires of a majority of shareholders.

State Intervention. The 1968 Williams Act is the principal federal securities law regulating tender offers. The Act sets procedural guidelines to govern tender offers and establishes rules requiring public disclosure of certain information relating to the bidder's intentions and to the intended method of financing the takeover. State legislatures often have intervened in the takeover process by mandating stricter disclosure rules and longer tender offer periods than those required by the Williams Act. These state rules typically are designed to protect the management of a corporation and have worked to the disadvantage of the shareholder.[1] Until recently, such state laws were held to impose an unconstitutional burden on interstate commerce.[2] The discriminatory nature of the state

1 Roberta Romano, "The Political Economy of Takeover Statutes," *Virginia Law Review*, Vol. 73, 1987, p. 112.

2 In *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), the Supreme Court struck down an Illinois takeover law. The decision effectively invalidated takeover laws in 36 other states. States subsequently amended their laws to accommodate *MITE*, repealed them, or eased their enforcement.

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takeover laws was said also to conflict with the neutrality of the Williams Act, thus violating the Constitution's Supremacy Clause, which provides that the "Constitution and the Laws of the United States...shall be the supreme Law of the Land."

Landmark Ruling. This interpretation changed with the Supreme Court's April 1987 decision in *CTS Corp.* v. *Dynamics Corporation of America.*[3] In this case, the Court found an Indiana anti-takeover statute constitutional. As a result of this landmark ruling, 27 states already have passed legislation designed to deter takeovers of corporations located in the state if the corporation's management opposes the takeover attempt. Among other provisions, the Indiana law removes the voting rights of any investor who acquires 20 percent of a company, unless the shareholders vote to reinstate them. This ostensibly is designed to prevent the holder of a large block of shares from taking control of the corporation.

Delaware, too, has moved against takeovers. Last February, Governor Michael Castle signed into law a statute that provides that an unwanted buyer who acquires more than 15 percent of a target company's stock cannot complete the takeover except unless:

1) A buyer acquires, all at once, at least 85 percent of the target company's outstanding stock, excluding shares owned by directors and officers; or

2) Two-thirds of the shares, excluding those held by the bidder, vote in favor of an acquisition; or

3) The board and shareholders decide to exempt themselves from the provisions of the law.[4]

Economist Robert Samuelson notes that with over half the *Fortune* 500 companies incorporated in Delaware, passage of the law, "amount[s] to a national anti-takeover law."

Hovering Constitutional Questions. Despite the Supreme Court's *CTS* decision, constitutional questions still hover over some state anti-takeover laws. On April 21, 1987, for instance, an Oklahoma federal court struck down the state's Control Shares Acquisition Act, ruling that unlike Indiana's takeover law (which applies only to in-state corporations) the Oklahoma law applies to corporations from any state. This, said the federal court, unnecessarily burdens interstate commerce.[5]

Legal scholars Henry N. Butler and Larry E. Ribstein of the George Mason University School of Law, meanwhile, argue that some state takeover laws violate the Contract Clause of the Constitution[6] to the extent that the laws amend the shareholders' contract with the managers of the firm without obtaining the shareholders' prior consent. According to this argument, the modern corporation is a nexus of implied contracts among many different parties.

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3 107 S. Ct. 1637 (1987).

4 Stephen Labaton, "Debate Over a New Takeover Law," *The New York Times,* February 1, 1988, p. D1.

5 *TLX Acquisition Corp. v. Telex,* 1987 WL 42600 (April 21, 1987).

6 The Contract Clause refers to Article I, Section 10 of the United States Constitution which states that, "no state shall [pass any] law impairing the Obligation of Contracts...."

In deciding whether a state's anti-takeover statute is unconstitutional under the Contract Clause, it must be determined whether the law impairs the corporate contract. Under the Indiana statute and similar state laws, shareholders lose their power to transfer control freely. Whereas prior to the Indiana law a selling shareholder could transfer full voting rights to any purchaser of his stock, a bidder who has acquired 20 percent of the corporation is foreclosed from receiving voting power. Furthermore, shareholders who bought stock with the intent of acquiring control before the corporation was covered by the anti-takeover law are denied rights that had accrued to them.[7]

A Matter of Contract Rights. By limiting the market for shares and discriminating against minority shareholders, state takeover laws such as Indiana's seem to impair the contract rights of shareholders. In effect, these laws may be an involuntary restriction on shareholder suffrage.

In justifying the necessity of such laws, some states argue that without them corporate managers will re-charter their corporations in states that have greater protection. Butler and Ribstein argue that this is "clearly...a taking of share value from the shareholders for the benefit of the state,...[entitling] the shareholders to reasonable compensation."[8]

AMENDING THE WILLIAMS ACT

In its consideration of S. 1323, the Senate Banking Committee discussed several proposals for correcting the perceived deficiencies of state anti-takeover laws. Among the proposals were provisions for total federal preemption of state anti-takeover law and measures to require that all publicly held corporations adopt the one share/one vote standard. This latter issue is important because it prevents management from creating "special" classes of stock with inordinate voting power. These amendments were rejected by the Banking Committee. In its present form, S. 1323 is silent on the issue of the federal-state role in the regulation of hostile takeovers.

S.1323 changes the Williams Act in the following manner:

1) Purchase Disclosure Requirements. The period for disclosure of a 5 percent acquisition of a company's stock is shortened from ten to five days. The disclosure must include the identity of those with whom the acquisition was discussed during the 30 days prior to disclosure, along with information on financing and fees. Purchases beyond 5 percent must be disclosed within one day.

2) Group Activity. Coordinated buying programs involving separate acquirers, even in the absence of an agreement to act together, must be disclosed.

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7 Henry N. Butler and Larry E. Ribstein, "State Anti-Takeover Statutes and the Contract Clause," from working paper, February 1988, p. 61-63.

8 *Ibid.*, p. 74.

3) Acquisition Intent. Buyers must disclose clearly whether their acquisition is for passive investment purposes or for control of the company. Those who claim a passive intent may not, for at least 60 days, change their intent and begin buying shares for takeover purposes.

4) Tender Offers. The tender offer period is lengthened from 20 to 35 business days. If an Employee Stock Ownership Plan (ESOP) owns more than 10 percent of a firm that is the object of a tender offer and the employees decide to make a bid for the company, the tender offer period is lengthened by 60 business days.

5) Proxy Solicitations. Owners of more than 10 percent of a company can, at the company's expense, include their own materials and board candidates in the proxy mailing distributed by the firm.

S. 1323 also limits the use of "greenmail,"[9] increases insider trading penalties, requires arbitrageurs to register with the Securities and Exchange Commission, and authorizes studies on the role of the states, leveraged buyouts, and the proxy solicitation process.

Opting Out Provisions. State takeover laws typically restrict the sale of corporate assets, limit the voting power of acquiring shareholders, require a supermajority of stock owners to approve any takeover, and extend tender offer periods. But in many cases, corporations are permitted to "opt out" of the regulations if the shareholders choose not to be included in the law's coverage. But these opt-out provisions often are more cosmetic than real. Example: under Delaware's takeover law, unless opting out is approved by the corporation's board of directors (unlikely because the directors presumably want to preserve their jobs), stockholders must wait until the next annual meeting and usually will have to wage an expensive proxy fight to opt out. But even if the stockholders win an opt-out vote, they must wait one year before their action becomes effective.

In other states, corporate directors are given the alternative of "opting in" to the coverage provided by the law. By taking advantage of the statute, directors can limit shareholders' rights sharply in ways that are not possible at a general meeting.[10] Indeed, many state anti-takeover laws have been enacted hastily at the behest of a local firm. When T. Boone Pickens, Jr., the Texas oilman and takeover specialist, for example, sought to acquire Seattle-based Boeing Co. in April 1987, the Washington state legislature convened a special one-day session to adopt an anti-takeover statute. The law was designed specifically to hinder Pickens.

EFFECT ON THE ECONOMY

Do takeovers harm the economy? It is difficult to make a case that they do. So far, for instance, takeovers have not deterred investment in research and development. Between 1979 and 1986, a period of intense takeover activity, funds designated for research and

9 "Greenmail" occurs when a company makes a payment to a potential acquirer who has purchased a block of the company's stock with the intent of making a hostile tender offer. In order to negate the threat, the company buys the block of stock from the potential acquirer at a premium.

10 Butler and Ribstein, *op. cit.*, p. 62.

development increased by 51 percent in real terms. Between 1969 and 1976, when hostile takeovers rarely made news, the rise was just 12 percent.

Nor have corporate takeovers increased unemployment. An active market for corporate control expands, rather than decreases, employment by encouraging restructuring of the economy. And even when a takeover results in some layoffs, generally this is an alternative to a plant shutdown, which would cause much larger job losses. Between 1981 and spring 1988, a period of heightened takeover activity, the unemployment rate has fallen from 7.5 percent to 5.4 percent. And the National Bureau of Economic Research concludes that "wages generally grow faster following acquisitions [and]...employment grew faster."

Impacts on Shareholder Wealth. One of the most reliable indicators of the wisdom of an acquisition is the judgment of the stock market. Studies find that the shareholders of target companies typically see stock price jumps of 16 to 34 percent.[11] A Securities and Exchange Commission (SEC) study finds that, between 1981 and 1986, shareholder wealth increased by $167 billion as a result of takeovers.[12]

By contrast, state takeover laws do not seem to benefit stockholders. Studies by the Federal Trade Commission and the SEC of the New York and Ohio takeover statutes, respectively, conclude that the laws generally harm stockholders of state-protected firms.[13] The wealth of shareholders in New York-chartered corporations, for instance, declined by $1.2 billion. More recently, two former Council of Economic Advisors staff members conducted a study of the economic impact of Indiana's takeover law and conclude that shareholders of Indiana corporations lost $2.65 billion in equity value.[14]

Economic protectionism appears just as harmful at the state level as at the national level. The depressing effects of state anti-takeover regulations should serve as a lesson to Congress as lawmakers consider federal regulation of the market for corporate control.

Defensive Measures. To the extent that shareholders themselves freely desire to be "protected" from takeovers, the corporate charter process already provides them with a

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11 See Michael C. Jensen, "Takeovers: Folklore and Science," *Harvard Business Review*, November-December 1984, pp.109-121; David L. Prychittco, "Corporate Takeovers and Shareholder Interests," Citizens For A Sound Economy *Issue Alert* No. 13, April 16, 1987; Gregg A. Jarell, James A Brickley, and Jeffrey M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," *Journal of Economic Perspectives*, Winter 1988, pp. 49-68.

12 Joseph A. Grundfest and Bernard S. Black, "Stock Market Profits from Tender Activity between 1981 and 1986: $167 Billion is a Lot of Money." Securities and Exchange Commission, September 28, 1987.

13 See Laurence Schumann, "State Regulation of Takeovers and Shareholders' Wealth: The Effects of New York's 1985 Takeover Statutes," Federal Trade Commission, March, 1987; and Office of the Chief Economist, "Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers," Securities and Exchange Commission, May 18, 1987.

14 J. Gregory Sidak and Susan E. Woodward, "Corporate Takeovers, The Commerce Clause and The Efficient Anonymity of Shareholders," working paper, March 17, 1988.

flexible means to structure the company accordingly. If the shareholders desire to make it more difficult for their corporation to become a takeover candidate, they may vote to adopt a variety of defensive measures, including those found in state anti-takeover laws. For instance, they can adopt "poison pills"[15] or staggered terms for directors. If, on the other hand, the owners would like to become more open to possible acquisition, they may amend the charter by adopting provisions such as one share/one vote rules.

Such stockholder self-help approaches are essentially private contractual arrangements between the shareholders and the corporation's management which, ostensibly, works for the shareholders. Anti-takeover amendments to the corporation's charter thus are decisions made by those with a direct ownership stake in the consequences of their actions. By contrast, anti-takeover statutes are the product of legislators who will not bear the costs of their actions.[16]

CONCLUSION

Corporate law long has been the prerogative of states rather than the federal government. This prerogative is a cornerstone of America's federal structure and should be preserved. Yet free interstate commerce also is a cornerstone of the American system. And state laws hindering the interstate transfer of corporate ownership can be as harmful to shareholder and employee long-term interests as any federal law limiting shareholder rights. Thus in determining the proper role, if any, of the federal government regarding corporate takeovers, it is necessary to consider the principles of both federalism and free interstate commerce. Federal preemption of state law in this area would be an undesirable intrusion into the traditional role of the states in formulating corporate law – even if federal statutes were to enhance the rights of shareholders. Yet for Washington to do nothing would allow state anti-takeover laws to interfere with interstate commerce.

Proper Federal Role. The federal role thus must be to protect interstate commerce and property rights, while leaving the regulation of corporations to the states. It would be a legitimate exercise of federal power, for example, for a federal law to mandate that all state statutes connected with takeovers include an "enabling clause" requiring management to obtain stockholder approval before adopting any anti-takeover measures permitted in a state law. Instead of being forced as they now are to take the initiative and go to the expense and trouble of "opting out" of anti-takeover statutes, shareholders would not be subject to state anti-takeover measures unless they voluntarily "opted in." It also would be appropriate for federal law to prevent corporate managers from taking hasty action specifically to thwart a takeover. A federal law thus could allow corporations to adopt takeover defense provisions only prior to announcement of a tender offer.[17] When a tender offer was filed formally with the Securities and Exchange Commission, however, the

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15 A "poison pill" usually is an issue of stock designed to discourage hostile takeovers. Upon completion of a hostile takeover, the typical poison pill stock becomes convertible into cash or into common stock, thus considerably raising the cost of the acquisition.

16 Henry N. Butler, "Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters," Draft of a paper requested by the *Wisconsin Law Review*, December, 1987, p. 13.

17 Butler, *op. cit.*, p. 32.

corporate governance contract would be frozen until control of the corporation was resolved.

A federal law focusing on the rights of shareholders to determine how open the corporation should be to possible acquisition would accommodate both federalism and economic freedom principles. States should be permitted to enact legislation regulating takeovers (provided that the laws pass constitutional tests) and corporations should be free to adopt the powers granted by the law after obtaining stockholder approval. Requiring stockholder prior consent before the corporation is subject to a state takeover law's coverage thus would maintain the supremacy of state corporate law while preserving the right of shareholder self-determination.

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