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Arthur R. Pinto

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Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*

ARTHUR R. PINTO**

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I. INTRODUCTION

Although federal law, particularly federal securities law, regulates aspects of many corporations, it is state law that traditionally governs the formation, structure, and internal relationships of corporations. Congress could federalize most corporate law, but has deliberately chosen not to do so.[1] Moreover, the Supreme Court of the United States has repeatedly recognized the importance of state corporate law in our federal system.[2] Yet recent federal court decisions have found state corporate statutes that have an impact on tender offers unconstitutional as an impermissible burden on interstate commerce. These decisions are both undercutting the development of state law and calling into question existing provisions of state corporate law.

The Supreme Court has noted probable jurisdiction in *CTS Corp. v. Dynamics Corp. of America*[3] and should decide the case this year. The case raises significant questions about the interplay between the

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1. *See generally* Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. ___ (1987); Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

2. *See infra* text accompanying notes 102-05.

3. 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

interstate commerce clause of the Constitution[4] and state corporate law.

The increase in the number of hostile takeovers, where an outside group wants to take over another corporation without the approval of its management, as a phenomenon of corporate life, has led to responses by Congress and many state legislatures.[5] In 1968, Congress passed the Williams Act,[6] which was designed to regulate corporate takeovers. The first generation of state takeover statutes, enacted for the most part after the Williams Act, generally gave state officials broad powers to require additional disclosure beyond that required in the Williams Act and to determine the fairness of a tender offer and often extended the time periods provided by the Williams Act. In *Edgar v. Mite Corp.*,[7] the Supreme Court of the United States found most of these statutes unconstitutional as an unreasonable burden on interstate commerce.

Subsequently, state legislatures began to enact statutes applicable only to corporations that were incorporated in that state. These statutes usually attempt to insure that all shareholders receive equivalent payments, or require a shareholder vote upon acquisition of a certain percentage of shares to authorize either the purchase of their shares or other acquisitions.[8] This second generation of statutes often has a direct impact on the acquisition of shares in a corporation through a tender offer.

Now, state legislatures have enacted a new third generation of takeover statutes. These statutes also apply to corporations incorporated in the state, but do not directly affect the acquisition of shares. Rather, they affect the ability of the acquiror to vote or use those shares. Thus, these statutes are more like the traditional corporate statutes that regulate the internal affairs of corporations.

These statutes have been the target of constitutional attacks under the commerce clause. I believe that the use of the interstate commerce clause to invalidate some of these statutes is improper and unwise. Although one may disagree with these statutes for policy reasons, the use of the commerce clause to strike them down has negative

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4. U.S. CONST. art. I, § 8, cl. 3.

5. *See generally* Aranow & Einhorn, *State Securities Regulation of Tender Offers*, 46 N.Y.U. L. REV. 767 (1971); Pinto, *Takeovers of Public Corporations in the United States*, 34 AM. J. COMP. LAW 271 (Supp. 1986).

6. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982)).

7. 457 U.S. 624 (1982).

8. *See* Warren, *Developments in State Takeover Regulations:* Mite *and Its Aftermath*, 40 BUS. LAW. 671 (1985); *see also* Sargent, *Do the Second Generation State Takeover Statutes Violate the Commerce Clause?*, 8 CORP. L. REV. 3 (1985).

implications for other state corporate laws and for the internal affairs doctrine. The result, in effect, may be to federalize some state laws by allowing federal courts to eliminate significant state corporate law provisions. If the Supreme Court were to use a preemption analysis[9] to avoid the impact of the statutes, the results will be less problematic for state corporate law development. I believe, however, that the Williams Act does not preempt many of these statutes.[10]

This article will focus on the implications of using the commerce clause to attack state anti-takeover statutes. I will first discuss the Supreme Court's response in *Edgar* to the first generation of state statutes. The next section describes the various state law models that legislatures have enacted since *Edgar* and the implications of the Court's analysis of the commerce clause on these models. I will then focus on the importance of the internal affairs doctrine of conflict of laws as a single law in fostering commerce, the state's role in the market for corporate charters, and the contractual nature of corporate law in analyzing the impact of the commerce clause on these models. I will review the implications of two recent decisions finding several statutes unconstitutional for my analysis and will suggest, given my concerns, how the courts should analyze the statutes.

II. *Edgar v. Mite*

In 1968, Congress responded to the rising number of hostile tender offers by enacting the Williams Act, which amended sections 13 and 14 of the Securities and Exchange Act of 1934.[11] Much of the Williams Act follows the general approach of federal securities law of enhancing investor protection by requiring sufficient time and disclo-

9. When Congress exercises its power in an area, the issue of preemption of concurrent state law under the supremacy clause of the Constitution arises. U.S. CONST. art. VI, cl. 2. Federal law will override state law that conflicts with it. State regulation may be preempted when "[a] conflict will be found 'where compliance with both federal and state regulations is a physical impossibility . . . or' where state 'law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.' " *Edgar*, 457 U.S. at 631 (citations omitted) (quoting Ray v. Atlantic Richfield Co., 435 U.S. 151, 158 (1978)).

10. The argument that the Williams Act preempts state statutes focuses on the congressional concern in enacting the Act with neutrality between incumbent management and the hostile offeror. State law that favors incumbent management arguably frustrates the purpose of the Williams Act. I am not convinced that, in 1968 and 1970, Congress adopted the market for corporate control as its model for both state and federal regulation of tender offers. The references to neutrality in the legislative history refer to federal legislation not to state law. *Edgar*, 457 U.S. at 655 (Stevens, J., concurring). Congress clearly knew how to affect shareholders' rights and state corporate law by specifically enacting provisions in the Williams Act for the protection of investors, such as the mandatory equal opportunity rule in the Act. *See infra* note 12.

11. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982) (amended 1968).

sure of material information so that the shareholder offerees can determine whether to tender their shares.[12]

Although Virginia had a statute dealing with tender offers prior to the Williams Act, there is no evidence that Congress considered the Virginia statute when passing the Williams Act.[13] From the 1968 enactment of the Williams Act until the Supreme Court decision in *Edgar* in 1982, a total of thirty-seven states enacted statutes that dealt with tender offers.[14] These "first generation" statutes generally provided additional defenses for incumbent management in fighting hostile tender offers, such as mechanisms that could delay or even halt a tender offer. The legislatures apparently believed that they were protecting local investors and industry from the potential disruption a successful hostile tender offer might cause.[15] Critics, on the other hand, argued that the legislation was an attempt by state legislatures to protect incumbent management from losing control.[16]

The Illinois statute challenged in *Edgar* typified many of these first generation statutes. The statute provided that the Secretary of State could hold a fairness hearing concerning a tender offer and determine whether there was "full and fair disclosure to the offerees."[17] The Secretary of State was empowered to enjoin a nationwide tender offer if the statute's requirements were not met. The statute was applicable to a target corporation that had ten percent of its shareholders in Illinois and satisfied two of the three following conditions: 1) its principal executive offices were located in Illinois; 2) it was organized under Illinois law; or 3) ten percent of its stated capital or paid in surplus was situated in Illinois.[18]

A tender offeror challenged the statute on the theories that the Williams Act preempted it and that its provisions unconstitutionally burdened interstate commerce. While the Supreme Court found that the statute was unconstitutional as an "indirect burden" on interstate commerce, a majority of the Court never reached the preemption

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12. *See generally* T. HAZEN, THE LAW OF SECURITIES REGULATION 359 (1985). The legislation also gives shareholders an important substantive right, an equal opportunity to share in the premium offered pursuant to the tender. Securities Exchange Act of 1934, § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982).

13. *Edgar*, 457 U.S. at 631 n.6.

14. *Id.*; *see also* Warren, *supra* note 8, at 671 nn.2-3.

15. Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1282-83 (5th Cir. 1978), *rev'd sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979).

16. Dart Indus. v. Conrad, 462 F. Supp. 1, 9-10 (S.D. Ind. 1978).

17. Illinois Business Take-Over Act, ILL. REV. STAT. ch. 121 1/2, ¶ 157 (1982), *repealed by* 1983 Ill. Laws 365; *see also Edgar*, 457 U.S. at 627.

18. ILL. REV. STAT., ch. 121 1/2, ¶ 137.51-.70 (1982).

issue.[19] Justice White, joined by two other Justices, found the Illinois Act preempted because it frustrated the purposes of the Williams Act.[20] He found that a "major aspect of the effort of the Williams Act to protect the investor was to avoid favoring either management or the takeover bidder" and that Congress "expressly embraced a policy of neutrality."[21] The Illinois statute, which favored incumbent management by enabling it to cause delays that could preclude the shareholders from making their own choice, inhibited investor autonomy and thus was not neutral.[22] Several courts have used this rationale to preempt both second and third generation statutes.[23]

Five Justices in *Edgar* found that the Illinois statute was an unconstitutional indirect burden on interstate commerce. Although states may not regulate interstate commerce directly, they may use their powers in ways that have an indirect burden on interstate commerce unless the burden imposed on interstate commerce exceeds the "putative local benefits" of the regulation.[24] The Court held the burdens imposed by the Illinois statute to be excessive in relation to the local interests served by the statute.[25] The statute burdened interstate commerce, according to the Court, because it interfered with nationwide tender offers and affected shareholders and the economy.[26] The frustration of tender offers causes shareholders to lose an opportunity to sell their shares at a premium, lessens the reallocation of economic resources to a higher valued use, and hinders the incentive management has to perform well to avoid a hostile tender offer.[27]

Illinois claimed that a benefit of the legislation was the protection of shareholders. The Court found the interest to be insufficient. First, Illinois had no interest in protecting out-of-state shareholders. Second, the exemption in the statute for self-tenders by target corporations undermined the state's argument that the statute protected investors. Finally, some of the protection provided by the statute on

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19. For a discussion of preemption, see *supra* note 9.

20. *Edgar*, 457 U.S. at 630-40.

21. *Id.* at 633.

22. *Id.* at 637-38. Delays provided by the timing requirements of some statutes can be viewed as interfering with the timing requirements of the Williams Act. *See* Canadian Pac. Enters. (U.S.) Inc. v. Krouse, 506 F. Supp 1192 (S.D. Ohio 1981).

23. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (finding that federal law preempts Indiana's voting rights third generation statute); Icahn v. Blunt, 612 F. Supp. 1400 (W.D. Mo. 1985) (finding that federal law preempted Missouri's shareholder approval second generation takeover statute); *see also infra* notes 32-54 and accompanying text (discussing the statutory models).

24. *Edgar*, 457 U.S. at 646.

25. *Id.*

26. *Id.* at 643-44.

27. *Id.*; *see infra* notes 76-83 and accompanying text.

disclosure and timing went beyond that provided in the Williams Act and did not appear to enhance investor protection. If there were benefits to these requirements, they were speculative and outweighed by the burden caused by management's enhanced ability to defend against a tender offer.[28]

Illinois also claimed that its statute merely regulated the internal affairs of Illinois corporations. The internal affairs doctrine is a conflict of laws principle that generally applies the law of the state of incorporation to matters that involve the relationship among shareholders, managers, and directors of a corporation.[29] The Court did not discuss the significance of the internal affairs doctrine to the commerce clause because it found the doctrine to be inapplicable. According to the Court, tender offers involve transactions between shareholders and offerors which do not implicate the internal affairs doctrine. In addition, the Illinois statute did not require the corporations to be incorporated in Illinois and the doctrine does not cover foreign corporations.[30]

III. LEGISLATIVE RESPONSES

In an attempt to avoid the fate of the Illinois statute, several state legislatures have enacted or amended their statutes so as to withstand constitutional attack. If a majority of the Court were to adopt Justice White's preemption view, however, there would be little room for state law that impacts on tender offers. Most takeover statutes would probably be unconstitutional as favoring management, thereby not maintaining neutrality.[31] The states have primarily sought to avoid the commerce clause problem. In this endeavor, they have used several different statutory models.

One of the first approaches to the *Edgar* problem was a "shareholder approval model" that was first enacted in Ohio.[32] The law

28. *Edgar*, 457 U.S. at 643-44; *see infra* notes 84-86 and accompanying text.

29. RESTATEMENT (SECOND) OF THE CONFLICT OF LAWS § 302 (1971).

30. *Edgar*, 457 U.S. at 645.

31. In Piper v. Chris-Craft Industries, the Supreme Court stated: "[N]eutrality is, rather, but one characteristic of legislation directed toward a different purpose—the protection of investors." 430 U.S. 1, 29 (1977). One could argue that if the state legislation helps investors, then federal law does not preempt it. For example, the second tier model may protect investors by assuring equal opportunity. *See infra* text accompanying notes 35-38. Although the statute may increase costs that could deter an offer, the primary purpose of the Williams Act is investor protection.

32. OHIO REV. CODE ANN. §§ 1701.01, .831 (Anderson 1985). *See generally* Kreider, *Fortress Without Foundation? Ohio Takeover Act II*, 52 U. CIN. L. REV. 108 (1983). The Sixth Circuit held the statute unconstitutional on preemption and commerce clause grounds. Fleet Aerospace Corp. v. Hoderman, 796 F.2d 135 (6th Cir. 1986).

applied only to corporations incorporated in Ohio.[33] Furthermore, its provisions were applicable only if the Ohio corporation had fifty or more resident shareholders, and its principal place of business, principal executive offices, or substantial assets were located in Ohio. The acquisition of the shares of a corporation subject to the Ohio statute would require the approval of the disinterested shareholders at specific ownership thresholds.[34] Thus a corporation was to treat the tender offer similar to other forms of acquisitions, such as mergers, by requiring a shareholder vote.

A different approach, taken by Maryland,[35] was a "second tier" model which focused on the strategy of some offerors to use the front loaded two-tier takeover. That strategy involves, as a first step, the offeror announcing a tender offer for a sufficient number of shares to gain control of the corporation. The tender offer, usually in cash, is at a higher price than the price the offeror has announced it will pay to the remaining shareholders in a second step transaction. In the second step, the offeror now in control votes to effectuate what is called a freezeout transaction, such as a merger, through which the shareholders lose their equity position.[36] When shareholders are faced with an offer of a higher price in cash in the tender offer and the lower price in the freezeout, they will generally feel compelled to tender their shares to try to receive the premium. Commentators and courts have suggested that such tactics are coercive, because they force shareholders to tender for the higher price, and unfair to unsophisticated shareholders who fail to tender at that price.[37] The Maryland statute sought to respond to this concern by assuring the shareholder of a Maryland corporation either a supermajority vote on the second stage of the transaction or a fair price to the nontendering shareholders that would be at least as much as the price offered in the first tier tender

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33. OHIO REV. CODE ANN. § 1701.01(A) (Anderson 1985).

34. The Ohio Takeover Act established three thresholds for shareholder voting on acquisitions of: (a) one fifth to one third of the voting stock; (b) one third to less than a majority; or (c) a majority or more. *Id.* § 1701.01(Z)(1).

35. MD. CORPS. & ASS'NS CODE ANN. §§ 3-601 to -603, 8-301(14) (1985); Scriggins & Clarke, *Takeovers and the 1983 Maryland Fair Price Legislation*, 43 MD. L. REV. 266 (1984).

36. *See* Comment, *Going Private*, 84 YALE L.J. 903, 928-29 (1985). The shareholders who are in a minority position usually must accept the payment offered or seek appraisal. Appraisal is not often a viable alternative because it is time-consuming and uncertain.

37. *Id.*; *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (permitting Unocal to exclude a hostile offeror from a self tender because, among other things, the court was concerned with front loaded two-tiered takeovers); Bebchuk, *Towards Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1696 (1985) (arguing that these offers lead to a distorted choice by shareholders because they fear they will be excluded from the premium price).

offer.[38]

A third approach, the "share redemption model," enacted in Pennsylvania, requires any shareholder who acquires a certain percentage of stock (such as thirty percent) to buy out the remaining shareholders at "fair value" upon their demand.[39] This model, like the second tier model, avoids the problems of the two tier front loaded tender offer and provides shareholders with equal opportunity to be bought out at a fair price.[40]

Another approach, also taken by Pennsylvania,[41] can be described as the "fiduciary duty model." It authorizes the board of directors to consider the effects of any of the board's actions on employees, suppliers, and customers of the corporation and the communities in which the corporation is located.[42] By expanding the fiduciary concept, the statute allows directors to employ legitimately any defensive strategy to resist hostile tender offers that negatively impact on corporate constituencies other than shareholders.[43]

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38. *See supra* note 35. Several corporations have enacted the equivalent of the Maryland statute by requiring a fair price provision in the certificate of incorporation. *See* Profusek & Gompf, *State Takeover Legislation After* MITE*: Standing Pat, Blue Sky, or Corporation Law Concepts?*, 7 CORP. L. REV. 3, 30 n.168 (1984).

39. 15 PA. CONS. STAT. ANN. §§ 1408B, 1409.1(c)(1)-(3), 1910 (Purdon 1986). The fair price will be determined in a manner comparable to other appraisal proceedings, but any premium the offeror paid will also be considered. *Id.*; Newlin & Gilmer, *The Pennsylvania Shareholder Protection Act: A New State Approach to Deflecting Corporate Takeover Bids*, 40 BUS. LAW. 111, 115 (1984). It is possible that fair value could be determined by appraisal in the "share redemption model" to be greater than the amount offered in the first tier.

40. In Great Britain, the City Code on Takeovers and Mergers requires an offeror, upon acquiring 30% of the securities, to purchase the remaining shares. DeMott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. REV. 945, 960 (1983).

41. 15 PA. STAT. ANN. § 1408 (Purdon Supp. 1984-1985).

42. *Id.* § 1408B. Corporations have enacted social responsibility charter amendments which are similar to the model. *See, e.g.*, Profusek & Gompf, *supra* note 38, at 30 n.168. Ohio recently enacted several changes to its corporate law in response to Sir Goldsmith's attempt to takeover Goodyear Tire and Rubber. Greenhouse, *Ohio's Tough Takeover Curb*, N.Y. Times, Dec. 16, 1986, at D2. The amendments extend the protection of the business judgment rule to changes in control and termination of the director's services and place the burden on a plaintiff to establish a violation using a clear and convincing evidence standard. OHIO REV. CODE ANN. § 1701.59(c) (Anderson 1986). In addition, the directors can consider the long-term interests of the corporation and the possibility that the independence of the corporation may serve those interests. *Id.* § 1701.59(E)(4).

43. In Unocal Corp. v. Mesa Petroleum Co., the Supreme Court of Delaware, in upholding a self tender which excluded a hostile offeror, stated that "the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders." 493 A.2d 946, 954 (Del. 1985). *But cf.* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (indicating that a lock up option could violate a director's fiduciary duty). The *Revlon* court indicated that *Unocal* permits consideration of other constituencies provided there are "rationally related benefits accruing to the stockholders." *Id.* at 182.

Many states, including Minnesota,[44] have enacted the "full disclosure model." This statutory model requires an offeror to give a variety of information to the shareholders.[45] The increased disclosure can include more information about the offeror and the impact of the tender offer on all of the corporate constituencies and the community.[46] The state legislatures have limited the application of these statutes to shareholders residing in the state of incorporation.[47] Failure to comply with the statutes precludes the tender offer only in that state because an offeror may choose to make its offer in other states.[48]

A "voting rights model" has recently been adopted in a number of states, including the Indiana statute which the Supreme Court will review in *CTS*.[49] Under this model, shareholders who acquire a certain percentage of shares may be denied their voting rights unless they comply with the statute. The statutes usually require the vote of the disinterested shareholders in order for the offeror to have voting rights in the additional shares acquired.[50] The statute may also restrict the transferability of the shares and provide for redemption by

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44. 1984 MINN. SESS. LAW SERV. 488 (West). In Cardiff Acquisitions, Inc. v. Hatch, the court found the Minnesota full disclosure statute to be constitutional on both commerce clause and preemption grounds. 751 F.2d 906 (8th Cir. 1984).

45. Some of the information required by the statutes is often similar to that required under the Williams Act. In *Cardiff*, the court emphasized that repetition may be beneficial given the limited resources of the SEC in enforcing its rules. 751 F.2d at 912. *But cf.* National City Lines v. LLC Corp., 687 F.2d 1122, 1131-32 (1985) (additional disclosure " 'may accomplish more harm than good' by confusing shareholders").

46. *E.g.*, N.Y. BUS. CORP. LAW § 1603(a) (McKinney 1986). *See generally* Pinto & McGrath, *Problems and Issues Raised in State's New Takeover Law*, N.Y.L.J., Mar. 17, 1986, at 21 (discussing New York statute).

47. *E.g.*, N.Y. BUS. CORP. LAW §§ 1601(c)-(d), 1602 (McKinney 1986).

48. An offeror seeking to continue its tender offer in another state may invoke the SEC's recent all holders rule, which allows an offeror to avoid making an offer in a given state if the offeror has made a good faith attempt to comply with the statute of that state, but has been barred from making an offer due to administrative or judicial action, so long as the statute is held to be constitutional. *Amendments to Tender Offer Rules—All-Holders and Best Price*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,016 (July 11, 1986).

49. Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

50. IND. CODE §§ 23-1-42-1 to -11 (1986). The statute does not define a disinterested shareholder, but "interested shares" means

> the shares of an issuing public corporation in respect of which any of the following persons may exercise or direct the exercise of the voting power of the corporation in the election of directors:
>
> (1) An acquiring person or member of a group with respect to a control share acquisition.
>
> (2) Any officer of the issuing public corporation.
>
> (3) Any employee of the issuing public corporation who is also a director for the corporation.

Id. § 23-1-42-3.

the target corporation.[51]

The "business combination model," which originated in New York,[52] differs significantly from the other models because it does not directly affect an offeror's ability to acquire or vote its shares. In fact, there are no restrictions on an offeror's ability to acquire or use the shares. This model focuses on the ability to use the target's assets after control has been acquired. Once a shareholder acquires a certain percentage of stock in a corporation, that "interested shareholder" must receive director approval before it acquires more shares or before it seeks a business combination with the corporation.[53] Failure either to seek or to receive the requisite approval precludes future business combinations between the interested shareholder and the corporation for a specified period or a shorter period if the disinterested shareholders approve of opting out of the statute. Because business combinations are broadly defined in the statute,[54] the model effectively limits an acquiror's ability to effectuate transactions that freezeout the minority shareholders to take complete control of the corporation or to use the corporate assets to finance the acquisition through leveraging. A business combination is required for those transactions.

The voting rights and business combination models represent what I describe as the third generation of state statutes. They allow the tender offer to occur, but severely limit the offeror's rights in the corporation.

All of the models are found in various states, sometimes in combination with each other[55] and often with differing require-

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51. *Id.* § 23-1-42-10. Wisconsin has a variation of this model which provides that anyone who acquires in excess of 20% of the voting power shall be limited to 10% of the voting power of those shares. WIS. STAT. § 180.25(9)(a) (1986).

52. N.Y. BUS. CORP. LAW § 912 (McKinney 1986). *See generally* Pinto & McGrath, *supra* note 46; Pinto, *N.Y. Law*, Nat'l L. J., Feb. 24, 1986, at 17.

53. N.Y. BUS. CORP. LAW § 912(b). In New York, an interested shareholder is one who owns 20% of the voting stock. *Id.* § 912(a)(10).

54. Under New York law, the definition of a business combination includes mergers and consolidations; sales or dispositions of assets having a value equal to 10% or more of the aggregate market value of all assets; liquidations and recapitalizations; issuance or transfer to an interested shareholder by the resident domestic corporation of any stock having a market value of 5% or more of the aggregate market value of all the outstanding stock of the corporation; a reclassification of the securities or any other transaction that results in an increase in the interested shareholders' proportionate share of the outstanding shares, and any receipt by the interested shareholders of loans, tax credits or other financial assistance from the resident domestic corporation. *Id.* § 912(a)(5).

55. *E.g.*, IND. CODE § 23-1-42-1 to -11 (1986). Indiana's statute includes both the voting rights and business combination models. Only the voting rights model was found unconstitutional in Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 250 (1986).

ments.[56] What is common to most of the state statutes is that they apply only to corporations that are incorporated in that state. In addition, the statutes often require that there be some shareholders residing in the state and that the principal executive offices or significant assets are located in the state. Unlike the first generation statute invalidated in *Edgar*, none of the models, except the full disclosure model, involves any state administrative mechanism with the tender offer. Many of the statutes have either an opting out or opting in provision, which allows a corporation to elect whether it should be covered by aspects of the model.

IV. THE COMMERCE CLAUSE

It is important to determine whether any of these models is permissible under the commerce clause to evaluate the extent to which states can regulate tender offers. If the commerce clause severely limits or precludes this type of state activity, then other state corporate law that affects tender offers may also be impermissible.

The commerce clause of the Constitution provides, "Congress shall have the Power . . . to regulate Commerce . . . among the several States . . . ."[57] Although the clause clearly gives Congress authority to regulate commerce, it does not explicitly restrict the states when Congress has not regulated. It is the "great silences" of the Constitution which have given the Supreme Court the power to determine the role of the states in regulating interstate commerce.[58] If Congress has taken no action in an area, then the extent to which a state can regulate interstate activities rests on the "dormant" or unexercised commerce clause.[59] In *Cooley v. Board of Wardens*,[60] the Court

56. Both Indiana and New York have business combination model statutes, yet Indiana has a 10% interested shareholder requirement, while New York requires 20%. *Compare* IND. CODE § 23-1-43-10(a)(1)-(2) *with* N.Y. BUS. CORP. LAW § 912(a)(10).

57. U.S. CONST. art. I, § 8, cl. 3.

58. H.P. Hood & Sons, Inc. v. DuMond, 336 U.S. 525, 535 (1949).

59. *See* G. GUNTHER, CONSTITUTIONAL LAW 230 (11th ed. 1985); *see also* Tushnet, *Rethinking the Dormant Commerce Clause*, 1979 WIS. L. REV. 125. According to Professor Tushnet, courts should use the dormant commerce clause sparingly, especially given Congress's ability to preempt state law. He would use an enhanced due process analysis of state regulation. *Id.* at 125; *see also* Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425 (1982). Professor Eule argues that state parochialism today is more likely to eviscerate the democratic process than free trade and argues for a process-oriented protection of representational government. *Id.* at 428-29. He also emphasizes the ability of Congress to preempt state law as a reason to limit the use of the dormant commerce clause especially given the role of regulatory agencies. *Id.* at 435. Congress plays an active role in securities law issues and the SEC has shown a willingness to use its power to preempt state law. For example, the all holders rule, *see supra* note 48, preempted the Delaware Supreme Court decision in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *see supra* note 43 (discussing *Unocal*).

established the principle that state activity that affects interstate commerce will "be judged in light of the desirability of permitting diverse responses to local needs and the undesirability of permitting local interference with such uniformity as the unimpeded flow of interstate commerce may require."[61]

When analyzing state economic regulation, the courts will attempt to distinguish between "direct" and "indirect" state activity.[62] The courts will generally strike down a statute that regulates interstate commerce directly, discriminates against interstate commerce, or favors state economic interests over out-of-state interests.[63] When a nondiscriminatory statute has an indirect effect on interstate commerce, courts will uphold the statute if it "regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental . . . unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[64]

A plurality of four Justices in *Edgar* found the Illinois statute to be a direct burden on interstate commerce and therefore invalid.[65] The plurality found the statute to be a direct burden because it could preclude shareholders who were residents of another state from transacting in interstate commerce with the offeror.[66] The plurality was concerned that other states would impose similar regulations that could stifle interstate tender offers. The Court also indicated that a statute whose application takes place wholly outside of a state, even if it has effects within the state, is not permissible.[67]

If the post-*Edgar* statutes directly burden interstate commerce,

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60. 53 U.S. (12 How.) 299 (1851).

61. L. TRIBE, AMERICAN CONSTITUTIONAL LAW 325 (1978). According to Professor Tribe, the issue of whether to classify the regulation as "national" or "local" has become less important and the focus is now on how the state proposes to regulate interstate commerce. *Id.*

62. Professor Tribe indicated that the labels of direct and indirect burden are only conclusory and misleading and, in their place, the Court has substituted a more indeterminate principle. State regulation will be upheld if (1) it is rationally related to a legitimate state end, and (2) the burden imposed on interstate commerce and any resulting discrimination are outweighed by the state's interest in enforcing the regulation. *Id.* at 326. The Court appears to recognize the difficulty in distinguishing between direct and indirect burdens, but still uses the distinction. *See* Edgar v. Mite, 457 U.S. 624, 640-41 (1982).

63. Brown-Forman Distillers Corp. v. New York State Liquor Auth., 106 S. Ct. 2080, 2084 (1986).

64. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

65. *Edgar*, 457 U.S. at 643. In *Brown-Forman*, the Court cited the plurality in *Edgar*, which could indicate that a majority of the Court now views the Illinois statute as a direct regulation. *Brown-Forman*, 106 S. Ct. at 2084, 2086.

66. *Edgar*, 457 U.S. at 642.

67. *Id.* at 642-43. The Court indicated that it will look to whether the practical effect of regulation is beyond the state. *Id.* at 643.

then a court should find them invalid without weighing their benefits. For example, the plurality's reasoning indicates that the shareholder approval model affects nationwide tender offers more directly than other models because it includes a mechanism that can preclude the acquisition of shares in a nationwide tender offer. The other models may in fact defeat or deter a tender offer but do not directly prohibit it.[68] Under the shareholder approval model, an offeror is unable to acquire shares unless it receives approval by a vote of disinterested shareholders.[69] This provision in effect replaces the tender offer market with a market for votes through a proxy fight.

Although the shareholder approval model may have more of a direct impact on interstate commerce than do the other models, it does not follow that such regulation is per se invalid and not subject to the balancing tests used when there is indirect impact. In *Edgar*, the Illinois statute gave a governmental agency the power to stop a tender offer, while the determination of whether a tender offer is accepted under the shareholder approval model depends on the nongovernmental action of the shareholders. In *Brown-Forman Distillers Corp. v. New York State Liquor Authority*,[70] the Supreme Court referred to *Edgar* when it indicated that seeking "regulatory approval in one state before undertaking a transaction in another directly regulates interstate commerce."[71] Thus, the shareholder approval model is not an example of direct state regulation of interstate commerce; rather it regulates corporations and allows shareholder voting, which may have an effect on interstate commerce, and therefore should be considered at most an indirect regulation.

The second tier, fiduciary duty, redemption, full disclosure, voting rights, and business combination models have, if anything, an indirect impact on tender offers because they do not prohibit the offer.

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68. If a substantial number of shareholders is present in the state of incorporation, a state agency, under the full disclosure model, may effectively preclude a tender offer by prohibiting the offer in that state. *See infra* note 72.

69. Recent post-*Edgar* decisions have found state shareholder approval statutes to be direct restraints on interstate commerce. Fleet Aerospace Corp. v. Holderman, 637 F. Supp. 742, 760-61 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986) (Ohio Control Share Acquisition Act); Terry v. Yamashita, 643 F. Supp. 161 (D. Haw. 1986) (Hawaii Control Share Acquisition Act). Both courts followed the reasoning of the plurality opinion in *Edgar*. The court in *Terry* suggested that the Supreme Court's reliance on *Edgar* in *Brown-Forman* indicated that a majority of the Court "now squarely disapproved of such a direct regulation on interstate commerce." *Terry*, 643 F. Supp. at 165 (discussing Brown-Forman Distillers Corp. v. New York State Auth., 106 S. Ct. 2080 (1986)). Yet the Ohio and Hawaii statutes differed from the statute in *Brown-Forman* because they required shareholder approval of the tender offer as opposed to government approval.

70. 106 S. Ct. 2080 (1986).

71. *Id.* at 2086.

These models regulate corporate actions that either make the tender offer more costly or frustrate the plans of the offeror. Similar to other blue sky regulation, the full disclosure model restricts its application to shareholders within the state and can only limit the tender offer in that state.[72] The redemption model allows tender offers so long as all the shareholders are treated equally. The fiduciary model allows tender offers, but gives directors more discretion to adopt defensive tactics that can thwart the offer. The second tier, voting rights, and business combination models allow the offeror to acquire shares on any terms it chooses, but affect its ability to use those acquired shares. The second tier model restricts voting by the offeror only on transactions that would freezeout shareholders. The voting rights model has a greater negative impact on the offeror because it restricts all voting rights, which is the fundamental reason to buy shares. If the model also restricts transferability or requires redemption of shares, then it leaves the offeror with little reason to buy the shares. The business combination model has a lesser impact than the other two models because it prevents the offeror from using its shares to effectuate transactions for its benefit, but allows the offeror to vote its shares to gain control of the corporation.

A majority of five Justices in *Edgar* used the balancing test to hold that the Illinois statute was an impermissible indirect burden on interstate commerce.[73] The Court found that the burdens the statute imposed were excessive in relation to the benefits. The Court indicated that the burden of the Illinois statute was its negative impact on nationwide tender offers and shareholders because it interfered with the market for corporate control. The theory of the market for corporate control is based upon the assumption that the trading markets are efficient and the price of a corporation's stock reflects all available information about the corporation.[74] Because management runs a corporation without a substantial equity interest in the corporation, a

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72. In *Edgar*, the Court appeared to view the blue sky regulation favorably as being explicitly allowed by Congress in section 28 of the Securities and Exchange Act of 1934, and as applying to transactions within the state. *Edgar*, 457 U.S. at 641 (discussing 15 U.S.C. § 78bb(a) (1982)). Yet the Court's broad language, which supports the market for corporate control, could undercut such regulation if for example there is a significant number of shareholders in a state, which would in effect stop the offer. In Martin-Marietta Corp. v. Bendix Corp., the court suggested that a statute that prevents local shareholders from participating in a nationwide tender offer might have the effect of defeating tender offers where the tender offer can succeed only with the participation of the local residents. 690 F.2d 558, 567 (6th Cir. 1982).

73. *Edgar*, 457 U.S. at 643-44.

74. *See* J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-97 (1973); *see also* Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). *But see* Lowenstein,

possibility exists that it may manage the corporation inefficiently or for its own interests. Assuming the efficiency of the market, the price of the corporation's stock will reflect the fact that management is not maximizing value and will attract an offeror willing to pay a premium over the market price to run the corporation more efficiently.[75]

The Court gave three reasons why interference with the market for corporate control burdened interstate commerce. First, if tender offers are prevented, shareholders are deprived of an opportunity to sell their shares at a premium.[76] While it is generally true that shareholders receive more than the current market price, it is not so clear that all shareholders do in fact benefit by the premium compared to the value of the shares after a thwarted tender offer.[77] Second, according to the Court, tender offers reallocate economic resources to their higher valued use, which should in theory improve efficiency and competition.[78] Again, it is not clear that the shareholders of the offeror benefit by an acquisition. Recent studies have indicated that acquiring companies are not benefiting their own shareholders with tender offers.[79] The fact that someone is willing to pay more for a corporation does not mean that efficiency will follow. In both micro and macro economic terms, the verdict is still out on the benefits of hostile takeovers.[80] Third, the tender offer provides a mechanism motivating incumbent management to perform well in order to keep prices high.[81] While the trading markets are generally efficient, it does not follow that the price of a corporation's stock on a given day reflects the intrinsic value of the corporation or its value in the acqui-

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Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 COLUM. L. REV. 249, 274-76 (1983); *infra* note 82.

75. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173-74 (1981); *see also* COUNCIL OF ECONOMIC ADVISORS, 1985 ECONOMIC REPORT OF THE PRESIDENT 187-88 (1985).

76. *Edgar*, 457 U.S. at 643-44.

77. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 109-10 (1979). *But see* F. Easterbrook & G. Jarrell, SEC Advisory Committee on Tender Offers 48-49 (July 8, 1983) (dissenting statements in an unpublished report based on efficient capital market hypothesis).

78. *Edgar*, 457 U.S. at 643-44.

79. *See, e.g.*, Scherer, *Takeovers: Present and Future Dangers*, 4 BROOKINGS REV. 15 (Winter/Spring 1986). *Contra* Ginsburg & Robinson, *The Case Against Federal Intervention in the Market for Corporate Control*, 4 BROOKINGS REV. 9 (Winter/Spring 1986).

80. *See, e.g.*, Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

81. *Edgar*, 457 U.S. at 643-44. Many commentators have argued that offerors seek out well-managed corporations. *E.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979). It is argued that the shares of those corporations that take the long-term view trade at prices below their intrinsic value, subjecting the corporations to hostile takeover threats. *See* E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 98-103 (1981); Lowenstein, *supra* note 74, at 268-76.

sitions market.[82] The Court's wholesale adoption of the market for corporate control thesis without noting its deficiencies or its impact on other concerns in corporate law seems unwarranted.[83]

The two benefits that Illinois cited to defend its statute were that the statute protected resident shareholders and merely regulated the internal affairs of Illinois corporations. The *Edgar* Court had little difficulty in dismissing these concerns because the scope of the legislation went well beyond the protection of resident shareholders and there were insufficient benefits to justify this impact.[84] In addition, the statute exempted the target corporation's acquisition of its own shares undercutting the Illinois argument of investor protection. The Court dismissed the internal affairs issue because, in the tender offer context, the issues involve the transfers of shares between shareholders, which does not implicate the internal affairs of the target corporation.[85] In addition, the statute did not require that the corporation be incorporated in Illinois and Illinois had no interest in regulating the internal affairs of foreign corporations.[86]

The articulated reasons for state takeover legislation other than investor protection and the internal affairs doctrine include the protection of local industry, employment, and the long-term growth of local companies.[87] These arguments have not fared well with the courts. Courts faced with this rationale are skeptical about whether the legislation in fact produces the benefits ascribed to it. One court indicated that it will not assume that a state's interest is furthered by a statute; the court stated that it "has the constitutional duty to determine whether state-desired benefits can, in fact, result from the statute and only those which are not speculative may be placed in the scale to be balanced against the burden on interstate commerce."[88] The legis-

82. Lowenstein, *supra* note 74. Recent articles have questioned the use of the efficient market theory in developing corporate law. *See* Kornhauser, Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 CALIF. L. REV. 341 (1986).

83. *Cf.* Buxbaum, *Federalism and Company Law*, 82 MICH. L. REV. 1163, 1165-66 (1984).

84. *Edgar*, 457 U.S at 644.

85. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 comment e (1971).

86. *Edgar*, 457 U.S. at 644.

87. Icahn v. Blunt, 612 F. Supp. 1400, 1417 (W.D. Mo. 1985); *see also Edgar*, 457 U.S. at 648 (Powell, J., concurring). One commentator has suggested that takeover regulation may be prompted by four concerns: 1) states want to assure resident shareholders enough time and information; 2) states are exercising their rights to prescribe share attributes in corporations organized in that state; 3) states are concerned with maintaining local plants and facilities; and 4) states are interested in the quality of life in the areas where the corporations are headquartered. Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733, 746 (1979).

88. APL Ltd. Partnership v. Van Dusen Air, Inc., 622 F. Supp. 1216, 1221-22 (D. Minn. 1985).

lation that generally favors incumbent management in its ability to thwart a tender offer does not appear to protect a state's business climate because it is not clear that either a hostile offer will negatively affect the local economy or that the incumbent management has any great concern for a particular state.[89] The fact that legislation has a potentially economic parochial basis may make it easier to attack on economic protectionist grounds. There also may be more direct ways to accomplish the desired results than to expect that management will look out for the economic interests of the state.

Assuming the Court will continue to use the balancing test in cases involving those statutory models that have an indirect impact on tender offers and will continue to adopt the market for corporate control thesis that tender offers benefit shareholders and society, then to what extent should the commerce clause invalidate the various models previously described? What benefits and burdens should the Court consider when looking at these various models?

The Court in balancing the burdens and benefits should weigh heavily the importance of the internal affairs doctrine which comes into play particularly with the third generation statutes. The doctrine provides advantages as the source of a single law and as a necessary component of the market for corporate charters. Indeed, because the *Edgar* Court recognized the importance of the market for corporate control thesis espoused by the law and economics movement,[90] the Court should also recognize the significant advantages to shareholders that flow from a competitive market for corporate charters and the contractual nature of corporate law. These features of state takeover statutes indicate that the burdens placed on commerce, if any, are likely to be small.

V. INTERNAL AFFAIRS

The internal affairs doctrine is a conflict of laws principle that suggests that the law of the state of incorporation shall govern intracorporate relationships such as matters concerning the relationship among or between the corporation and its officers, directors, and shareholders.[91] In some cases where a state other than the state of

89. *Icahn*, 612 F. Supp. at 1417.

90. The Court in *Edgar* cited Professors Easterbrook and Fischel to support its view that interference with hostile takeovers burdens interstate commerce. *Edgar*, 457 U.S. at 643-44 (citing Easterbrook & Fischel, *supra* note 75; Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5, 27-28, 45 (1978)). *See supra* text accompanying notes 76-81.

91. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 comment e (1971). *See generally* DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 LAW &

incorporation has a more significant relationship to a particular issue and the parties, its law will apply.[92] Thus, many of the statutory models require a significant relationship, such as significant corporate assets, principal place of business, or significant number of resident shareholders in a state, in addition to the requirement of incorporation in a state.[93] The internal affairs doctrine, which requires the use of one state's law, encourages convenience and predictability of legal application.[94]

A. *Single Law Principle*

In considering the constitutional implications of the internal affairs doctrine, most commentators and courts have focused on the full faith and credit clause[95] or the due process clause of the fourteenth amendment,[96] although some commentators have recognized that the interstate commerce clause might serve as a basis for establishing constitutional choice of law rules.[97] As Professor Horowitz has suggested, courts should use the commerce clause in choice of law analysis when more than one state has an interest in having its law prevail and should choose the law that facilitates multistate commercial transactions, i.e., keeps interstate commerce free of unreasonable burdens. In the case of the legal relationships among shareholders, creditors, and others who are widely dispersed, the use of a single rule of law benefits interstate commerce. The use of the internal affairs

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CONTEMP. PROBS. 161 (1985). The Maryland Supreme Court has provided a widely accepted definition: "[W]here the act complained of affects the complainant solely in his capacity as a member of the corporation, whether it be as stockholder, director, president, or other officer, and is the act of the corporation, whether acting in stockholders' meeting, or through its agents, the board of directors, then such action is the management of the internal affairs of the corporation . . . ." North State Copper & Gold Mining Co. v. Field, 64 Md. 151, 154, 20 A. 1039, 1040 (1885).

92. Section 302(2) of the *Restatement (Second) of Conflict of Laws* indicates that:

> The local law of the state of incorporation will be applied to determine such issues, except in the usual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302(2) (1971).

93. For example, New York's business combination model applies to "resident domestic corporations" which are corporations incorporated in New York with their principal executive offices and significant business operations located in New York and at least 10% of their voting stock owned by New York residents. N.Y. BUS. CORP. LAW § 912(a)(13) (McKinney 1986).

94. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 comment b (1971).

95. U.S. CONST. art. IV, § 1.

96. U.S. CONST. amend. XIV, § 1. *See generally* Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1; Reese & Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118 (1958).

97. Horowitz, *The Commerce Clause as a Limitation on State Choice-of-Law Doctrine*, 84 HARV. L. REV. 806 (1971); Reese & Kaufman, *supra* note 96, at 1129 n.42.

doctrine in corporate law, under which a single rule of law is selected, minimizes the problems of multiple state regulation.[98]

Edgar has been viewed as potentially giving support to the view that a single rule of law should apply.[99] If the internal affairs doctrine dictates the use of the law of incorporation as the single law, it would obviate the plurality's concern in *Edgar* of the problems associated with multiple state regulation over corporations not incorporated in a state.[100] Illinois's attempt to use the internal affairs doctrine to support the benefit of its statute was rejected because its statute could apply to corporations that were not incorporated in Illinois and tender offers involve transfers of shares between shareholders and third parties.[101] Because the court in *Edgar* based its rejection of the internal affairs argument on the fact that the internal affairs doctrine did not apply to the statute, it is unclear whether the single law principle will be accepted when the doctrine is applicable.[102]

In considering the significance of allowing the benefit of using state corporate law as a single law principle to be weighed in the balance, the Court should recognize its traditional deference to state corporate law. In *Shaffer v. Heitner,*[103] the Court recognized in a footnote that the internal affairs doctrine is based more upon the need for uniformity and certainty than upon perceived state interests. In *Cort v. Ash,*[104] the Court emphasized that corporations are creatures of state law and "except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[105] In *Santa Fe Industries v. Green,*[106] the Court reiterated its views in *Cort* and indicated that without clear indication of congressional intent, it would be "reluctant to federalize the substantial portion of the law of corpora-

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98. Horowitz, *supra* note 97, at 814. The Supreme Court has found that statutes that create an inconsistent regulatory pattern impermissibly interfere with interstate commerce. *E.g.*, Bibb v. Navajo Freight Lines, 359 U.S. 520 (1959).

99. Kozyris, *supra* note 96, at 35.

100. Edgar v. Mite, 457 U.S. 624, 642 (1982).

101. *Id.* at 624; *see* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).

102. *See infra* notes 132-58 and accompanying text.

103. 433 U.S. 186, 215 n.44 (1977). Justice Brennan suggested in his dissent that because a corporation is the creature of the state, actions that impact on the management of the corporation, whose powers and duties are defined by state law, implicate the state's public policy. *Id.* at 228 (Brennan, J., dissenting).

104. 422 U.S. 66 (1975).

105. *Id.* at 84. In Burks v. Lasker, the Court reiterated the importance of state corporate law: "Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." 441 U.S. 471, 478 (1979).

106. 430 U.S. 462 (1977).

tions that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[107] This deference to state corporate law does not indicate that states are free to enact statutes highly restrictive of interstate commerce. But it does show that courts should be wary of using their power under the commerce clause to invalidate state corporate law. Otherwise, the impact of the courts may be federalization through nullification of particular state corporate laws.

B. *The Market for Corporate Charters*

Legal scholars have long debated whether state corporate law protects investors.[108] Those on both sides of the debate recognize that states compete for incorporations, thereby creating a market for corporate charters but disagree about whether the market protects shareholders. While I am not convinced that the market for charters is protective of shareholders, the Court should consider the interstate competition inherent in this market and the importance of the internal affairs doctrine to maintaining this competition when determining if state law impermissibly interferes with interstate commerce.

The development of state corporate statutes from a regulatory focus to an enabling law should be considered when analyzing state law under the commerce clause.[109] Corporate existence in the United States began as a special privilege granted by the legislature and corporations were subject to extensive state law limitations.[110] The competition between states for corporate charters, described by Justice Brandeis as a race "not of diligence but of laxity,"[111] began with the liberalization of the corporate laws of New Jersey in the late nineteenth century. Some have viewed this development as being grounded on utility and the need to allow corporations the flexibility to function as an economic entity with the resulting increase in man-

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107. *Id.* at 479.

108. *Compare* Cary, *supra* note 1 (arguing for minimum federal standards) *with* R. WINTER, GOVERNMENT AND THE CORPORATION (1978) (arguing for the continued use of state corporate law). *See generally* Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Law as Product*]; Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. __ (1987) [hereinafter Romano, *State Competition*].

109. *See generally* Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968).

110. *See generally* W. CARY & M. EISENBERG, CORPORATIONS 1-5 (5th ed. 1980); Williston, *A History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105 (1888).

111. Liggett Co. v. Lee, 288 U.S. 517, 558-59 (1933).

agement power over the shareholders.[112] Critics of the market for charters theory view it as a "race for the bottom" because states will sacrifice shareholder protection for a pro-management bias in order to attract incorporations and the revenue obtained from the incorporations. State law of this type is a form of economic protectionism because it protects the state's interest in attracting and keeping corporations.[113]

Others view the competition in the market for corporate charters as a healthy development for shareholders. They argue that management will generally seek out those states that are beneficial to shareholders;[114] otherwise, the value of the shares of those corporations will decrease if management is not maximizing the firm's value. The reduced value of shares increases the corporation's cost of raising capital, which places the corporation at a cost disadvantage in the market for its products. A failure to manage in the shareholders' interests also affects the managers by reducing the value of their services in the market for managers. If the value of the shares decreases, the market for corporate control will also serve to protect shareholder interests by replacing management and encouraging new management to reincorporate in another state whose law benefits shareholders.[115] Thus, the market for corporate charters encourages states to enact laws that are beneficial to shareholders.[116]

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112. *See generally* J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES (1970).

113. A 1968 report to the New Jersey Legislature stated:

> It is clear that the major protections to investors, creditors, employees, customers, and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts. . . . Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions.

REPORT OF THE CORPORATION LAW REVISION COMMISSION, June 20, 1968, *reprinted in* N.J. STAT. ANN. tit. 14A, ix, xi (West 1969).

114. An empirical study, which Peter Dodd and Richard Leftwich conducted, indicated that firms that reincorporated experienced positive abnormal returns over a two year period prior to reincorporating. Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980). For a thoughtful analysis of the study and an explanation of reincorporation, see Romano, *Law as Product*, *supra* note 108, at 244-65.

115. *See* R. WINTER, *supra* note 108; *see also* Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982).

116. Underlying the argument supporting the market for corporate charters theory and much of the law and economics view of corporate law is a theory of the firm that is based upon a "nexus of contracts." This theory views the corporation as a legal fiction which serves to facilitate contracting among the corporate constituencies. Because investors benefit by holding a diverse portfolio of securities, most will choose not to concentrate their holdings and incur

Under the market for corporate charters thesis, state takeover statutes must be beneficial to shareholders because states are competing to enact laws that enhance shareholders' wealth.[117] If the statutes adversely affect the value of the corporation's shares, then the markets for products and managers will require reincorporation and states will compete with each other by eliminating laws that deter takeovers. Thus, the choice of reincorporation remains as a means to opt out of those statutes that harm shareholders.[118]

Without the internal affairs doctrine, a state will be severely restricted in its ability to apply its law to shareholders, managers, and assets outside of the state of incorporation, and thus would be unable to effectively compete in the market for corporate charters and offer law that some view as generally beneficial to shareholders.[119] In order to protect this market, any federal encroachment on the doctrine through the commerce clause should be restricted. While invalidating those statutes that limit takeovers may enhance the disciplinary impact of the market for corporate control, the invalidation also negatively affects the market for corporate charters and the states' ability to develop their law. States as market participants as opposed to regulators in the market for corporate charters might be subject to the "market participant" exception, which limits the use of the interstate commerce clause to invalidate state activity.[120]

C. *Corporate Law as Contract*

The corporation has emerged as an organization in which much

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the substantial costs of monitoring management. The resulting separation of ownership from management is beneficial because it leaves the running of the business in the hands of professional managers. While this separation involves costs, the gains from this generally efficient division of labor should normally outweigh these costs. Several market mechanisms including the market for charters insures that management will look out for the interests of shareholders. Fischel, *supra* note 115, at 917-18.

117. Professor Romano discussed the evidence of whether shareholders benefit by reincorporations and found an absence of negative returns to reincorporating firms. She also found that there were no negative returns for corporations reincorporating for antitakeover reasons. Romano, *Law as Product*, *supra* note 108, at 280.

118. If all states had similar takeover statutes, the competition for charters could be severely limited. But, as indicated, there are several different models and not all statutes necessarily deter takeovers. Significantly, Delaware has not enacted a pro-management model. Judge Winter has argued that state takeover legislation may serve to monopolize the market for management control. R. WINTER, *supra* note 108, at 43-44. His discussion of state takeover statutes reflected the first generation statutes that were not limited to corporations incorporated in the state and thus their restrictions would not affect the market for charters. *Id.* The second and third generation are limited to corporations incorporated in the state and their restriction does impact on the market for charters.

119. R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1076-77 (1986).

120. *See* Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976).

can now be accomplished through contractual arrangements.[121] State corporate statutes are no longer regulatory, but are really enabling statutes which allow greater flexibility in contractual arrangements.[122] Some commentators dispute the notion that all corporate law should be viewed as contractual and thus subject to variation, particularly when the controlling shareholders contract to lower fiduciary standards.[123] While the use of the contract model may not be appropriate when controlling shareholders attempt to restrict the court's scrutiny of fiduciary duty, the use of state statutes to implement contracts between the corporate constituencies seems well established.[124] The provisions of most state corporate statutes permit corporations to vary the statutory requirements if the by-laws or certificate of incorporation provide for such variation.[125] In fact, many states have explicitly recognized the contractual nature of their law by permitting corporations to opt out of the particular takeover statute.[126] In some cases, shareholders have amended their certificates to provide for provisions equivalent to those found in some of the models.[127] Courts should not use the commerce clause to preclude the state from providing contractual terms through its statutes that the shareholders can alter.

Corporations choose to incorporate in a given state and can choose to reincorporate in a different state. Although such transactions are not without costs, movement can potentially enhance shareholder wealth.[128] One of the key reasons a corporation chooses a given state is that particular state's corporate law. While the corpo-

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121. *See* J. HURST, *supra* note 112; R. WINTER, *supra* note 108.

122. Kaplan, *supra* note 109; *see* Data-Probe Acquisition Corp. v. Datalab, Inc., 722 F.2d 1 (2d Cir. 1983). According to Judge Winter, "*Mite*, of course, did not involve the fiduciary obligations of a contractual nature imposed by state law." *Id.* at 5 n.3.

123. *See generally* Brudney, *Corporate Governance, Agency Costs, and The Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (J. Pratt & R. Zeckhauser eds. 1985).

124. *E.g.*, Delaware General Corporation Law, DEL. CODE ANN. tit. 8, §102(b)(7) (1985). The Delaware legislature recently enacted this provision in response to the difficulty in procuring directors' liability insurance. The statute permits corporations to amend their certificate to limit director liability in duty of care cases.

125. *E.g.*, N.Y. BUS. CORP. LAW § 616 (McKinney 1983) (permitting the use of supermajority voting requirements if shareholders vote to place the requirement in the certificate).

126. One may view shareholders' ability to opt out or into the statutes as further removing these statutes from being considered state regulation and as encouraging the freedom to contract. *See supra* text accompanying notes 152-53.

127. *See supra* notes 38 & 42.

128. *See* Romano, *Law as Product*, *supra* note 108 (discussing the benefits of reincorporation).

rate charter itself is a contract,[129] it is generally understood that the terms of that contract include the state's statutory law as it evolves and its case law interpreting legislative action. By selecting a given state, the shareholders and managers agree to be bound by the internal affairs doctrine and that state's law; shareholders purchase and value the stock with that choice in mind.[130]

If one views a corporation in terms of contracts between private parties, then the burdens imposed on interstate commerce by corporate law are no greater than contract law. Because many things are currently achieved through contract, state corporate law provides a standard legal arrangement which reduces the transaction costs of private bargaining, thereby benefiting shareholders.[131] The use of the commerce clause to restrict state corporate law development will negatively impact on the benefits shareholders achieve through contracting. The commerce clause should not interfere with the contractual choice of management and the shareholders to select a state's law.

D. Van Dusen *and* CTS

Given that the internal affairs doctrine as a single law benefits interstate commerce and is important to the market for corporate charters and the contractual nature of corporate law, I will review the impact of two recent cases on its use. In *APL Limited Partnership v. Van Dusen Air*,[132] a federal district court found the Minnesota Control Acquisition Act unconstitutional because it impermissibly burdened interstate commerce.[133] The Minnesota statute enacted a shareholder approval model[134] that contained penalties for failure to comply with the statute. These penalties included denial of voting

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129. Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

130. In Rogers v. Guaranty Trust Co., the Supreme Court indicated, "When, by acquisition of his stock, plaintiff became a member of the corporation, he, like every other shareholder, impliedly agreed that in respect of its internal affairs the company was to be governed by the laws of the State in which it was organized." 288 U.S. 123, 130 (1933).

131. R. WINTER, *supra* note 108, at 1. Another view of corporate law is that the privilege of corporate form is a grant from the state and corporate acts are in effect acts of the government. *Id.*

132. 622 F. Supp. 1216 (D. Minn. 1985).

133. *Id.*; *see also* Johnson, *Minnesota's Control Share Acquisition Statute and the Need for New Judicial Analysis of State Takeover Legislation*, 12 WM. MITCHELL L. REV. 183 (1986). In *Van Dusen*, the parties settled their dispute and the Eighth Circuit declined to consider the appeal. The Eighth Circuit vacated the judgment so it does not have any direct effect on the Minnesota statute. Steinbrink, *State Takeover Statutes*, in SEVENTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 181 n.5 (S. Friedman, C. Nathan, H. Pitt & R. Santoni eds. 1986).

134. *See supra* text accompanying notes 32-34.

and transfer rights for a year and possible redemption at the same price at which the shares were acquired. The court indicated that "[t]here is little doubt that a state has some constitutionally sanctioned right to govern the internal affairs of its corporations."[135] The issue for the court was whether the internal affairs doctrine applied to the statute. Although the statute applied only to corporations incorporated in Minnesota, the court decided that the internal affairs doctrine was inapplicable because the "[r]egulation of *shareholders*—and those who would become shareholders—is not the same as regulating the corporation itself."[136] This decision is consistent with the *Edgar* Court's view that the acquisition of shares does not implicate the internal affairs doctrine. In dictum, the district court indicated that "[t]he use of shareholders' power *once the shares have been acquired* may well be a proper subject of state regulation . . . ."[137]

The court rejected Minnesota's argument that the model is analogous to a merger statute, which would be covered by the internal affairs doctrine. Mergers and sales of assets involve the corporation as a party, which is not true of transfers of shares. The court indicated that a merger statute is "a lawful exercise of the state's authority to regulate a legal entity created by state statute."[138] The implications of *Van Dusen* are that regulations that directly affect transfers of shares are impermissible but that the internal affairs doctrine should protect other activities that regulate the corporate entity and only indirectly affect shares from invalidation under the commerce clause.[139]

135. *Van Dusen*, 622 F. Supp. at 1223.

136. *Id.* The court referred to the statement in *Edgar* that transfers of stock to third parties "*do not themselves implicate the internal affairs of the target company.*" *Id.* (quoting Edgar v. Mite, 457 U.S. 624 (1982)). In Fleet Aerospace Corp. v. Holderman, the court indicated: "If the tender offer is successful, it is true that voting control may well be changed, but the changing identity of the shareholder or shareholders owning sufficient stock to exercise control does not itself change the nature of the corporate entity or alter its internal affairs." 637 F. Supp. 742, 763 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986).

137. *Van Dusen*, 622 F. Supp. at 1223-24. The court in *Van Dusen* indicated that the state had no interest in protecting nonresident shareholders even if they owned stock in a Minnesota corporation. *Id.* at 1222. This statement must be limited to circumstances where internal affairs is not implicated. Otherwise other provisions of state law such as inspection rights that are clearly designed to protect shareholders would be inapplicable to nonresident shareholders.

138. *Id.* at 1224.

139. The courts struck down shareholder approval statutes in Hawaii and Ohio as direct regulations of interstate commerce. *See supra* note 69. Because only four Justices in *Edgar* found the Illinois statute to be a direct regulation, the courts also analyzed their respective statutes under the balancing tests used with indirect regulation. In Terry v. Yamshita, 643 F. Supp. 161 (D. Haw. 1986), and Fleet Aerospace Corp. v. Holderman, 637 F. Supp. 742 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986), the courts found the shareholder approval model to be an improper interference with interstate commerce using analysis similar to *Van Dusen*. *See supra* note 69. Because the shareholder approval model directly restricts tender offers, it is more susceptible to attack than other models because the internal affairs doctrine traditionally

The Seventh Circuit's opinion in *Dynamics Corp. of America v. CTS Corp.*[140] is problematic for the internal affairs doctrine and state corporate law. Judge Posner, writing for the court, found Indiana's Control Share Acquisition Act to be preempted by the Williams Act[141] and unconstitutional on interstate commerce grounds. The Indiana statute was a voting rights model which required approval by a majority of both shareholders and disinterested shareholders for share acquisitions of twenty percent or more. An offeror was not precluded from acquiring the shares, but failure to receive shareholder approval would mean the denial of voting rights.[142] Using the balancing test, the court viewed the statute as impeding takeovers and transactions between nonresident shareholders, with trivial or negative benefits to Indiana or its residents. According to the court, "Even if a corporation's tangible assets are immovable, the efficiency with which they are employed and the proportion in which the earnings they generate are divided between management and shareholders depends on the market for corporate control . . . that the state of Indiana is not authorized to opt out of . . . ."[143] This broad statement of the limits on a state's ability to regulate when its law adversely affects the market for corporate control may have severe consequences for the development of state corporate law and invites extensive federal court scrutiny of traditional corporate law.

The *CTS* court indicated that the internal affairs doctrine would not save the statute.[144] The court conceded that a state has broad latitude in regulating internal affairs even if the regulating complicates takeover efforts; but when a statute's "effect on the interstate market in securities and corporate control is direct, intended, and substantial[,] it is not merely the incidental effect of a general regulation of internal corporate governance."[145]

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did not cover the transfers of shares, which are not a matter of organic structure or internal administration. Yet the court in *Fleet* also relied on Judge Posner's analysis in Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986). *See infra* notes 143-45 and accompanying text.

140. 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

141. Judge Posner accepted the view of Justice White and two other Justices that the Williams Act was designed to maintain a balance between incumbent management and the offeror. The court refused to allow the delays effectively imposed by the Indiana statute, which provided that the shareholder meeting concerning a tender offer could take place as long as fifty days after the tender offer commenced (as contrasted with the Williams Act time period of approximately a month). *Id.* at 261.

142. *Id.* If the offeror failed to file an acquiring person's statement, the corporation could redeem the shares at "fair value." *Id.*

143. *Id.* at 264.

144. *Id.*

145. *Id.* In *Fleet*, the court cited with approval the discussion of internal affairs in *CTS*,

Judge Posner's opinion extends the scope of the commerce clause further into the state corporate law area. The Indiana statute significantly differs from the shareholder approval model found unconstitutional in *Van Dusen,* because it restricts not the acquisition or selling of the shares but the voting rights of those shares. Under *Van Dusen,* restrictions on voting rights are within the internal affairs doctrine and thus permissible.

There is no question that denial of voting rights will thwart a tender offer and may negatively affect the value of those shares, but so does other traditional state law. The court in *CTS* indicated that provisions such as those providing for cumulative voting, which can delay an offeror's ability to take complete control of the board and thus detract from the benefits of a tender offer, should not be affected by the court's holding because the effect of a cumulative voting provision on the market for corporate control is not "direct, intended, and substantial."[146]

The voting rights model found in Indiana is not as direct a regulation of the market for corporate control as the shareholder approval model that directly precludes the transactions of shares. Under the voting rights model, one can acquire the shares without a shareholder vote. The voting rights model in Indiana was intended to affect the market for corporate control but legislative intent is not always clear. The impact of the model is substantial; this impact, however, may also encourage the market and protect the shareholders. The statutes could enhance shareholders' premium by encouraging negotiations and the auctioning of the corporation to a higher value. Even those who favor the market for corporate control cannot agree on whether it is beneficial for management to be passive toward takeovers or to auction the corporation.[147] The shareholder vote may also protect the shareholders from front-loaded two tier takeovers.

According to the *CTS* court, the Indiana statute is "an explicit

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and the distinction between mergers and tender offers found in *Van Dusen.* Fleet Aerospace Corp. v. Holderman, 637 F. Supp. 742, 761-63 (S.D. Ohio), *aff'd,* 796 F.2d 135 (6th Cir. 1986) (citing *CTS,* 794 F.2d at 264; *Van Dusen,* 622 F. Supp. at 1223-24). *See supra* notes 138-39 and accompanying text.

146. *CTS,* 794 F.2d at 264.

147. *Compare* Easterbrook & Fischel, *The Proper Role of Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161, 1165-74 (1981) (management should be passive when faced with a tender offer) *with* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 STAN. L. REV. 819 (1981) (management should bargain with offeror to secure higher price or seek a competitive bid) *and* Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982) (same). The idea that directors should auction their company when an offer is made is gaining acceptance by the courts. *E.g.,* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

regulation of tender offers," and even though it is a voting rights statute, it is subject to review; otherwise, it "would invite facile evasions of the clause."[148] Judge Posner seems to assume that the commerce clause protects the market for corporate control without regard to the effect of state regulation in benefiting other markets such as the market for charters. The internal affairs doctrine, which encourages use of a single law, the market for corporate charters, and the contracting rights of the constituent corporate groups all enhance interstate commerce.

How close a relationship between a statutory provision and the market for corporate control is required before it is found to be unconstitutional? My discussion has primarily focused on state statutory takeover provisions, but the commerce clause, as analyzed by Judge Posner, could also be used to upset other law. Does a case in which a court views the common law as allowing directors a free reign to thwart takeovers, such as by implementing a poison pill defense which could preclude a hostile offer, violate the interstate commerce clause as having a direct, intended, and substantial effect on the market for corporate control?[149] Does the implementation of the poison pill pursuant to a statutory grant or a general legislative authorization violate the commerce clause?[150] If the shareholders, by

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148. *CTS*, 794 F.2d at 264.

149. Poison pills involve actions that have repercussions to an offeror that will be as if it swallowed a poison pill. *See* Chittur, *Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense*, 11 J. CORP. L. 25 (1985).

150. It is not always easy to determine whether a state legislature intended a particular statute to regulate tender offers. In 1984, the New York legislature amended section 512 of the New York Business Corporation Law to authorize redeemable shares, which are necessary for poison pills that use preferred shares. *See generally* Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984). Redeemable shares also have other uses in corporate finance. Would that statutory amendment or its implementation pursuant to the statute fail under Judge Posner's thesis? How would Judge Posner respond to the following explanation?

> The legislation also would provide for the issuance of certain classes of stock heretofore prohibited under the business corporation law. Specifically, a corporation is presently prohibited from issuing any stock which give the shareholder the right to compel the corporation to redeem the shares. Under the proposed amendment, a company could elect to issue a class of preferred shares which gives the shareholder redemption rights. Neither corporations nor shareholders have the option today of issuing or purchasing this type of stock from New York incorporated companies even though such stock is [sic] come into accepted practice in the financial markets. *The economic debate of whether takeovers are good for the overall economy is not the subject of this legislation.* However, this legislation would say to the management of corporations that New York State is moving to provide a corporate law climate in which a company could receive shareholder approval for measures which will allow it to focus on the long term competitiveness of their companies and not be encumbered with

amending the certificate, approve a dual classification of shares that allows management or a family group the bulk of the voting rights pursuant to state statutory authority, will the certificate amendment be precluded because it is authorized by statute and adversely affects the market for corporate control?[151] While none of these actions is authorized by a specific statute enacted to deal with tender offers such as the models, they do represent state sponsored activities taken pursuant to the corporate law of the state that has a direct, intended, and substantial effect on the market for corporate control.

The role of the shareholders may be important in a court's analysis of whether a statute violates the commerce clause. Shareholders are not usually involved in the approval or implementation of the poison pill preferred because the board of directors has the authority to issue preferred stock. Yet the shareholders at some point would have had to authorize the preferred stock by amending the certificate of incorporation. Shareholder approval of the creation of two classes of common stock with different voting rights would be required. If the shareholders' role is significant because it further removes the state's role in regulating and encourages private contracting,[152] then the fact that some of the statutory models, particularly the third generation statutes, allow the corporation to opt out of its requirements should also be considered significant.[153]

> the emphasis on short-term performance which is often the case with companies which live under pressure of hostile takeovers.

1984 NEW YORK STATE LEGISLATIVE ANNUAL, MEMORANDUM OF SENATOR JESS J. PRESENT 211 (emphasis added).

151. The New York Stock Exchange recently approved changes in its listing standard to allow recapitalizations that create different classes of voting common stock. *See generally* Karmel, *The SEC's Power to Regulate Stockholders Voting Rights*, N.Y.L.J., Aug. 21, 1986, at 1, col. 1. The SEC will hold public hearings in 1987 on this controversial issue.

152. *Cf.* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985) ("The fact that directors of a corporation act pursuant to a state statute provides an insufficient nexus to the state for there to be state action which may violate the Commerce Clause or Supremacy Clause."). The ability of shareholders to act could also provide an insufficient nexus for state action.

153. For example, the New York business combination statute permits corporations to opt out of the provisions of the statute after 18 months if a majority of the disinterested shareholders pass an appropriate bylaw. N.Y. BUS. CORP. LAW § 912(d)(3) (McKinney 1986). Indiana allows corporations to opt out of its voting rights statute prior to the acquisition of the "control shares" if provided for in the certificate of incorporation or bylaws. IND. CODE § 23-1-42-5 (1986). The idea of opting into a statute by a shareholder vote as opposed to opting out is arguably more in line with the idea of shareholder rights and corporate law as enabling. Yet, shareholders have shown a willingness to amend their certificates by adding antitakeover amendments viewed as harmful to shareholders. *See Shark Repellents: The Role and Impact of Antitakeover Charter Amendments*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,714 (September 7, 1984) (study of SEC office of Chief Economist). One could use this evidence to suggest that shareholder voting is meaningless or

The distinction in *Van Dusen* between the transfer of shares and the use of shares does less harm to the internal affairs doctrine, the market for corporate charters, and the contractual nature of corporate law than Judge Posner's thesis. The *Van Dusen* distinction between the acquisition of shares and their use fits within the traditional coverage of the internal affairs doctrine. The distinction also is consistent with the traditional corporate law view that stock has the attributes of property and restrictions on transferability imposed after the issuance of stock are usually not allowed.[154] Changes affecting the use of the stock, such as changes in voting rights, are generally permitted under corporate law by a shareholder vote.

Under the *Van Dusen* rationale, the shareholder approval model is unconstitutional, but the third generation statutes (voting rights and business combination models) appear to survive because they affect the use of shares and do not directly affect one's ability to acquire shares. The second tier and fiduciary duty models also do not directly impact on the acquisition of shares. The full disclosure model limits purchases in a particular state and would seem to be saved by section 28 of the Securities and Exchange Act and language in *Edgar* recognizing that protection of local investors is a significant local benefit.[155] The redemption model creates an equal opportunity for all shareholders to sell on the same terms and thus requires offerors to buy all the shares offered. One can argue that the law is designed to protect shareholders by creating a market, but *Van Dusen* indicates that the state has no interest in protecting nonresident shareholders in the acquisition of shares. Thus the redemption model may not survive.

Under Judge Posner's view, all of the models could be invalid. All of them are intended to affect the market for corporate control and have as much a direct effect as the voting rights model found unconstitutional in *CTS*. An issue that remains unclear under Judge Posner's test is how substantial must the effect of these models be on the market? Each model involves costs to the offeror which might deter a tender offer. Of all the models, the second tier may be the fairest to shareholders because it insures shareholders an equal opportunity to sell shares when the offeror decides to take complete control of the corporation. Judge Posner would seem to favor that model because he distinguishes fair price amendments from the use of poison

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that shareholders are willing to accept defensive mechanisms because they increase their premiums. *Cf.* Romano, *State Competition*, *supra* note 108.

154. *See generally* W. CARY & M. EISENBERG, CORPORATIONS 468-78 (1980).

155. Edgar v. Mite, 457 U.S. 624, 641 (1982).

pills because the former heads "off a stampede to tender that may reduce the price of the tender" whereas the latter dilutes the value of the shares thereby defeating the object of the tender offer.[156]

The potential invalidation of all of the models under Judge Posner's thesis and the invitation to the courts to invalidate other state corporate law harms the interests that the internal affairs doctrine protects. The negating of state corporate law will adversely affect its development and the market for corporate charters. It will also restrict the ability of corporate constituencies to contract.

I believe that the *Van Dusen* distinction should serve as a starting point for a court's analysis of the impact of state corporate laws on interstate commerce. Courts should first determine whether the law in question directly restricts the transfers of shares or, rather, regulates the use of those shares. If it affects the transfers of shares, then the statute would normally not be covered by the internal affairs doctrine and thus would be subject to the balancing test. If the law involves the use of shares and similar issues with respect to which the internal affairs doctrine traditionally has been applied, then the commerce clause should, most often, not invalidate the statute; rather such a statute should be presumed to be valid.

The importance of internal affairs in the analysis of interstate commerce and this presumption of validity does not mean that a state is free to enact any legislation that applies to corporations incorporated in the state and that is within the internal affairs doctrine.[157] If a statute is found to burden directly or discriminate against interstate commerce, courts should find that it impermissibly interferes with interstate commerce. For example, I would assume that a state that passed legislation prohibiting a corporation from reincorporating in another state would violate the commerce clause, even though the statute regulates internal affairs.[158]

VI. CONCLUSION

The courts should not use the commerce clause to affect the

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156. Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 255 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

157. *Cf.* South-Central Timber Dev. v. Wunnicke, 467 U.S. 82 (1984) (limiting the market participant exception, which allows the state a greater role under the commerce clause, to the relevant market).

158. In Great Western United Corp. v. Kidwell, the Fifth Circuit indicated that "statutes *requiring* business operations be performed in the home state that could more efficiently be performed elsewhere impose a burden on commerce that is *per se* illegal." 577 F.2d 1256, 1282 (5th Cir. 1978) (citing Pike v. Bruce Church, Inc., 397 U.S. 137, 145 (1970)), *rev'd sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979).

development of state corporate law, but should recognize the importance of the internal affairs doctrine and that doctrine should serve as an important factor in determining whether state corporate law impermissibly interferes with interstate commerce. This principle recognizes the importance of a single law governing corporations, the market for corporate charters, and the contractual basis of corporate law and its importance to shareholders. Applying the commerce clause broadly to invalidate state corporate law would undermine these developments which often are beneficial to commerce.

If state takeover statutes result in harm to shareholders, nonconstitutional remedies are available. The statutes have not eliminated the idea that directors are fiduciaries and have a duty to protect the interests of shareholders. Courts have not allowed the business judgment rule to permit management to oppose takeovers at all costs.[159] There is no evidence that any of the models have insulated a corporation from a hostile takeover or an eventual buyout at a premium.[160] Proxy fights are still available to opt out of a statute or change management who would support a takeover. Individual shareholders are still able to express their views on corporate policy through the shareholder proposal mechanism permitted by the federal proxy rules.[161] Although all these checks on management power have costs, unbridled takeovers and the lessened influence of internal affairs also have costs.

In the past, when state law was viewed as inadequate to protect investors or shareholders, it was Congress who reacted with appropriate legislation such as federal securities regulation. Those who argued that state law was lax argued for federal minimum standards. If state takeover laws are further undermining the protection of shareholders, then the remedy should be federal legislation directed at tender offer abuses or accepting a preemption argument, not an open-ended use of the interstate commerce clause.

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159. *CTS*, 794 F.2d at 256 (discussing Delaware caselaw concerning the business judgment rule).

160. *Cf. Id.* at 255 (Judge Posner conceded that the evidence is mixed as to whether particular defensive tactics could increase or decrease shareholder welfare.). *But cf.* Romano, *State Competition*, *supra* note 108 (viewing statutes like other defensive tactics as increasing premiums at the cost of a reduced number of bids).

161. 17 C.F.R. § 240.14a-8 (1982). Shareholder proposals have frequently been used to suggest corporate activities that might enhance investor wealth. For example, the shareholders of TWA sought to separate the airline business from its other operations. The shareholders lost the proxy fight, but succeeded in convincing management to implement the suggestion. Levy, *Inside the Battle Over Trans World*, FORTUNE, June 13, 1983, at 106.