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## The Tender Balance - Dynamic Corporation of America v. CTS Corporation

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## “THE TENDER BALANCE”

### *DYNAMICS CORPORATION OF AMERICA v. CTS CORPORATION*

794 F.2D 250 (7TH CIR. 1986), REV'D,  
55 U.S.L.W. 4478 (APR. 21, 1987)<sup>1</sup>

#### INTRODUCTION

During the 1960's, cash tender offers became a highly publicized method of gaining corporate control. Unlike traditional proxy solicitations or exchange offers, cash tender offers were generally unregulated until Congress enacted the Williams Act in 1968.<sup>2</sup> Subsequent to the enactment of the Williams Act, a number of states adopted their own tender offer regulations that were designed to expand on both the procedural and substantive provisions of the Williams Act.<sup>3</sup> Recently, Dynamics Corp. of America (DCA) challenged the new Indiana tender offer statute, The Indiana Control Share Acquisition Chapter.<sup>4</sup> The Court of Appeals for the Seventh Circuit in *Dynamics Corp. of America v. CTS Corp.*<sup>5</sup> found that the Indiana statute was unconstitutional on both Supremacy and Commerce Clause grounds.

Part I of this comment will review the historical background of federal and state regulation of tender offers. Part II will examine the facts of *Dynamics* and describe the court's reasoning. Part III will analyze the court's decision and Part IV will discuss wealth maximization as a theory of investor protection. This comment will conclude by suggesting that Congress preempt state regulation of tender offers.

1. As this comment was being printed, the Supreme Court reversed the Seventh Circuit's holding. However, the Seventh Circuit's decision in this case presents an interesting illustration of how economic theory pervades much of Judge Posner's legal analysis. As noted above, Part IV will discuss how the theory of wealth maximization may explain the Seventh Circuit's decision in *Dynamics*. The Supreme Court's opinion will be briefly discussed in the Appendix.

2. 15 U.S.C. §§ 78n(d)-(f) (1982). The Williams Act was an amendment to the Securities Exchange Act of 1934. 15 U.S.C. §§ 78n (a)-(c) (1982). This conclusion, of course is weakened by the Supreme Court's reversal of the Seventh Circuit. However, it may be that the recent disclosure of massive insider trading on Wall Street put the Court in a more deferential mood vis-a-vis state regulation of tender offers.

3. These statutes fell under the rubric of "first generation" takeover regulations. For a complete listing, see Note, *State Regulation of Tender Offers*, 7 J. CORP. L. 603, 603 n.2 (1982).

4. IND. CODE §§ 23-1-42-1 to -11 (Supp. 1986).

5. 794 F.2d 250 (7th Cir. 1986), rev'd, 55 U.S.L.W. 4478 (Apr. 21, 1987).

## I. HISTORICAL BACKGROUND

Prior to the 1960's, corporate takeover attempts had typically involved either proxy solicitations<sup>6</sup> or exchange offers of securities.<sup>7</sup> Both processes, however, were and still are very time consuming, requiring as long as three to four months to complete. In the meantime, the target corporation remains vulnerable to takeover attempts by other would-be acquirers.<sup>8</sup> In response to the time delays inherent in both proxy solicitations and exchange offers, cash tender offers evolved as an alternative method of gaining corporate control.<sup>9</sup> Since tender offers were generally unregulated,<sup>10</sup> potential suitors were able to consummate their offers with greater speed and with less cost than if they had chosen to gain control by means of a proxy solicitation or exchange offer.<sup>11</sup>

By 1968 a perception was developing that the average investor was not being provided with adequate information or time to formulate an intelligent investment decision in response to a tender offer.<sup>12</sup> Congress responded by enacting the Williams Act<sup>13</sup> which mandated that the of-

6. Proxy solicitations involved an attempt by either outsiders or shareholders to effect changes in the management or operations of the firm. This is done by gaining the voting power of the other shareholders by means of a written authorization given by a shareholder to someone else for the purpose of representing him and voting his shares at a shareholder's meeting. Proxy solicitations are regulated under § 14 of the Securities Exchange Act, 15 U.S.C. §§ 78n (a)-(c) (1982) [hereinafter 1934 Act].

7. An exchange offer involves the trading of two companies shares for each other, e.g., Company ABC offers 1/2 share of class 1 ABC preferred and 1/2 share of ABC Common in exchange for one share of XYZ Common. Exchange offers, unless exempted, are subject to regulation under the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa(1982) [hereinafter Act of 1933].

8. See Nathan, *Lock-Ups and Leg-Ups: The Search for Security in the Acquisitions Marketplace*, 13 INST. ON SEC. REG. 13, 15-16 (1981).

9. The Williams Act does not define "tender offer" and its meaning remains unsettled. However, it is generally regarded as an invitation, publicly made to all shareholders of a corporation, to sell their shares at a specified price. See generally E. ARANOW, H. EINHORN, & G BERLSTEIN, *DEVELOPMENT IN TENDER OFFERS FOR CORPORATE CONTROL* 1 (1977).

10. For example, prior to 1968 the only avenue available to a company or shareholder seeking to restrain a tender offer was to bring suit under § 10(b) of the 1934 Act. 15 U.S.C. § 78j(b)(1976); Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240 10b-5 (1977). Specifically, rules 10b-6 and 10b-13 are designed to prevent the offering company from making separate deals with holders of large blocks of target stock and from dealing in its own shares of target stock so as to manipulate the price of target shares. B. FOX, *CORPORATE ACQUISITIONS AND MERGERS*, 13A. BUSINESS ORGANIZATIONS § 27.05[4] (1986).

11. See 113 CONG. REC. 24,664 (1967) (remarks of Sen. Williams) (tender offer is "cheaper and faster than proxy solicitation"), cited in Note, *Target Defensive Tactics As Manipulative Under Section 14(e)*, 84 COLUM. L. REV. 228, 228 n.3 (1984). A further advantage of the tender offer is that it robs the target company's management of time to prepare defenses against the offer. For a general discussion of the various defensive techniques which have been raised by target companies to defeat tender offers, see Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 44-63 (Nov. 1986).

12. See S. REP. NO. 550, 90th Cong., 1st Sess. 2-4 (1967) [hereinafter S. REP. NO. 550].

13. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454 (amending Securities Exchange Act of 1934, §§ 12-14, 16; 15 U.S.C. §§ 78m-78n (1964) (codified as amended at 15 U.S.C. §§ 78n(d)-(f) (1982)).

feror provide investors full and fair disclosure of the offer's terms. The Act also gave the offeror and target management an equal opportunity to present their respective cases.<sup>14</sup> Congress, however, was careful not to favor either target management or the offeror by tipping the balance of regulation in either direction.<sup>15</sup>

The procedural provisions of the Williams Act require that the tender offeror file a disclosure statement with the Securities and Exchange Commission if, after the offer, the maker would own more than five percent of a particular class of equity securities.<sup>16</sup> This statement, known as a schedule 14D-1, requires the offeror to provide the shareholders of the target company with all material information contained in the offer.<sup>17</sup> In addition to the procedural requirements, the Williams Act also contains four substantive provisions. These provisions: (1) allow a shareholder to withdraw tendered shares any time within seven days after publication of the offer or sixty days from the date of tender if the offeror has not purchased them;<sup>18</sup> (2) provide for pro rata acceptance of oversubscribed offers;<sup>19</sup> (3) provide for equal treatment of all selling

14. See generally S. REP. NO. 550, *supra* note 12.

15. See Note, *The Constitutionality of State Takeover Statutes: A Response to Great Western*, 53 N.Y.U. L. REV. 872, 876 (1978). Further support for the conclusion that Congress meant for the Williams Act to be neutral as between target management and the offeror may be derived from early drafts of the Act which were decidedly pro-management. See *Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 30 (1977) (Court discusses legislative history of the Act) and comments made by Manuel Cohen, then Chairman of the SEC, "[T]he principal point is that we are not concerned with assisting or hurting either side. We are concerned with the investor who today is just a pawn in a form of industrial warfare. . . . The investor is lost somewhere in the shuffle." *Full Disclosure of Corporation Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 178 (1967) (statement of Manuel Cohen, Chairman, SEC), *quoted in Piper*, 430 U.S. at 27-28 (1977).

16. 3 Fed. Sec. L. Rep. (CCH) ¶ 24, 284C, at 17,735-38 (1986). The required information on schedule 14D-1 is as follows: (1) target company and security sought; (2) identity and background of the purchaser; (3) pass contracts, transactions, and negotiations with the target company; (4) source and amount of funds used in the purchase; (5) the purpose of the transaction including any plans to liquidate, sell the assets of, merge, change the boards of directors or management of, or make any material changes in the business or corporate structure of the target; (6) the number of shares the offeror, associates, and majority-owned subsidiaries own or have a right to acquire; (7) information as to any contracts, arrangements, or understandings with respect to the securities; (8) the identity and terms of employment of all persons retained to make solicitations or recommendations; (9) financial statements of the offeror, other than natural persons, when material to a securityholder's decision whether to tender; (10) such additional information as is material to a securityholder's decision; and (11) solicitation materials used in the tender offer.

17. 15 U.S.C. § 78n(d)(1) (1982); 17 C.F.R. § 240.14d-6 (1986).

18. 15 U.S.C. § 78n(d)(5) (1982). This gives the investor time to change his mind. The Act provides that tendered securities may be withdrawn until the expiration of seven days after the time definitive copies of the offer or request or invitation are first published or sent or given to security holders, and at any time after sixty days from the date of the original tender offer or request or invitation, except as the Commission may otherwise prescribe. *Id.*

19. 15 U.S.C. § 78n(d)(6) (1982). Pro rata acceptance is necessary where the offer is made for fewer than all shares of a particular class. The effect of this provision is to avoid any need on the part of a shareholder to make a quick decision.

shareholders;<sup>20</sup> and (4) impose affirmative duties on the offeror to prevent any false or misleading statements as well as fraudulent or manipulative acts.<sup>21</sup>

Despite these procedural and substantive provisions of the Williams Act, a number of business executives believed that the Act had not gone far enough in providing investors with sufficient protection against what they believed were corporate raiders.<sup>22</sup> Consequently, these local business executives exerted pressure on their state legislators to remedy what they considered to be a gap in investor protection. Many states responded by enacting their own form of tender offer regulations.<sup>23</sup> In some cases, the new state regulations merely expanded on the procedural provisions of the Williams Act by imposing greater disclosure rules or by requiring the offeror to notify both state authorities and target management before commencing a tender offer.<sup>24</sup> Others, though, imposed stricter substantive provisions than those provided for by the Act. For example, some of the state statutes mandated longer withdrawal periods or extended the proration period for the duration of the offer.<sup>25</sup> On their face, many of the stricter procedural and substantive provisions enacted by the states were designed to provide shareholders with increased time for making a decision. Thus, it was argued that the state regulations added to the protections offered by the Williams Act.<sup>26</sup> Some, however, were designed to protect in-state management from the threat of a takeover.<sup>27</sup>

Regardless of their purpose, critics of these state regulations con-

20. 15 U.S.C. § 78n(d)(7) (1982). In some cases, an offering company may find it necessary to increase its offering price. Some shareholders, however, may have already tendered their shares. § 78n(d)(7) insures that early tenderers will have the advantage of any later offer increase.

21. 15 U.S.C. § 78n(e) (1982).

22. In fact, many of the state statutes which were enacted were originally sponsored by local companies. Bartell, *The Wisconsin Takeover Statute*, 32 BUS. LAW. 1465, 1466 (1977) (Special Issue). See also E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 172 (1973).

23. See *supra* note 3.

24. See, e.g., ARK. STAT. ANN. § 67-1264.2(5) (1977) (10 day notice required before commencing); Illinois Business Takeover Act § 4, ILL. REV. STAT. ch. 121½, § 137.54(E) (1981) (repealed 1983) (20 days). In contrast, the Williams Act requires only that the tender offeror file its disclosure statement on the day commencement of the offer begins. Other state procedural provisions imposed greater disclosure requirements than required by the Act. See, e.g., GA. CODE ANN. § 14-6-2 (repealed 1986); HAW. REV. STAT. § 417E-2(b)(3) (Repl. 1986).

25. See, e.g., ALASKA STAT. § 45.57.010(2) (1986) (21 day withdrawal right); DEL. CODE ANN. tit. 8, § 203(a)(2)(1983) (20 days). For those extending the proration period for the duration of the offer, see e.g., MASS. ANN. LAWS ch. 110C, § 7 (Michie/Law. Co-op. Supp. 1986); S.C. CODE ANN. § 35-2-80(4) (Law. Co-op 1985).

26. See Note, *Second Generation State Takeover Legislation: Maryland Takes a New Track*, 83 MICH. L. REV. 433, 439 (1984).

27. See, e.g., 1976 Ky. Acts 534 (prevention of takeover bids). This statute was held unconstitutional by the Kentucky Supreme Court. *Esmark v. Strode*, 639 S.W.2d 768, 770 (Ky. 1982).

tend, the state statutes delay effectiveness of the tender offer, thereby making it easier for target management to defeat an unwanted tender offer.<sup>28</sup> In the critics' view, statutes that create delay tip the scale of regulation in favor of target management and are contrary to the Williams Act which attempts to maintain a neutral balance between tender offeror and target management.<sup>29</sup>

The courts have generally agreed with the critics. In particular, the courts have found that state regulation of tender offers is either preempted by the Williams Act or that such regulations impermissibly burden interstate commerce. For example, in *Great Western United Corp. v. Kidwell*,<sup>30</sup> the Court of Appeals for the Fifth Circuit held unconstitutional an Idaho statute which required any person making a tender offer for an Idaho company to file a registration statement with, and be declared effective by, the state's department of finance before commencing the tender offer.<sup>31</sup> The Fifth Circuit found that the Idaho statute was unconstitutional on supremacy clause grounds because it upset the neutrality struck by the Williams Act between tender offeror and the target management and was therefore preempted by the Act. The court also found that the Idaho statute violated the commerce clause because it impermissibly burdened interstate commerce by interfacing with "security transactions all over the country."<sup>32</sup> Consequently, the Idaho statute was held unconstitutional on both supremacy and commerce clause grounds.

Similarly, the Seventh Circuit declared the Illinois Business Takeover Act<sup>33</sup> unconstitutional in *MITE v. Dixon*<sup>34</sup> on commerce clause grounds. Especially troublesome to the Seventh Circuit in *MITE* was the fact that the Illinois Act authorized the Secretary of State to pass on the "fairness" of the offer, blocking those which he deemed "unfair."<sup>35</sup> The Supreme Court agreed with the Seventh Circuit's finding. Justice White, writing for a majority of the Court held that the Illinois Act was uncon-

28. See Note, *supra* note 26, at 439.

29. See Aranow & Einhorn, *State Securities Regulation of Tender Offers*, 46 N.Y.U. L. REV. 767, 768 (1971); Langevart, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213, 240 (1977); Maylon, *State Regulations of Tender Offerors*, 58 MARQ. L. REV. 687, 690 (1975); Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1, 18 (1976); but c.f. Arsht, *The Delaware Takeover Statute—Special Problems for Directors*, 32 BUS. LAW. 1461 (1972).

30. 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds sub. nom. LeRoy v. Great W. United Corp.*, 443 U.S. 173 (1979).

31. 577 F.2d at 1274-86.

32. *Id.* at 1279, 1286.

33. ILL. REV. STAT. ch. 121½, §§ 137.51-.70 (1979) (repealed 1983).

34. 633 F.2d 486 (7th Cir. 1980), *aff'd sub. nom. Edgar v. MITE Corp.*, 457 U.S. 624 (1981).

35. 457 U.S. at 627.

stitutional because it imposed excessive burdens on interstate commerce in relation to the local interests served by the statute.<sup>36</sup> The Court pointed out that under the Illinois Act, the Secretary had the power to block a nationwide tender offer for the purpose of protecting local investors. While concluding that Illinois may have had a legitimate interest in protecting local investors, it clearly did not have such an interest in protecting non-resident shareholders.<sup>37</sup>

A plurality of the Court also found that the Illinois Act was preempted by the Williams Act. The plurality reasoned that the hearing provisions of the Illinois Act frustrated congressional purpose by introducing extended delay into the tender offer process.<sup>38</sup> Justice White noted that the target company could use these hearing provisions as a "powerful weapon to stymie indefinitely a takeover. In enacting the Williams Act, Congress itself recognized that delay can seriously impede a tender offer and sought to avoid it."<sup>39</sup> Consequently, Justice White joined by Chief Justice Burger and Justice Blackmun would have ruled that the Illinois Act was preempted by the Williams Act. However, Justice White's preemption analysis was expressly rejected by Justices Powell and Stevens. They noted that Congress' decision to follow a policy of neutrality was not necessarily "tantamount to a federal prohibition against state legislation designed to provide special protection to incumbent management."<sup>40</sup>

Several states responded to the *MITE* decision by simply amending or repealing those aspects of their takeover laws that the Court had found objectionable, leaving their statutes relatively unchanged.<sup>41</sup> A number of states, however, developed new methods for regulating takeovers. For example, Ohio instituted a requirement that those seeking acquisition of controlling blocks of shares receive an affirmative vote

36. *Id.* at 643.

37. *Id.* at 644. Justice White concluded that the Secretary's power to extend his reach beyond the state's borders to block a nationwide tender offer constituted an indirect burden on interstate commerce. He was joined in this opinion by Chief Justice Burger and Justices Powell, Stevens, and O'Connor. Justice Powell, however, was unable to join Part V-A of Justice White's opinion which found that the Illinois Act directly burdened interstate commerce. Justice Powell, however, was willing to join Part V-B because it left the state some room for regulating tender offers. A finding that the Illinois Act directly burdened interstate commerce would have precluded this possibility. *Id.* at 646 (Powell, J., concurring). It should be noted that Justice Powell found the case moot, but was willing to consider the merits anyway. *Id.*

38. *Id.* at 634-39.

39. *Id.* at 637.

40. 457 U.S. at 655. Justices Marshall, Brennan, and Rehnquist found that the case was moot and therefore were unwilling to reach the merits.

41. See Note, *supra* note 26, at 434 n.8. These revised state statutes have been referred to as "second generation" takeover statutes. *Id.* at 434.

from the shareholders before proceeding.<sup>42</sup> Similarly, Maryland imposed supermajority voting requirements<sup>43</sup> and "fair price" amendments on business combinations such as mergers.<sup>44</sup> Likewise, Pennsylvania enacted provisions restricting the voting rights of "interested shareholders" in certain corporate transactions such as mergers.<sup>45</sup> The Pennsylvania enactment also provided all disinterested shareholders with a right of redemption for their shares if a person or group were to acquire thirty percent or more of the corporation's stock.<sup>46</sup>

All of the remaining states that have enacted new statutes tend to follow either the Ohio, Maryland, or Pennsylvania approach.<sup>47</sup> The *MITE* decision, however, set few clear standards for evaluating the constitutionality of these new forms of legislation. As a result, it remained uncertain as to whether these new forms of regulation would be preempted by the Williams Act or alternatively fail to pass constitutional muster on commerce clause grounds. Against this backdrop of doubt, the Court of Appeals for the Seventh Circuit was faced with the question of whether Indiana's new statute, The Control Share Acquisition Chapter,<sup>48</sup> which combines elements from all three of the above approaches, was unconstitutional.

42. OHIO REV. CODE ANN. §§ 1701.01, .11, .37, .48, .831, .832, 1707.01, .042, .23, .26, .99 (Baldwin 1985). The Sixth Circuit has recently found this statute unconstitutional on both supremacy and commerce clause grounds. *See Fleet Aerospace Corp. v. Holderman*, 796 F.2d 135, 139 (6th Cir. 1986).

43. Supermajority refers to provisions which require that a substantial majority rather than just, say 51%, approve an acquisition. *See, e.g., MD. CORPS. & ASSNS. CODE ANN. § 3-602* (1985) (at least 80% of the outstanding shares eligible to vote and at least two thirds of the voting shares not owned by "interested shareholders" or by the affiliates).

44. *Id.*

45. 15 PA. CONS. STAT. ANN. §§ 1408(b), 1409.1(c)(1)-(3), 1910 (Purdon 1986).

46. *Id.*

47. *See Note, supra* note 26, at 434 n.8.

48. IND. CODE §§ 23-1-42-1 to -11 (West 1986). "This statute is part of a series of amendments to the Indiana Business Corporation Law which were signed into law on March 4, 1986, and which are to become effective August 1, 1987. IND. CODE § 23-1-17-3 (a). Section 23-1-17-3 (b) of the statute, however, permits those corporations which so elect by resolution or [their] board of directors, to be governed by the statute as of April 1, 1986." On March 27, 1986, CTS, by resolution of its board, elected to be covered by the statute for all tender offers made for CTS shares as of April 1, 1986. *Dynamics Corp. of Am. v. CTS Corp.*, 637 F. Supp. 389, 390-91 (N.D. Ill. 1986).

Under this statute, shares acquired in a control share acquisition are stripped of their voting rights unless the shareholders resolve otherwise. A "control share acquisition" is defined as the acquisition by a single entity of shares which give it more than 20% of the voting power with respect to shares in an "issuing corporation". IND. CODE § 23-1-42-2. An "issuing corporation" is defined as a corporation that has (1) one hundred or more shareholders; (2) its principle place of business, its principal office, or substantial assets within Indiana; and (3) either: (A) more than 10% of its shareholders resident in Indiana; (B) more than 10% of its shares owned by Indiana residents; or (C) 10,000 shareholders resident in Indiana. *Id.* § 23-1-42-4(a). In order to regain voting rights, a tender offeror must have a resolution approved by (1) each voting group entitled to vote separately by a majority of all votes entitled to be cast and (2) a majority of all votes entitled to be cast, excluding all "interested shares." *Id.* § 23-1-42-9(b). "Interested shares" are defined as shares, the



## II. FACTS OF THE CASE AND REASONING OF THE COURT

On March 10, 1986, Dynamics Corp. of America (DCA) announced its intention to make a partial tender offer for one million shares of CTS Corp. (CTS) and to wage a proxy contest for control of CTS' Board.<sup>49</sup> In response to DCA's announcement, CTS adopted a shareholders' rights plan, also known as a "poison pill."<sup>50</sup> Under this plan, each CTS shareholder was entitled to purchase a unit of CTS securities at a price equal to 25 percent of the then current market value. In addition to adopting the "poison pill," CTS also chose to be covered by Indiana's new tender offer statute, the Indiana Control Share Acquisition Chapter.<sup>51</sup> Under the statute, the effectiveness of a tender offer is delayed for a period of up to fifty days and the voting rights associated with each share of the target company stock are altered.<sup>52</sup>

Concurrent with announcing their intention to make a tender offer for CTS, DCA sought a preliminary injunction enjoining enforcement of both the CTS "poison pill" and the application of the Indiana Control Share Acquisition Chapter.<sup>53</sup> On April 9, 1986, the United States District Court for the Northern District of Illinois enjoined enforcement of CTS' "poison pill" plan on the grounds that CTS' directors had violated their fiduciary responsibilities.<sup>54</sup> In addition, the district court held that the Indiana takeover statute was unconstitutional on both supremacy and commerce clause grounds.<sup>55</sup> The case was certified for immediate appeal, and in an opinion written by Judge Posner, the Seventh Circuit affirmed on both grounds. The court held that the Indiana statute imposed a greater delay on the tender offer than that mandated by the Williams Act and was therefore preempted by the supremacy clause.

voting of which, is controlled by an acquiring person, any officer of the corporation, and any employee of the corporation who is also a director of the corporation. *Id.* § 23-1-42-3.

Furthermore, the special meeting called for the purpose of considering the voting rights of the acquired shares may be delayed up to 50 days but in any event must not be held sooner than 30 days after the offeror's request for the meeting. *Id.*

49. *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 257 (7th Cir. 1986), *rev'd*, 55 U.S.L.W. 4478 (Apr. 21, 1987). At the time the offer was made, DCA already owned 9.6% of CTS' common stock. If successful, the tender offer would have brought DCA's holdings up to 27.5% of CTS common. 794 F.2d at 251.

50. Under CTS' "poison pill" plan, each CTS shareholder was to receive a dividend distribution of one "right" per common share. These "rights" were worthless unless any person or group acquired 15% or more of CTS' common stock at which time the rights were to become nonredeemable, entitling the holders, other than the acquirer whose "rights" became null and void, to purchase a unit of CTS securities at a price equal to 25% of the then current market value.

51. IND. CODE §§ 23-1-42-1 to -11 (West 1986).

52. *See supra* note 48.

53. *Dynamics Corp. of Am. v. CTS Corp.*, 637 F. Supp. 389 (N.D. Ill. 1986).

54. *Dynamics*, 794 F.2d at 253.

55. *Id.* at 251.

Second, the court found that the Indiana statute violated the commerce clause because it imposed substantial burdens on interstate commerce.<sup>56</sup>

The first level of constitutional inquiry undertaken by the Seventh Circuit was whether the Indiana Control Share Acquisition Chapter was preempted by the Williams Act and hence unconstitutional under the supremacy clause of the Constitution.<sup>57</sup> Judge Posner began his analysis by examining the legislative history of the Williams Act.<sup>58</sup> In his view, when Congress enacted the Williams Act, it attempted to strike a delicate balance between the contending factions involved in the takeover controversy.<sup>59</sup> Therefore, Judge Posner reasoned, the states were implicitly forbidden from adopting more hostile regulations, a conclusion supported by a plurality of the Supreme Court in *Edgar v. MITE*.<sup>60</sup> The court then applied this reasoning to the Indiana statute and found that it forced

56. The court of appeals also sustained the district court's grant of a preliminary injunction against enforcement of the poison pill. DCA proceeded with their tender offer for CTS common ending up with 27.5% of the company. On the same day as the Seventh Circuit issued its decision, CTS announced the adoption of a new "poison pill." The new "pill" was to become effective if any shareholder obtained 28% of CTS. Each shareholder, other than the acquirer, would be entitled to turn in their shares and receive in exchange a \$50 debenture bond payable after one year with interest at 10% per annum. The plan was to remain in effect for one year but could be cancelled by CTS' board at any time. In addition, the "pill" would be automatically cancelled if anyone made a cash offer for all the outstanding shares at a price of \$50 or more. See *Dynamics Corp. of Am. v. CTS Corp.*, 805 F.2d 705, 707.

DCA immediately filed suit in the district court seeking a preliminary injunction against enforcement of the new "poison pill." This time, however, the district judge denied the motion. *Id.* The Seventh Circuit, however, vacated the denial and remanded for further factual findings. *Id.* at 718.

This second round of litigation between DCA and CTS is not pertinent to the constitutional issues decided by the Seventh Circuit and addressed in this comment. The decision in the "second" case raises some interesting questions regarding the proper application of the business judgment rule in the context of corporate control transactions. See generally *id.* at 711-18 (the standard of review is not gross negligence but "reasonableness"). *But cf.* decisions of the Delaware courts discussed in *Wander & LeCoque*, *supra* note 11, at 38-44 ("gross negligence" standard applied in Delaware).

57. *Dynamics*, 794 F.2d at 260-63. The court also addressed some non-constitutional issues. Specifically, the Seventh Circuit found that the district court had properly enjoined CTS' "poison pill" plan on the grounds that CTS' directors had violated their fiduciary responsibilities. Judge Posner reasoned that although defensive measures in general and "poison pills" in particular are within the power of a board, in this case the directors of CTS had failed to evaluate the tender offer in a cool, dispassionate and thorough fashion. Therefore, CTS' directors had failed to act in good faith and in the best interests of the company. *Id.* at 257-59.

In addition, the Seventh Circuit held that although the district court had failed to comply with 28 U.S.C. § 2403(b) which requires the court to notify the attorney general of the State when the constitutionality of a state statute is called into question, the violation was inadvertent and the prejudice to Indiana "nil." 794 F.2d at 260.

Finally, the court dismissed CTS' claim that if DCA's tender offer were to succeed, both companies would be in violation of § 8 of the Clayton Act which prohibits interlocking directorates. In the court's view, the record of the case contained no persuasive evidence that DCA and CTS were in competition or that any director of DCA would agree to serve as a CTS director. 794 F.2d at 265.

58. 794 F.2d at 262.

59. *Id.*

60. 457 U.S. 624 (1981).

tender offers to remain open up to fifty days and therefore upset the balance struck by the Williams Act.<sup>61</sup> Since this constituted a direct conflict with the Williams Act provision of twenty days, the Indiana statute was unconstitutional under the supremacy clause of the Constitution.

The second level of constitutional inquiry undertaken by the Seventh Circuit was whether the Indiana statute was unconstitutional under the commerce clause of the Constitution. Since the court had already held the statute unconstitutional under the supremacy clause, Judge Posner found the question of the Indiana statute's validity under the commerce clause "doubly academic."<sup>62</sup> Judge Posner nevertheless stated that there was lingering doubt that the Williams Act was really intended to preempt state regulation of tender offers. Therefore, he found it appropriate to determine the Indiana statute's validity under the commerce clause.<sup>63</sup> In the court's view, the question was answered by applying the traditional balancing test enunciated in *Pike v. Bruce Church, Inc.*<sup>64</sup> Specifically, the court proceeded to balance the burdens imposed on interstate commerce by the Indiana statute against its putative local benefits. The court found it troubling that in order for CTS to take advantage of the Indiana statute, only a small fraction of its shareholders had to reside in Indiana.<sup>65</sup> In the Seventh Circuit's view, Indiana had no interest in protecting residents of other states from "being stampeded" to tender their shares to Dynamics.<sup>66</sup> Furthermore, the court rejected any notion that Indiana's local interest in protecting employment and preventing the shift of assets out of the state was enough to save the statute. The Seventh Circuit concluded that the commerce clause does not allow states to prevent corporations from moving assets and employees to other states.<sup>67</sup>

As a result, the Seventh Circuit held that the burdens imposed on interstate commerce by the Indiana statute outweighed any local interest Indiana may have had in enacting the statute. Therefore, the Indiana Control Share Acquisition Chapter was unconstitutional under the commerce clause of the Constitution.<sup>68</sup>

61. *Dynamics*, 794 F.2d at 263. The court found the argument that the Indiana statute was less inimical to tender offers than the Illinois Act struck down in *MITE* unpersuasive. "The Illinois statute imposed both delay and put the acquirer at the mercy of the Illinois Secretary of State; the Indiana statute imposes slightly greater delay but puts the acquirer at the tenderer mercies of the 'disinterested' shareholders. If we had to guess we would guess that the Indiana statute is less inimical to the tender offer but that is unimportant." *Id.* at 262.

62. *Id.* at 263.

63. *Id.*

64. 397 U.S. 137, 142 (1970).

65. *Dynamics*, 794 F.2d at 263.

66. *Id.*

67. *Id.* at 264.

68. The court distinguished the decisions in *L.P. Acquisition Co. v. Tyson*, 772 F.2d 201, 205-

### III. ANALYSIS

The Seventh Circuit's decision in *Dynamics*, like the Supreme Court's holding in *MITE*, solves few of the questions raised by the state regulation of tender offers. The first question left open by *Dynamics* is whether Congress meant to preempt state regulation when they enacted the Williams Act. In *Dynamics*, the Seventh Circuit held that the Indiana statute was preempted by the Williams Act and therefore unconstitutional on supremacy clause grounds. However, the Seventh Circuit misread the Williams Act. The court construed the Act as requiring a neutral balance of regulation between the offeror and target management instead of as an investor protection act.

The second question left open by *Dynamics* is whether any state regulation of tender offers can surmount a commerce clause challenge. The Seventh Circuit's decision that the Indiana statute was unconstitutional on commerce clause grounds did not address whether the states have any legitimate local interest in regulating tender offers that is incidental and could outweigh the burdens imposed on interstate commerce.

#### A. Preemption of State Regulation

By operation of the supremacy clause federal law may preempt the laws of any state.<sup>69</sup> Little difficulty exists where Congress has explicitly excluded the states from regulating. The problems come about when congressional intent is unclear.<sup>70</sup> The Supreme Court has recognized that there is no simple formula that can be used to determine when federal law preempts state regulation. "The policy of not lightly overturning state legislation is balanced against the countervailing policy of not frustrating the Supremacy Clause."<sup>71</sup> More often than not, the outcome will turn on the Court's determination of legislative intent.<sup>72</sup>

The Court has established a four step inquiry for determining whether Congress intended to preempt state regulation of a particular field. State legislation will be preempted where:

07 (6th Cir. 1985) and *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906, 909-12 (8th Cir. 1984). 794 F.2d at 264. In *Tyson*, the Seventh Circuit noted, the Williams Act was not applicable and the disclosures required by the state statute conferred greater benefits on local residents than the disclosure required by the Indiana statute. *Id.* In *Cardiff*, the Seventh Circuit reasoned that the required disclosure was designed to give state residents information on the impact of a takeover and the delay imposed was only slight. *Id.*

69. 457 U.S. at 630-31.

70. See G. GUNTHER, *CONSTITUTIONAL LAW* 317-18 (11th ed. 1985).

71. See Note, *Blue Sky Laws and State Takeover Statutes: New Importance For an Old Battleground*, 7 J. CORP. L. 689, 758 (1982).

72. *Id.* (citing Note, *Preemption and the Constitutionality of State Tender Offer Legislation*, 54 NOTRE DAME L. REV. 725, 726 (1979)).

- (1) Congress has expressly provided;<sup>73</sup>
- (2) the scheme of federal regulation is so pervasive as to make reasonable the inference that Congress left no room to supplant it;<sup>74</sup>
- (3) state law actually conflicts with the federal law;<sup>75</sup>
- (4) state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.<sup>76</sup>

The only explicit expression of Congressional intent regarding the Williams Act is set forth in section 28(a) of the Securities Exchange Act of 1934 which provides:

Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.<sup>77</sup>

The argument has been made that since Congress did not amend section 28(a) when it enacted the Williams Act, state regulation of tender offers is not expressly preempted.<sup>78</sup> Interestingly, the Court in *MITE* pointed out "there [was] no evidence in the legislative history that Congress was aware of the state takeover laws when it enacted the Williams Act."<sup>79</sup>

The Seventh Circuit in *Dynamics* expressed no opinion on whether it thought Congress had expressly preempted state regulation of tender offers.<sup>80</sup> In addition, the court did not address the question of whether the Williams Act presents a pervasive scheme of federal regulations. If a negative answer to each question can be inferred from the court's silence, then the court was correct. There are no explicit words in the Act, therefore Congress did not expressly preempt state regulation of tender offers. Furthermore, the Williams Act does not present a pervasive scheme of

73. *Pacific Gas & Elec. Co. v. State Energy Comm'n*, 461 U.S. 190, 203 (1983).

74. *Pacific Gas & Electric Co.*, 461 U.S. 190; *Fidelity Fed. Sav. & Loan v. de la Cuesta*, 458 U.S. 141, 153 (1982). For example, in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) the Court held that absent a clear indication of congressional intent, it was reluctant to federalize the substantial portion of corporate law that deals with transfers of securities. *Id.* at 479. Similarly, in *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977), the Court found it appropriate to relegate a defeated tender offeror to those remedies available under state law in the absence of congressional intent to create a federal remedy. *Id.* at 41.

75. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963).

76. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (citing *Savage v. Jones*, 225 U.S. 501, 523 (1912)).

77. 15 U.S.C. § 78bb(a) (1982).

78. *Edgar v. MITE Corp.*, 457 U.S. 624, 630-31 (1981). *But see* Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733, 749-50 (1979) (arguing that § 28(a) is irrelevant for determining whether the Williams Act does or does not preempt state regulation).

79. 457 U.S. at 631 n.6.

80. Instead, the court focused its inquiry on the Supreme Court's plurality opinion in *Mite* as well the Seventh Circuit's own decision in that case and found that "whatever doubts of the Williams Act's preemptive intent we might entertain as an original matter [these doubts] are stilled by the weight of precedent." *Dynamics*, 794 F.2d at 262.

federal regulation of tender offers. The Act merely requires disclosure to shareholders of all material information relevant to a tender offer and provides shareholders with substantive protections such as withdrawal rights, pro rata acceptance and the equal treatment of all shareholders. The Act does not change the cooperative nature of federal and state securities regulation.<sup>81</sup>

The Seventh Circuit's inquiry in *Dynamics* incorrectly centered on whether the Indiana statute upset the balance struck by the Williams Act between the offeror and target management.<sup>82</sup> Judge Posner reasoned that any state regulation which was more "hostile" to offerors than the Williams Act would upset this balance and therefore be preempted.<sup>83</sup> He concluded that the Indiana statute was preempted by the Williams Act because it imposed a delay greater than that provided by the Act. Specifically, under the Indiana statute, a target company could force a tender offer to remain open up to fifty days; in contrast, the Williams Act requires offers to remain open only twenty business days.<sup>84</sup> Hence, the Indiana statute tipped the balance of regulation in favor of the target company, frustrating congressional intent to remain neutral between the offeror and target management.

However, the Seventh Circuit misread the Williams Act. The court's analysis should not have centered on whether the Indiana statute tips the balance of regulation in favor of the offeror or target management. The Williams Act was meant to be an "investor protection" Act. In his explanation of the legislation, Senator Williams, the chief sponsor of the Act, spoke of "closing a significant gap in investor protection."<sup>85</sup> The Act itself states that it is "designed to require full and fair disclosure for the benefit of investors."<sup>86</sup> Therefore, any neutrality as between the

81. *But see* Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 *FORDHAM L. REV.* 1, 29 (1976) (suggesting that the Williams Act, together with the balance of the 1934 Act, comprises a comprehensive scheme of regulation of tender offers).

82. 794 F.2d at 262. The court never set out the preemption framework discussed earlier. However, the court's discussion on the balance between target management and tender offeror seems aimed at the fourth prong of the test, *i.e.* whether the Indiana statute stood as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.

83. *Id.* "The reasoning is that Congress in the Williams Act (as in the federal labor laws) struck a delicate balance between the contending factions in the takeover controversy and wanted its balance to mean something and not be undone by the states." *Id.*

84. *Id.* at 263. "In any event, if the Williams Act is to be taken as a congressional determination that a month (roughly) is enough time to force a tender offer to be kept open, 50 days is too much." *Id.*

85. *See* 113 *CONG. REC.* 854 (1967); *see also* *Piper v. Chris Craft Indus.*, 430 U.S. 1, 24-37 (1977) (discussing the legislative history of the Williams Act).

86. *See* S. REP. NO. 550, *supra* note 12, at 3; Note, *supra* note 26, at 435 (the Williams Act is designed to protect investors); Note, *The Constitutionality of State Takeover Statutes: A Response to Great Western*, 53 *N.Y.U. L. REV.* 872, 876 (1978) (the stated purpose of protecting investors).

offeror and target management was but a by-product of legislation directed toward a different purpose.<sup>87</sup> Accordingly, the proper inquiry should have been whether the Indiana statute frustrated congressional intent to protect investors.

Accepting that the Williams Act was meant to be an investor protection act,<sup>88</sup> it seems inconsistent to find that a state regulation which attempts to provide investors with greater protection frustrates the Act. In fact, several observers have suggested that the Williams Act falls short of its investor protection goal because it fails to provide investors and management with adequate time to evaluate a tender offer.<sup>89</sup> Consequently, state regulations which are more stringent than the Williams Act should in theory provide greater investor protection and therefore not frustrate any congressional objectives.

In fact, reconciling the apparent inconsistency depends on the meaning ascribed to the term "investor protection." If "investor protection" means providing the individual shareholder with sufficient time and information to reach his own decision, then providing additional time and information would be consistent with investor protection. However, if "investor protection" means a rule which maximizes shareholder wealth, then more time and information may be harmful to the individual shareholder because any rule which requires additional time and information increases the costs of tender offers and therefore reduces the likelihood that they will be made.<sup>90</sup> Consequently, the individual shareholder is worse off since the reduced probability of a tender offer has decreased his options for maximizing his wealth. As a result, any rule which imposed time delays or disclosure beyond those required by the Williams Act would not be protecting investors and therefore should be preempted by the Williams Act.<sup>91</sup>

The theory that shareholder wealth is maximized when the likelihood of a tender offer is at its greatest seems to permeate Judge Posner's reasoning and may explain his interpretation of the Williams Act.<sup>92</sup> It is unlikely, however, that Congress had this theory in mind when they en-

87. *Piper*, 430 U.S. at 29. "Congress was indeed committed to a policy of neutrality in contests for control. [However], neutrality is, rather but one characteristic of legislation directed toward a different purpose—the protection of investors." *Id.*

88. There does not seem to be any disputing this conclusion. See generally S. REP. NO. 550, *supra* note 12; *Piper*, 430 U.S. at 29; *Edgar*, 457 U.S. at 634.

89. See, e.g., E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 9; Arsh, *supra* note 29.

90. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding To A Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981).

91. This assumes *a priori* that the Williams Act provides for the minimum amount of delay and information consistent with shareholder wealth maximization.

92. Part IV will discuss this theory at greater length.

acted the Williams Act.<sup>93</sup> Consequently, the Seventh Circuit was erroneous in holding that the Indiana Control Share Acquisition Chapter was preempted by the Williams Act.

### B. *The Commerce Clause as a Restraint on State Regulation*

It has long been held that the commerce clause,<sup>94</sup> even without implementing legislation from Congress, acts as a limitation upon state power.<sup>95</sup> The Supreme Court, however, has long recognized that the commerce clause does not limit the power of the states to erect barriers against interstate trade.<sup>96</sup> A state statute that incidentally regulates interstate commerce will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.<sup>97</sup>

The Seventh Circuit in *Dynamics* reasoned that all commerce clause questions can be settled by merely balancing the benefit to the state's residents against the burden to out-of-staters.<sup>98</sup> Judge Posner concluded that the Indiana statute gravely impaired DCA's ability to do business with CTS' shareholders.<sup>99</sup> Consequently, since Indiana had failed to establish any local benefit which outweighed the burdens imposed on interstate commerce, the Indiana statute was unconstitutional on commerce clause grounds.<sup>100</sup>

The Seventh Circuit was correct in finding that the Indiana Control Share Acquisition Chapter was unconstitutional on commerce clause grounds. However, the court's analysis was cursory, and did not address whether the states can ever assert a local interest in regulating tender offers that is great enough to outweigh the burdens imposed on interstate commerce. Proponents of state takeover regulation argue that the state takeover statutes promote two legitimate local interests. First, protecting

93. Support for this conclusion is drawn from Professor Fischel's argument that the Williams Act was designed to prevent shareholders from receiving an inadequate price for their stock. See Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 24-25 (1978). Professor Fischel's reasoning leads to the conclusion that Congress was not thinking in terms of protecting shareholders as a whole, but only particular shareholders involved in a tender offer.

94. The commerce clause of the United States Constitution provides that "Congress shall have power . . . to regulate commerce . . . among the several states." U.S. CONST. art. I, § 8, cl. 2.

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

96. *Raymond Motors Trans., Inc. v. Rice*, 434 U.S. 429, 440 (1978). The Seventh Circuit pointed out that the limitations imposed on the states by the commerce clause were not absolute. "[F]or example, a state may apply its health and safety regulation to imported goods even though the cost of compliance will be borne in part by people in other states, and the suppliers of the goods." *Dynamics*, 794 F.2d at 263.

97. 794 F.2d at 263.

98. *Id.*

99. *Id.*

100. *Id.* at 263-64.



target shareholders and second, regulating the internal affairs of domestic corporations under state law.<sup>101</sup> Both of these asserted interests, however, fail to outweigh the burdens imposed on interstate commerce.

Although the first local interest, the protection of local investors, is plainly a legitimate state objective, tender offer laws have global impact and could reach shareholders in every state. As the Supreme Court recognized, the state has no legitimate interest in protecting nonresident shareholders.<sup>102</sup> In reality, the state is using the notion of "investor protection" as a euphemism for the protection of local economic interests.<sup>103</sup> Statutes which protect local interests at the expense of out-of-state business run the risk of creating preferential trade areas destructive of the free trade which the commerce clause was designed to protect.<sup>104</sup>

The second legitimate interest asserted by proponents of state takeover legislation, regulating the internal affairs of a corporation incorporated under the state law, is also not a legitimate reason for the regulation of tender offers by the states.<sup>105</sup> The regulation of internal corporate affairs is meant to protect shareholders by imposing obligations on the corporation, its officers or controlling persons in their dealings with the shareholders. Tender offers, on the other hand, contemplate transfers of stock by shareholders to a third party and do not themselves implicate the internal affairs of the target company.<sup>106</sup>

Consequently, it is unlikely that any state regulation of tender offers will surmount a commerce clause challenge.<sup>107</sup> In fact, the whole area of tender offer regulation should be reexamined by Congress. As one commentator has noted, "considering the controversial nature of this area and the interests involved, it appears that a clearer statement of Congress-

101. See Shipman, *Some Thoughts About the Role of State Takeover Legislation: The Ohio Takeover Act*, 21 CASE W. RES. L. REV., 722, 740-46 (1970).

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

103. See, e.g., Note, *supra* note 3, at 622.

104. *Boston Stock Exch. v. Tax Comm'n*, 429 U.S. 318, 329 (1977) (citing *Dean Milk Co. v. Madison*, 340 U.S. 349, 356 (1951)).

105. The Supreme Court agreed with this conclusion in *Edgar*, 457 U.S. at 645-46.

106. 457 U.S. at 645. The internal affairs argument is even less persuasive given the fact that today many companies incorporate in a particular state to take advantage of its tax laws and have no other contact with the state. This last point raises the question of whether it still makes sense for the states to regulate corporate conduct. A discussion of this point, however, is beyond the scope of this comment.

107. In fact, none of the "second generation" statutes that have been challenged have survived judicial scrutiny. See, e.g., *Fleet Aerospace Corp. v. Holderman*, 796 F.2d 135, 139 (6th Cir. 1986)(Ohio statute unconstitutional under supremacy and commerce clause); *Terry v. Yamashita*, 643 F. Supp. 161, 166 (D. Haw. 1986)(Hawaii statute unconstitutional on commerce clause grounds); *Icahn v. Blunt*, 612 F. Supp. 1400, 1414-20 (W.D. Mo. 1985)(Missouri statute held invalid under both supremacy and commerce clauses); *APL Ltd. Partnership v. Van Dusen Air Inc.*, 622 F. Supp. 1216, 1220-24 (D. Minn. 1985)(Minnesota statute held invalid because of its substantial direct burdens on interstate commerce).

sional intent is needed.<sup>108</sup>

#### IV. PROTECTING INVESTORS BY MAXIMIZING SHAREHOLDER WEALTH

The theory of wealth maximization may explain why the Seventh Circuit centered its attention on the tender offeror (DCA) and the target company (CTS) when they found that the Williams Act preempted the Indiana statute. Judge Posner has long advocated using this theory in judicial decision making.<sup>109</sup> Although his application of economic theory in general, and wealth maximization in particular, to legal problems has generated a great deal of commentary and criticism,<sup>110</sup> the theory is well suited for analyzing the effects of regulation on tender offers.<sup>111</sup>

The theory of wealth maximization posits that the most efficient allocation of resources is that which makes the economic pie as large as possible, regardless of the relative size of the slices.<sup>112</sup> In the context of the securities market, wealth maximization means allocating resources in a manner that increases the returns to shareholders as a whole rather than any one particular shareholder.<sup>113</sup> The latter implies that the purpose of tender offer regulation, in particular, should be to improve the economic functioning of the capital markets to achieve better resource allocation.

Resources are allocated efficiently in the capital market when the prices of all traded securities accurately and promptly reflect the securities' intrinsic values relative to all publicly available information about

108. See Empirical Research Project, *Blue Sky Laws and Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. L. 691, 776 (1982); see also Greene, *Recent Tender Offer Developments: On The Edge or Deep In?*, 45 OHIO ST. L.J. 721, 722 (1984)(current regulatory scheme does not respond to modern realities of tender offers).

109. See Posner, *Wealth Maximization and Judicial Decision-Making*, 4 INT'L REV. L. & ECON. 131 (1984).

110. See, e.g., Samuels & Mercurio, *Posnerian Law and Economics on the Bench*, 4 INT'L REV. L. & ECON. 107 (1984); Tribe, *Constitutional Calculus: Equal Justice or Economic Efficiency?*, 98 HARV. L. REV. 592 (1985)(criticizing Professor Easterbrook's application of his wealth maximization theory); Comment, *Posnerian Jurisprudence and Economic Analysis of Law: The View from the Bench*, 133 U. PA. L. REV. 1117 (1985).

111. Unlike the questions of personal liberties, where concerns for efficiency and efficacy may overlook higher values protected by the Bill of Rights, the area of tender offer regulation is closely related to that area generally associated with economic analysis.

112. See Posner, *supra* note 109, at 132.

113. The return to an individual shareholder is a function of the company's dividend policy plus any appreciation in price of the firm's stock. The probability of earning a return is influenced by the degree of risk inherent in the particular investment. All things equal, the greater the risk in a given investment, the greater the return demanded by the shareholder. From the perspective of shareholders as a whole, wealth is maximized when resources are allocated to their highest and best use given a certain level of risk.

the corporation.<sup>114</sup> One of the most important pieces of information which influences the public's perception of the firm is the ability of the corporation's management.<sup>115</sup> If a firm is well managed, the price of its securities will be higher than under less competent management. In contrast, if the firm is poorly managed, the price of its securities will be lower than under more competent management.<sup>116</sup> In the latter case, the firm and society will benefit from a transfer of control from the current management to more capable management. The existence, however, of a securities market which is informationally efficient regarding the quality of the firm's management, does not mean that poorly performing management will be replaced swiftly.

In order for the capital market to function efficiently, there must be a mechanism that creates an incentive for management to maximize the welfare of its shareholders.<sup>117</sup> Since a successful takeover bid usually results in the displacement of current management, tender offers provide a strong incentive to corporate managers to operate efficiently and keep share prices high.<sup>118</sup> There are various methods of transferring corporate control.<sup>119</sup> The cash tender offer, however, is the means most favored by potential acquirers.<sup>120</sup> Accordingly, since tender offers provide a mechanism for maximizing shareholder wealth, the goal of any tender offer regulation should be to maximize the probability of a tender offer being made.

The stated goal of the Williams Act, as well as the various state statutes, has been to protect investors.<sup>121</sup> Although the concept of "investor protection" is nebulous, what the various legislators had in mind was more likely a system of regulation which insured that an individual shareholder in a given tender offer receive the highest price for his stock.<sup>122</sup> In general, the Act and its various state counterparts impose

114. This is known as the "efficient capital market theory." See Fischel, *supra* note 93, at 1.

115. *Id.*

116. *Id.* at 1-2.

117. Professor Fischel has referred to the shifting of corporate assets from one group of managers to another group who can employ them more profitably as the "market for corporate control." *Id.* at 2.

118. *Id.* at 9. Professor Fischel notes that while "theoretically, shareholders may oust poor management on their own initiative, the costs to such shareholders . . . [are] prohibitive." *Id.*

119. See *supra* notes 6-7 and accompanying text.

120. As noted earlier, tender offers are cheaper and faster than either proxy solicitations or exchange offers. See *supra* note 11 and accompanying text.

121. See *supra* note 15 and accompanying text.

122. Support for this conclusion can be gleaned from studying the provisions of the Act and its various state counterparts. Professor Fischel notes that the Williams Act was intended to protect shareholders, the greatest risk being that a shareholder will sell his shares for an inadequate price. However, the term "inadequate" has two distinct meanings. First, that the tender offer price is less than the intrinsic value of the shares at the time of sale. Second, a tender price could be inadequate

delay on the tender offer process for the purpose of giving shareholders the time to make an informed decision.<sup>123</sup> A by-product of the delay is to cause competing bidders to surface who are willing to pay a greater premium than that originally offered. Therefore, under this theory, shareholders are protected by being able to sell to a higher bidder.<sup>124</sup>

The weakness in this theory is that it fails to recognize that although delay may lead to a higher price for the firm's shares, shareholders as a whole do not necessarily benefit from this. This is because the value of any stock to the shareholders as a whole is comprised of the sum of two components: the price that will prevail in the market if there is no successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that some offer will succeed).<sup>125</sup> A shareholder's welfare is maximized when the sum of these components reaches its highest value. However, since the delay brought about by the various tender offer regulations increases the premium that must be paid for the stock, the usual interaction of supply and demand mean that fewer tender offers will be made.<sup>126</sup>

Although a higher premium is paid, the higher bid is not in accordance with the theory of wealth maximization. While the target shareholders receive a higher price, the gains are being exactly offset by the

if the shareholder could somehow receive a still higher price. But, as Fischel reasons, the Act is not concerned with inadequacy in the first sense since there is little danger that shareholders will get less than their shares are worth if they receive a premium above the market. Therefore, the Act is designed to protect against inadequacy in the second sense. See Fischel, *supra* note 93, at 25.

123. See *supra* text accompanying notes 16-27. In addition to giving the individual shareholder time to make an informed decision, the delay imposed by the Act and its state counterparts facilitates management's search for a "white knight" or gives them time to engage in a variety of defensive tactics. See Easterbrook & Fischel, *supra* note 90, at 1161-62.

124. The empirical evidence supports a conclusion that the delay brought on by the Act and the various state regulations increases the premiums paid to acquire target companies. According to a study done by Jarrell and Bradley, the premiums paid to target companies increased from 32% over market price to 53% following the enactment of the Williams Act. The effect of the state laws has been to increase the premium to over 73%. See Jarrell & Bradley, *The Economic Effects of Federal and State Regulation Of Cash Tender Offers*, 23 J. L. & ECON. 371, 373 (1980).

125. The premise that the value of any stock is comprised of the two components discussed above was originally developed by Judge Easterbrook (then a professor) and Professor Fischel in their work on the proper role of target management in the face of a tender offer. See Easterbrook & Fischel, *supra* note 90, at 1161. In this article, Judge Easterbrook and Professor Fischel argue that management should be passive in the face of a tender offer, *i.e.*, adopt no defensive measures designed to defeat the offer. Their conclusion is based on the reasoning that defensive measures increase the cost of a tender offer and thereby decrease the likelihood that one will be made. As a result, shareholders as a whole are worse off. *Id.* at 1164.

126. This conclusion is based on the premise that demand curves slope downward, *i.e.*, as price rises, the quantity demanded falls. It should be noted that the scope of this section is assessing only one of the variables discussed. Specifically, the probability that a tender offer will be made. Furthermore, it is being assumed that the percentage change in the probability that an offer will be made is greater than the percentage increase in price.

bidders' payment. Thus, the higher premium is really a tax on the offeror's shareholders. Therefore, shareholders as a group gain nothing.<sup>127</sup> Furthermore, if all the gains from the prospect of a properly managed firm go to the target shareholders, then no one will have any incentive to make a tender offer.<sup>128</sup>

Consequently, the Williams Act and its state counterparts limit the number of tender offers that will be made. At a minimum, Congress should act to preempt state regulation of tender offers because they impose the greatest threat to the goal of shareholder wealth maximization.<sup>129</sup> The state statutes usually impose greater delays on tender offers than the Act.<sup>130</sup> In addition, a significant amount of time and money is wasted litigating the legality of the state statutes. With few exceptions, none of the state regulations have ever withstood constitutional muster. Finally, it is inefficient to impose fifty different state regulations on transactions that run in the billions of dollars, criss-crossing the country, and sometimes the globe.

### CONCLUSION

Although the Seventh Circuit reached the correct result in *Dynamics Corp. of America v. CTS Corp.*,<sup>131</sup> the court's opinion solved few of the pressing questions raised by state regulation of tender offers. The court incorrectly construed the Williams Act as requiring evenhanded regulation between the tender offeror and the target company. However, the Williams Act was meant to protect investors. Any neutral effect between the offeror and the target company is but a by-product of legislation aimed at a different purpose. Therefore, the Seventh Circuit was errone-

127. See Easterbrook & Fischel, *supra* note 90, at 1175

128. *Id.* at 1177.

129. Professor Fischel goes a step farther by concluding that in addition to the state statutes, the Williams Act serves no valid purpose. See Fischel, *supra* note 93, at 45. Although Congress may ultimately agree with him with respect to the state statutes, it is unlikely that they will remove any of the impediments imposed by the Williams Act. In fact, the attitude of Congress seems to be in just the other direction. For example, one of the changes to the tax code brought about by the "Tax Reform Act of 1986" is the repeal of the *General Utilities* doctrine. See Tax Reform Act of 1986, Law and Controlling Committee Reports (CCH) ¶ 7631, at 1137. Under the *General Utilities* doctrine, an acquirer had been able to purchase the assets of a liquidating corporation or a deemed liquidation, and obtain a basis in the assets equal to their fair market value without the transferor recognizing any gain. However, the new tax law repeals the *General Utilities* doctrine by requiring the recognition of gain or loss on any liquidation or deemed liquidation. *Id.*

In addition, the recent insider trading scandal may cause the SEC or even Congress to impose restrictions on takeover activity. See Bianco & Farrel, *How the Boesky Bombshell is Rocking Wall Street*, BUS. WK. Dec. 1, 1986, 31, 31-33.

130. As illustrated earlier, the Indiana statute delayed the effectiveness of a tender offer for up to 50 days. See *supra* notes 24-25 and accompanying text.

131. 794 F.2d 250 (7th Cir. 1986), *rev'd*, 55 U.S.L.W. 4478 (Apr. 21, 1987).

ous in holding that the Indiana Control Share Acquisition Chapter was unconstitutional on supremacy clause grounds.

Furthermore, even though the court was correct in finding that the Indiana statute impermissibly burdened interstate commerce, the court's decision did not address the question of whether the states can assert any legitimate interest in regulating tender offers that outweighs the burden imposed on interstate commerce. Although the court is silent, the answer seems to be no. Tender offers contemplate transfers of stock by shareholders to a third party and therefore do not implicate matters that are traditionally the subject of state corporate law.

A possible explanation for the court's construction of the Williams Act is the theory of wealth maximization. Judge Posner has often advocated using this theory in judicial decision making. In the context of tender offer regulation, the theory of wealth maximization requires legal rules which encourage rather than discourage tender offers. Since state regulations impose significant burdens on tender offers, Congress should act to preempt state regulations.

#### APPENDIX

On April 21, 1987, the Supreme Court reversed the Seventh Circuit's finding that the Indiana Control Share Acquisition Chapter was unconstitutional.<sup>132</sup> Justice Powell,<sup>133</sup> writing for a majority of the Court, reasoned that the Indiana act differed from the Illinois statute considered in *Edgar v. MITE*.<sup>134</sup> Whereas the Illinois statute operated to favor management against offerors, the Indiana act protected individual shareholders against both the offeror and target management.<sup>135</sup> Justice Powell reasoned that by allowing shareholders to evaluate the fairness of a tender offer collectively, the Indiana act furthered the Williams Act goal of shareholder protection.<sup>136</sup> As a result, the Court concluded that the Indiana act did not conflict with the Williams Act and was not, therefore, preempted by the supremacy clause.<sup>137</sup>

132. *CTS Corp. v. Dynamics Corp. of America*, 55 U.S.L.W. 4478, 4480 (Apr. 21, 1987).

133. Justice Powell was joined by Chief Justice Rehnquist and Justices Brennan, Marshall and O'Connor. Justice Scalia filed a concurring opinion.

134. See discussion of case *supra* at 1005-06.

135. *CTS Corp.*, 55 U.S.L.W. at 4481. Justice Powell reasoned that the Indiana act had none of the defects found to exist in the Illinois statute. The Indiana act, unlike the Illinois statute did not require precommencement notice, did not delay indefinitely a tender offer, and did not allow the fairness of tender offers to be reviewed by a state official. *Id.* at 4481.

136. *Id.*

137. The Court also rejected Dynamics' argument that the Indiana act imposed an absolute 50 day delay on tender offers and was therefore in conflict with the 20 business day period established by the SEC under the Williams Act. Justice Powell reasoned that only an unreasonable delay would make the statute constitutionally infirm. Furthermore, in the Court's view, the Indiana act did not

The Court also rejected the Seventh Circuit's holding that the Indiana Control Share Acquisition Chapter unduly burdened interstate commerce. Justice Powell reasoned that the Seventh Circuit had "failed to appreciate the significance for commerce clause analysis of the fact that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law."<sup>138</sup> He noted that it was "an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."<sup>139</sup>

Consequently the Court concluded that Indiana had an interest in promoting a stable relationship among shareholders and the corporation as well as protecting shareholders from tender offers that may coerce them into tendering their shares.<sup>140</sup> The Court rejected Dynamic's argument that "the prospect of coercive tender offers is illusory and that tender offers generally should be favored because they reallocate corporate assets into the hands of management who can use them most effectively."<sup>141</sup> Justice Powell responded that "[t]he Constitution does not require the States to subscribe to any particular economic theory"<sup>142</sup> stating that the Court was "not inclined to 'second guess the empirical judgment of lawmakers'."<sup>143</sup>

Finally, the Court found unconvincing Dynamic's argument that the Indiana act was unconstitutional because it would ultimately limit the number of successful tender offers. In the Court's view, the Indiana act provided only regulatory procedures designed for the better protection of corporate shareholders.<sup>144</sup>

Although an analysis of the Court's decision is beyond the scope of this paper, a few points bear mentioning. First, as both Justice White

impose an absolute 50 day delay since an offeror was not precluded from purchasing shares as soon as permitted by federal law. *Id.* at 4482.

138. 55 U.S.L.W. at 4483.

139. *Id.* at 4484.

140. *Id.*

141. *Id.*

142. *Id.* Justice Powell noted that the potentially coercive aspects of tender offers had been recognized by the Securities and Exchange Commission as well as by a number of scholarly commentators. *Id.*

143. *Id.* The Court also rejected Dynamics' argument that Indiana had no legitimate interest in protecting nonresident shareholders. Justice Powell agreed that while Indiana has "no interest in protecting nonresident shareholders of nonresident corporations [the Indiana] act applies only to corporations incorporated in Indiana. *Id.*

144. Justice Scalia concurred, reasoning that a law can be both economic folly and constitutional. *Id.* at 4485. Justices White, Blackmun and Stevens dissented. In their view, the problem with the Indiana act was that while it protected the interests of a majority of the shareholders, in many instances, it would effectively prevent an individual investor from selling his stock at a premium. *Id.*

and Judge Posner noted, it is unlikely that anyone will make a tender offer if they risk losing the voting rights on the shares. Moreover, not only may a company deny a shareholder the right to vote in a takeover contest, but the right to vote may be permanently denied.<sup>145</sup> In addition, if the Indiana act was really a shareholder protection act, it is interesting that a corporation may opt out of its statutory provisions.<sup>146</sup>

Second, the Court seems all too willing to defer to the state's judgment because corporations are creations of the state. This view, however, fails to recognize the reality of today's financial markets. By allowing state regulation of tender offers, the Court is running the risk of creating preferential trade areas destructive of the free trade envisioned by the commerce clause. In reality, the purpose and effect of the Indiana Control Share Acquisition Chapter is not to protect shareholders, but to entrench management at the shareholders' expense.<sup>147</sup>

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145. *Id.* at 4479.

146. See IND. CODE § 23-1-42-5.

147. In its brief before the Court, the State of Indiana admitted that at least one of its goals was to protect Indiana Corporations. See *CTS Corp.*, 55 U.S.L.W. at 4486 (White, J., dissenting). For evidence that state tender offer regulation harms rather than protects shareholders, see recent SEC study of the Ohio act which showed stock prices declined an average of 2% following enactment of the law.



