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Corporate Takeovers: A Recommendation For a California Policy: An Overview of the Issue

Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions

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INTRODUCTION

The members of the Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions all have experience in some facet of corporation and securities law. Many of the Commission members are regularly involved with corporate takeovers, advising management, bidders and institutions.

Since October 1987, the Commission has been actively discussing and debating the issue of a state policy in response to the C.T.S.V. Dynamics case, which endorsed state takeover laws. This book therefore represents only small a portion of the background and discussion from which my recommendation emerged.

While there are many bills pending in the Legislature on takeovers and takeover related activities such as poison pills, supermajorities, and tiered offers, it should be noted that as laws, the legislation would affect only California corporations. Since there is a declining number of those corporations having substantial business contacts, the effect on business conduct is minimized.

Finally, I believe everyone involved in the discussion of a State Policy has the best interests of the State's economy and shareholders in mind when discussing or writing about the takeover issue. Given the obvious employer and client interests of Commission members this has not been an effortless task.

Senator Dan McCorquodale
March, 1988

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CHAPTER I

EXECUTIVE SUMMARY
BY SENATOR DAN McCORQUODALE

The Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions having studied the issue of corporate takeovers, submits the following conclusions and recommendations to the Legislature:

Conclusions:

- A California corporate takeover law would be an ineffective protection of corporations, workers and shareholders since it would apply to a minimal number of corporations having business contacts in the State.

- A national law requiring minimal standards of conduct for corporations, bidders and investors would reduce jurisdictional competition and claims among states.

- Problems associated with corporate takeovers such as depletion of assets and resources, debt burdens to corporations and other dislocations to the State's economy should be resolved as issues separate from tender offer legislation.

Recommendations:

- The California Legislature should support federal preemption of state takeover laws.

- The California Legislature should support state legislative proposals which will add to the protection of shareholders and pension investments.

- The California Legislature should support state legislative proposals relating to takeover activities when there is a potential for economic hardship to small corporations and their shareholders.

Dan McCorquodale is Chairman of the Senate Committee on Corporate Governance, Shareholder Rights and Securities Transactions and represents the San Jose and Modesto areas in the California legislature.

The Recommendation

Thirty-seven states have passed some form of legislation to restrict hostile corporate takeovers. Twenty-seven have restricted tender offers. California has not and should not.

A California takeover law will effect relatively few corporations, since few have either chosen to incorporate in the State or have sufficient business contacts to come under the jurisdiction of the State's Corporation Code Section 2115. A law will neither abet nor deter raids of most corporations. The passage of takeover legislation at this time would be an ineffective protection of shareholders, workers and the state's economy, as well as a deception of public policy of the first order.

Without addressing specific legislative proposals, the Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions recommends federal preemption of all states' laws relating directly to takeover activities. The preemption as described by the Commission should be limited to takeover activities and not infringe upon the appropriate state interests of corporate governance and internal affairs.

A line should also be drawn to separate internal management affairs of a corporation from takeover issues of corporate control. In addition, problems often associated with takeovers, such as plant closings or depletion of assets and resources, should be resolved as separate issues. This is not to diminish the seriousness of these issues or their impact on California's economy, resources and workers.

The recommendation is not intended to be prescriptive. California should have a voice in determining federal standards, but it is presumptuous to assume the actions of Congress and contradictory to circumscribe the rules for other states.

Lack of Jurisdiction

In most issues of corporate control, California is effectively preempted by other states, such as Delaware, by virtue of a corporation having the ability to select a choice of law through incorporation. Even if a corporation had a majority of its property, payroll, sales, shareholder and its headquarters located in California, it would not exclusively come under California laws should it choose to incorporate in another state.

The shocking reality is that despite having the sixth largest economy in the world, California can claim authority over only three Fortune 500 companies and less than four percent of New York Stock Exchange listed companies. Corporate laws affecting Times-Mirror, Wells Fargo or Atlantic Richfield for example are made not in Sacramento or Washington, D.C., but in Dover, Delaware. The merits of takeover legislation matter little, if California does not have jurisdiction over corporations.

It is also quite clear that California cannot enact corporation laws even if predisposed to do so, which would become as attractive to corporate management as the laws of Delaware or other states competing for incorporations.

It should be clear that not all of Delaware's laws adversely affect shareholders' interests. In some instances such as the declaration of dividends or valuation of acquisitions, Delaware law is quite favorable to shareholders.

However, California should not enter in to a competition for incorporations which it cannot win without substantially redirecting state law. The State should have the freedom to determine laws based upon economic, social, cultural and historical justification rather than a response to coercive competition between states. Delaware as an example, has a free hand to enact corporate laws which have relatively little effect on their own citizens except to provide additional revenue in franchise taxes and a disproportional effect on other states ability to regulate corporations.

As a small state with a modest economy, Delaware is the overwhelming choice of incorporation for corporations having their principal business contacts in other states. In addition, Delaware courts have established a body of case law unrivaled by other states. The incentives for Delaware incorporation are not likely to be reversed by the passage of a California takeover law. A law which would likely reverse past state policy.

Other states such as New York that have passed takeover laws with less balance and equity than the Delaware takeover law at the behest of their business lobbyists with such features as a five year prohibition on the divestiture of assets, lengthy disclosures and long tender periods have not experienced a return of corporations from Delaware. In most instances, state legislatures have reacted to the intimidation of a single corporation's threat to leave for Delaware, by immediately enacting protective legislation. This has been the case in Arizona (Greyhound), Minnesota (Dayton-Hudson), New Jersey (Singer), Washington (Boeing), and Ohio (Goodyear) to name a few examples.

The California legislature, much to its credit, has resisted overreaction despite takeover attempts on some of the major corporations in the state. Although California would like to provide a better business climate, that goal is unlikely to be realized by legislation that has a narrow application of relatively few corporations incorporated in California. California laws do not protect Delaware corporations.

California Alternatives

California has three alternatives: (1) do nothing and continue to abrogate authority over large corporations with substantial business contacts, (2) pass a takeover law which applies only to a relatively few corporations, or (3) assert jurisdiction through federal preemption of state laws by virtue of its Congressional representation. In light of these facts, the best alternative is to attempt to assert jurisdiction through federal preemption of state laws. Preemption would set a floor for shareholder protections and a ceiling for management prerogatives in the governance of corporations. States would be free to set additional standards above the floor or below the ceiling. With such a minimum federal standard, even set at a base approximating existing Delaware law (which is not being advocated), states would be free to decide an appropriate standard for governance of corporations with the certainty that Delaware or some other state would not continue the downward spiral of shareholder rights.

There is nothing innately wrong with states having different standards for corporate behavior. What is divisive is the competition to lower standards in the "race to the bottom." Minimal federal preemptive standards would establish a finish line for the race to the bottom.

In addition, the significance of multi-state claims and disputes over choice of law would be minimized as the disparities in state laws are restricted. This position is not contrary to the states' rights claim which was a major point of contention in the Indiana takeover case. To the contrary, such a proposal would promote states' rights. Differences in governance standards should reflect regional anomalies, not state entrepreneurialism. To restate the earlier question: Would California be better served being preempted by Congress or preempted by the Delaware Legislature? The current system in which a post office drop determines political and corporate behavior is totally irrational. It is an unimaginable metaphor for democracy.

What is a more reasonable alternative? A federal takeover law should recognize two precepts:

(1) It should be limited to the regulation of changes in corporate control. Responsibilities for corporate law traditionally vested with states should remain with states.

(2) It must be consistent with the consideration of neutrality among shareholders and unbiased between contending parties vying for ownership as presumed by the Williams Act.

The purpose of any law should be to allow the shareholders to make an informed decision regarding the ownership of a corporation free from coercive offers from both bidders and management. With the changes in ownership of corporations due to a shift of corporate equity to large pension funds perceptions of bias may have changed. This is but another reason to reexamine federal law.

A Final Perspective

California has been affected by the loss of jobs, resources and disruptions to the economy as much if not more than other states due to corporate takeovers of the last few years. Some of this disruption can be considered the price for the free movement of capital.

Considering the state has long been a net importer of capital, California has profited from a total increase in jobs and other benefits to the overall economy. Some measure providing for the protection of natural resources or sudden economic adjustment are warranted, but they would be ineffective if their application is limited to California corporations. Often the economic problems associated with takeovers are a result of poor business judgement and tactics in gaining or maintaining control of a corporation. The State cannot correct problems of business judgement and often lacks the authority to restrain harmful tactics.

The State's policy should be to unveil the myth of legal control over corporations and restore jurisdiction to California. That can only take place through federal legislation. Just as in the story of the Emperor's New Clothes, California bills itself as the sixth largest economy in the world without any control over the governance of the largest corporations doing business in the state. The Commission should advise the state of the nakedness of its authority and debunk the myth of state jurisdiction.

The Governance Commission

The California Senate created the Commission on Corporate Governance, Shareholder Rights and Securities Transactions, in 1986 to evaluate laws relating to and practices of corporate management, investment managers and investors, with particular concern to reconciling the need to establish stability for corporations operating in or desiring to locate in California with the fiduciary obligations of investment managers and pension fund trustees to prudently invest shareholder funds. The Commission's membership represents prominent members of the business, academic, investment and political communities. The Commission sponsors legislation and its members are often called upon for consultation or testimony on corporation and securities law issues before the Legislature.

CHAPTER II

REPORT AND COMMENTARY BY THE SUBCOMMITTEE ON CORPORATE TAKEOVER LEGISLATION

As discussed and suggested at the Commission's February 26, 1988 meeting the following letter was drafted for signature by the members of the California Legislature. Following are four commentaries on the proposal outlined in the letter by members of the subcommittee.

(Text of proposed letter to
members of the appropriate
committees)

The undersigned members of the California Legislature desire to express to you our support for the enactment by the Congress of the United States of certain federal minimum standards governing corporate takeover practices. We believe that recent events have underscored the impracticality of current attempts at regulation by the states. Corporate takeover activity is a national phenomenon that can only be regulated effectively at the national level, in a uniform fashion that pre-empts conflicting state laws.

In order to ensure that the federal standards cover the field and yet do not overly restrict smaller or private transactions for which there is less reason to intrude upon state law, we suggest that these standards be made applicable to all corporations with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or subject to the requirements of Section 15(d) of that Act.

We suggest that these standards should address the following areas of concern:

(1) Voting Rights. We urge that restrictions on voting rights based on acquisition of additional shares or the length of time shares are held, or which would disenfranchise the votes of existing public shareholders, be limited to those situations where a strong business justification exists for such voting limitations or where such limitations are otherwise adopted under circumstances designed to insure fairness. Examples of appropriate justifications would be where shareholders (other than management) have approved the limitation, where the limitation is placed on the shares prior to the time any shares of that class are sold to the public, or where the regulated nature of a company's business might require distinctions in voting power.

(2) "Poison Pills." We have concluded that so-called "poison pills" in many cases operate to deprive shareholders of the opportunity to benefit from takeover proposals. Accordingly, we would support a prohibition on "poison pills" unless they require shareholder approval (other than management) within one year after adoption in

order to continue in effect, as well as shareholder approval at least once every three years thereafter (i.e., a "sunset" provision).

(3) "Greenmail." We support a prohibition on the purchase by corporations of more than 5% of their own shares from a shareholder who has owned the shares less than one year unless one of the following formulas designed to ensure that a shareholder does not receive an unfair premium applies: (i) the purchase price is equal to or less than the market price of the shares on the third day following public announcement of a takeover bid or the thirty-day average post-announcement market price (whichever is elected by the target company); (ii) the shareholders have approved the transaction by a majority vote; or (iii) the same offer is made to all shareholders or the selling shareholder sells its shares pursuant to an agreement entered into prior to the time that the selling shareholder purchased a significant interest.

(4) "Fair Price." We support the "fair price" type of provision adopted by several corporations and enacted into law in several states and suggest that it be adopted at the federal level. Such provisions typically require a majority vote of the minority stockholders prior to a business combination with a substantial shareholder, unless the price to be paid is equal to or more than the greater of: (i) the highest price paid by the offeror in the past two year period; (ii) an amount which bears the same or greater percentage relationship, in a tender offer situation, to the market price prior to the announcement of the merger as the highest price per share paid by the offeror during the tender offer bears to the market price of the stock immediately prior to the commencement of the tender offer; or (iii) an amount equal to the earnings per share for the corporation's previous year multiplied by the then price/earnings ratio of the offeror.

(5) Schedule 13D Filing Deadline. We support shortening from ten days to five days the period in which acquirors have to file an initial Schedule 13D, and support a prohibition on the acquisition of additional shares until the Schedule 13D has been filed.

(6) Open Market Purchases Following a Tender Offer. We believe that where a bidder terminates a tender offer and immediately thereafter engages in massive open market purchases, the purposes of the Williams Act are significantly frustrated. Accordingly, we advocate prohibiting acquisitions for thirty days following the termination of a tender offer, or at least until the tender offer would have expired by its original terms.

(7) Favoring Acquisitions in Excess of a 15% Interest by Tender Offer. We believe that federal law should encourage acquisitions of outstanding shares in excess of 15% of a corporation's outstanding stock to be made by tender offer only, and therefore subject to the Williams Act. Excepted from this requirement would be stock acquired involuntarily by gift or otherwise; stock acquired by statutory merger or consolidation; stock acquired during the previous 12 months that did not exceed 2% of the outstanding stock of that

class; stock acquired by block trade in the normal course of business; purchasers exempted by the Securities Exchange Commission; owners of 85% or more of the corporation's stock; and stock that is acquired by a syndicate or other group that does not purchase additional shares after acquiring the required 15% or greater amount except by tender offer or purchase from the issuer.

(8) Disclosure of Control Intent in Schedule 13D Statement. We believe that the intentions of potential acquirers must be detailed within their Schedule 13D filing. If the acquisition of shares is stated to be for investment purposes only, then any subsequent takeover bids should be prohibited until an intention to obtain control has been disclosed and an appropriate waiting period has expired or until the approval of shareholders (other than management) has been obtained.

These proposed minimum standards were developed by the California Senate Commission on Corporate Governance, Shareholder Rights and Securities Tranactions. No matter what form these proposed minimum standards ultimately take, we believe that some measures for the governance of corporate takeover activity need to be enacted at the federal level.

DEPARTMENT OF CORPORATIONS
OFFICE OF THE COMMISSIONER
600 S. COMMONWEALTH AVENUE
LOS ANGELES, CALIFORNIA 90005
(213) 736-2741

IN REPLY REFER TO:

FILE NO. ________ ________

March 10, 1988

The Honorable Dan McCorquodale
Member of the Senate
State Capitol, Room 4032
Sacramento, CA 95814

Dear Senator McCorquodale:

The Department of Corporations has reviewed the initial rough draft of a proposed Resolution of the California Legislature regarding corporate takeovers. This resolution would recommend to the U. S. Congress the enactment of certain federal minimum standards in this area and was proposed by a member of the SR 41 Commission's Subcommittee on Takeovers. The Department finds itself supporting many of the sentiments expressed by Mr. Willie R. Barnes in his February 19, 1988 letter to Michael J. Halloran, the draftsman of the proposed resolution. In general, we believe the proposed resolution is excessively and unnecessarily detailed. Furthermore, the provision dealing with voting rights is objectionable to the Department.

In our opinion, the proposed resolution would do better to focus, in a straight-forward manner, on the need for a national, uniform standard for takeovers accomplished by purchase of securities rather than proposing such detailed and extensive provisions. We believe this focus would better serve the SR 41 Commission, also.

Below, please find our specific comments:

1. As Mr. Barnes points out in his February 19th letter, the provision for shareholder approval overrides substantially diminishes (indeed, defeats) any minimum standards sought to be adopted. The result of the shareholder override provisions is that there may be no minimum standard at all.

2. The incorporation of the proposed Securities and Exchange Commission Rule 19c-4 into the proposed resolution (Paragraph (c)) is particularly objectionable. There are two reasons for this:

- As proposed, this rule sets forth limited disenfranchisement standards (some will say that there are no standards at all) with respect to voting rights for common stock listed on a national securities exchange or quoted on NASDAQ. As you know, the appropriateness of these proposed standards also is the subject of the California debate under the California Securities Law on minimum voting rights standards for securities listed on the NYSE and ASE or designated national market system securities on NASDAQ. Specifically, Senate Bill 451 proposes to amend subdivision (o) of Corporations Code Section 25100 to include proposed Rule 19c-4 standards. This bill is presently before the California Legislature. The inclusion of the proposed SEC rule in a proposed resolution of the California Legislature to the U. S. Congress states, in effect, that this is the California position on minimum voting rights when in fact the California Legislature has not yet spoken. As you know, California has a long history of support for a one share, one vote standard which we are hopeful will continue as California's standard for common stock. Accordingly, we recommend this provision be deleted from the proposed resolution.

- At present the United States Congress is considering legislation to adopt a one-share/one-vote standard for equity securities listed on national securities exchanges or quoted on the NASD interdealer quotation system. This legislation is HR 2668 (Rinaldo) and HR 2172 (Markey). In our opinion, it would be preferable for the California Legislature to lend its support to these bills, particularly HR 2172, than to attempt to fashion other legislative recommendations out of whole cloth.

3. We agree with Mr. Barnes' comment regarding the appropriateness of the inclusion of Paragraph (g) in the proposed resolution. The threshold for a freeze-out of minority shareholders in a merger (whether it should remain at 90% or be reduced to 85%) should be a decision of the Legislature in the normal course of its deliberations and should not be presented in the form of a resolution requesting action of the U. S. Congress.

4. We are uncertain why a restriction on the acquisition of more than 15% of equity securities (Paragraph (m)) is necessary or desirable. We believe greater explanation is required on the part of the draftsman before this proposal can be analyzed effectively.

5. With respect to Paragraphs (i), (j), (l) and (n), we find we need further explanation before we can comment. Consequently, we request the draftsman supply an explanation to the SR 41 Commission members as to what result is being sought and why these provisions are necessary to achieve it.

These are weighty issues. The SR 41 Commission comprises a number of individuals with substantial practical experience in the securities area and who devote many hours of their time to the Commission. Many of the Commission members saw the Subcommittee draft for the first time at the conclusion of the last full Commission meeting. I strongly suggest that these issues receive a complete hearing at a full Commission meeting before a recommendation is made to the Legislature.

Very truly yours,

Christine W. Bender

CHRISTINE W. BENDER
Commissioner of Corporations
(213) 736-3481

CWB:kw

cc: Members, Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions

Dick Damm, Consultant
Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions

MANATT, PHELPS, ROTHENBERG & PHILLIPS
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
ATTORNEYS AT LAW

11355 WEST OLYMPIC BOULEVARD
LOS ANGELES, CALIFORNIA 90064

TELEPHONE (213) 312-4000

TELEX 215653 CABLE MPRT UR
FAX (213) 479-0565 (213) 478-1652

WASHINGTON, D.C. OFFICE
1200 NEW HAMPSHIRE AVE., N.W.
WASHINGTON, D.C. 20036
(202) 463-4300

February 19, 1988

OUR FILE NO.

Michael J. Halloran, Esq.
Pillsbury, Madison & Sutro
225 Bush Street
P.O. Box 7880
San Francisco, CA 94120

Dear Mike:

I am in receipt of your Memorandum dated February 2, 1988 and the enclosed initial rough draft of a proposed Resolution of the California Legislature recommending to the Congress the enactment of certain federal minimum standards for corporate takeover activity. Considering the limited amount of time the Subcommittee had to express its views on this notion of federal minimum standards in our meeting of January 8, 1988, you and members of your staff are to be congratulated for an excellent job in reducing to writing and formulating these concepts for further review and discussion.

Although the draft report of the Senate Commission on Corporate Governance, Shareholder Rights and Securities Transaction (the "Commission") sets forth two alternatives to addressing the so called "Delaware Race to the Bottom", the consensus of those at the last meeting of the Commission favored federal preemption of state regulation in the corporate takeover area combined with minimum federal standards. In this respect, the initial draft Resolution raises for me two broad philosophical issues on which I will want to deliberate further. First, I believe the draft Resolution, in addressing some of the typical anti-takeover devices, intrudes extensively and unnecessarily in the general corporate governance area. While I would not object to federal preemption of state regulation of takeovers, I would oppose any federal legislation which would preempt the states from regulating in the traditional corporate governance arena. I recognize that we are treading a thin line, that some principles (voting rights, for example) fit easily in either category and achieving an appropriate balance will not be precise. Nonetheless, the potential erosion of the traditional power of the states to regulate the internal affairs of corporations is of concern. Secondly, and historically, there has not been general support for enactment of federal minimum corporate standards and we run the risk of federal preemption without a floor of minimum corporate standards. I believe, however, that this risk can be minimized if our recommendations are narrowly defined.

With these general observations behind me, I do have a few specific comments on the various provisions contained in the proposed Resolution:

1. Shareholder Approval Override. My reaction to the shareholder approval override is that it defeats or diminishes the objective sought to be achieved, i.e. minimum standards of fairness. Allowing a majority of the shareholders to limit the voting rights of the minority is pretty much the status quo. A number of public companies, with the approval of shareholders, have gone from one class of common to two classes of common, with disproportionate voting rights between the two classes. Some have gone even further to restrict the voting power of a shareholders once his ownership reaches a certain threshold (i.e. 15% of the outstanding shares).

I am having difficulty reconciling minimum standards of fairness with the concept of shareholder approval override.

2. Subdivision (c) Enactment Into Law of Restrictions Contained In Proposed SEC Rule 19c-4 Prohibiting Restrictions on Voting Rights is misplaced and should be eliminated. Proposed Rule 19c-4 would constitute a minimum standard regarding the types of voting securities permitted to be listed on a national securities exchange or authorized for quotation reporting. Proposed Rule 19c-4 addresses more a corporate governance issue (i.e. One Share One Vote) rather than an anti-takeover measure. In fact, some states, including California, prefer a true one share one vote over the SEC's proposal. Whether or not the SEC adopts 19c-4, there is no reason for the Congress to take away the power of the states in this basic corporate governance area.

3. I am opposed to the inclusion of Subdivision (g) in the Resolution. While Subdivision (g) is titled 'Assurance of Right to Perform Second Step "Cash Out" Merger', it might also be titled "Facilitation of Freeze-out of Minority Shareholders". What Subdivision (g) will do is change existing California law. As you know, of course, there are parallel provisions in the present General Corporations Law (Sections 1101, 1001(d) and 407)

which prohibit a cash-out of minority shareholders, except where the majority shareholder owns 90% or more of the voting power of the corporation and such shareholder could consummate a short form merger under Section 1110 to accomplish the same objective. Subdivision (e) to Section 1001 and Section 1101.1 do permit the cash-out of minority shareholders where the 90% threshold is not met if the Commissioner of Corporations has approved the terms and conditions of the trans-action in fairness of such terms and conditions. A similar out is provided for insurance companies, public utilities and banks. If a determination is to be made that freeze-out of minority share-holders is appropriate at 85% rather than 90%, I believe that this policy decision should evolve through the normal legislative process.

4. Subdivision (i) raises some interesting issues and a further exposition of its intended effect may be warranted. As you know, of course, the significance of the exclusivity of the appraisal remedy has been eroded by the 1977 General Corporation Law and the availability of federal private remedies. In any event, I question, however, whether this is the forum to deal with these issues.

5. Subdivision (m) - Acquisition of Greater than 15% Interest by Tender Offer Only. Until I have had an opportunity to explore the full ramifications of this Subdivision, I am withholding judgment. I am not yet convinced that the exceptions provided in subparagraphs 1 through 7 sufficiently balance the restrictions placed on free market acquisition of shares.

Unfortunately, I will not be able to attend the February 26, 1988 meeting of the full Commission; however, if there is a need to schedule a conference call among the Subcommittee members prior to that date, I will make myself available.

Very truly yours,

WILLIE R. BARNES
Manatt, Phelps,
Rothenberg & Phillips

WRB:rw

cc: Members of the Subcommittee on Takeovers

STANFORD LAW SCHOOL

February 19, 1988

Dick Damm
State of California
Senate Office of Research
1100 J Street, Suite 650
Sacramento, CA 95814

Dear Dick:

A prior commitment requires me to be out of the state on the day of the Commission's next meeting. Because the Commission may take up at that meeting the proposal that California recommend federal preemption in the takeover area, I thought I should make my views known. Please feel free to circulate this letter to other members of the Commission if you think it appropriate.

I fully support the proposal that California recommend federal preemption. The principal argument in favor or preserving state regulation is that competition among states leads to the "best" corporation laws as corporate managers select the state whose corporate statute they preceive as most efficient and state legislators respond by enacting efficient statutes in order to secure the revenues associated with in-state incorporations.[1] However persuasive this argument might be with respect to other aspects of corporate law, it fails with respect to regulation of takeovers. This market for corporate charters works only if managers, acting on behalf of the shareholders, genuinely seek the most efficient state law. If, however, the interests of management and shareholders conflict, as they quite obviously do with respect to takeover regulation, management's choice of state of incorporation will reflect management's interests on this point, not the shareholders' interests in efficiency. The result, then, would not be selection of the most

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[1]In this regard, it might be noted that over the period from 1960 to 1981, the percentage of Delaware's total tax collections that came from its corporate franchise tax range from 10.9% to 24.9%. R. Gilson, The Law and Finance of Corporate Acquisitions 1076, note 146 (1986).

Crown Quadrangle Stanford University Stanford California 94305-8610

efficient state law, but, rather, one that provides managers at least a base level of protection from hostile takeover activity.[2] The recent performance of the Delaware legislature, it seems to me, brooks of no other explanation.

Although I favor a general statement supporting federal preemption of state takeover regulation -- issues of national importance should be resolved by Congress, not the Delaware Legislature -- I do have some strong views concerning in how much detail detail our position favoring a preemption position should be set forth. I do not think it wise that we advance a substantive position with respect to each of the areas as to which we recommend federal preemption. To be sure, it is important to indicate the general subjects as to which we recommend preemption in order to cut off claims that we are proposing a full scale federal displacement of state corporate law. However, that concern can be met by detailing the general areas of concern -- e.g., differential voting rights, poison pills, second-step transactions -- without taking a position on how each issue should be treated in federal legislation.

A number of points counsel in favor of such self-restraint. First, on a substantive level, the empirical and legal literature on each aspect of takeover regulation is voluminous. A review of that literature adequate to formulate and justify substantive positions (based on other than anecdote) would be an extraordinarily time consuming enterprise and, frankly, one that might well prove to be beyond the competence of a part-time commission.

Second, expressing a substantive position on particular issues cannot help but divert attention from what is our most important point. With respect to substantive provisions, our position is but one of many that have been expressed by different groups in the course of Congressional hearings and reflected in one or another of the bills that have been introduced in Congress. California simply has no special position from which to assert particular substantive outcomes. Our unique position concerns preemption. It is a singular event for a state to advocate federal preemption of state law. That position deserves, and will get, attention unless we allow it to be diluted by debate on the particular terms of federal legislation. I do not suggest that, at the appropriate time, California not express its views on actual outcomes, but I do

[2] Id. at 1076-77.

think it ill advised at this point to confuse the wisdom of preemption with the merits of how particular issues should be resolved.

Finally, I would resist coupling the preemption point with specific resolutions because the result is to make it more difficult to garner support for preemption. So long as the Commission's only point is preemption, then individuals and groups who may differ with respect to the appropriate resolution of particular issues nonetheless can support preemption. Because broad support for the Commission's position on preemption is politically critical, I would do nothing that made it more difficult for anyone to sign on.

In short, I urge that the Commission do no more than recommend preemption with respect to specified subject matter areas. We should not, at this time, recommend particular outcomes with respect to any of these subject matters.

I apologize in advance for missing next week's meeting.

Best regards,

Ronald J. Gilson

Ronald J. Gilson
Professor of Law

RJG:jd

R. JAMES SHAFFER, ESQ.
16412 Sundancer Lane
Huntington Beach, California 92649

February 19, 1988

Michael J. Halloran, Esq.
Pillsbury, Madison & Sutro
225 Bush Street
San Francisco, CA 94120

Re: Your memorandum dated February 2, 1988 to the Subcommittee on Takeovers of the Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions

Dear Michael:

The subcommittee has obviously put in much time on the proposed resolution. With that in mind, it is with no enthusiasm that I write this letter. However, I do feel that I must express myself. I have very carefully read the proposed resolution and have given it considerable thought. As a result, I have concluded that I cannot support the proposed resolution.

Extreme care must be taken in abdication of local control to the Federal Government. Casting of the proposed resolution into Federal law would be the first step towards federalization of corporation law. Once something gets into the Federal system, it is invariably there for good and very difficult to change. On balance, I don't believe that would be in the best interests of California residents.

Each area of the proposal is very complicated. There are numerous competing interests that must be considered in each case. To be complete, the proposal should take these interests into account. The California legislative process will not produce the same degree of debate that some of these issues have recently experienced in Washington. Accordingly, I do not think we would be taking a well honed product to our congressional delegation. On the other hand, depending upon whether congressional or administrative action is being considered at the national level, there already are avenues available to thoroughly debate the issues in the main as well as the finer points and their nuances.

Evidently an article on the subcommittee's work was recently published in the Eastern Edition of the Wall Street

Journal. I received several calls from people who read it. The gist of the message was that they would resent an attempt to legislate California's views of corporate law/morality on them. The resolution may impress the California delegation but probably would be considered an affront by those of other states. Passage of the resolution will obviously require expenditure of public resources. I am of the opinion that those resources could be better spent on pursuits that will have a greater range of support at the level of final action.

By a copy of this letter to Senator McCorquodale, I am asking that he record my opposition to the proposed resolution in its present form or as may be modified when it comes up for consideration next Friday. Unfortunately, I have a previous commitment for February 26. If it were not for that conflict, I would attend and personally cast my vote in opposition.

Very truly yours,

RJS:mas

cc: The Honorable Dan McCorquodale
Richard Damm

CHAPTER III

STATE LEGISLATION RESTRICTING TAKEOVERS: AN ECONOMIC VIEW BY JOHN POUND

I. Introduction

In 1987, more than a dozen states passed new legislation designed to change the environment in which hostile takeovers occur. While state activism on the takeover issue has been building steadily since 1985, the developments of 1987 were unprecedented. As the year closed, Delaware which had previously refrained from promulgating new takeover restrictions, also came forward with significant new legislative proposals. This action virtually ensures that other states, which have until now remained on the sidelines, will be compelled to offer new takeover initiatives. This document discusses the economic structure of recent state plans, their potential effects on shareholders and corporations, and their efficiency consequences for the states and the national economy.

II. Types of Laws

Two primary types of antitakeover statutes have been introduced and passed by states since 1985. A first type sets direct terms and conditions under which business combinations may take place. Examples are the New York State law, and the proposed Delaware law. Typically, these statutes place explicit limits on the actions of an outside shareholder who acquires controlling interest in a target firm against the wishes of directors. The laws explicitly forbid such hostile acquirers from taking further actions for a specified period after the control position has been achieved. The New York law forbids the controlling shareholder from consolidating a merger with the target, selling assets, or otherwise restructuring the target firm for five years from the date of acquisition. The proposed Delaware statute contains similar restrictions, effective for three years after controlling interest is acquired.

The second type of recent statute changes the voting structure of the target firm. The laws restrict the voting rights of shareholders who acquire large blocks of target corporations' stock over the explicit objection of the target firm's management. When the outside shareholder crosses a specified ownership threshold without management permission, the voting rights attached to the acquired block of shares are revoked. They can only be reinstated by a majority vote of "disinterested" shares, defined as shares that are not owned by either the large stockholder or current management. The ownership thresholds specified in most statutes (including those of Massachusetts, Indiana, and Ohio) are 20%, 33%, and 50% of outstanding common shares.

John Pound is an Assistant Professor of Public Policy at the J.F. Kennedy School of Government at Harvard University, and is Director of the Corporate Voting Research Project.

Both types of laws have generally contained novel legal features relative to the first-generation state statutes that were struck down by the Supreme Court in the late 1970's. Among these are the "opt out" and "opt in" clauses governing applicability to in-state and out-of-state corporations. Generally, the laws are structured so that corporations residing in the state are automatically covered unless management proposes and shareholders vote to "opt out" of the new terms in favor of some other set of rules. Most laws are also structured so as to allow out-of-state firms with a substantial asset base in the state to "opt in" to the protections and structure of the statute. Out-of-state firms may generally become covered by the statute upon an affirmative vote of their shareholders.

III. The Economic Effects of the New State Antitakeover Statutes

The two new types of antitakeover statutes are often supported with detailed arguments about their effects on the structure of the takeover market. However, both types of laws also have common, broad effects on shareholders, management, corporate structure, and state and national economic efficiency. This section summarizes both the broad and the specific effects of the laws.

A. The Balance of Power Between Shareholders and Management

The fundamental effect of all the new state takeover statutes is to vest more power in the hands of management and the board of directors of public corporations. Under the new laws, management of a target firm faced with a takeover attempt has a broad-based veto power over the ability of the bidding firm to proceed with the takeover attempt. Under the New York type of statute, the veto power is absolute: a takeover transaction simply may not go forward without management consent. Under the Indiana-style law, a takeover is made more difficult. Without management consent, the outside shareholder must plan and execute an offer whose success is more costly and more uncertain than in the law's absence.

Both of these types of statutes thus shift the balance of power in the corporate control arena towards management. Shareholders either are prevented (under the New York law) or discouraged (under the Indiana law) from transferring control of the corporation over the objections of the Board of Directors. This creates additional deterrence in the takeover market. Faced with the prospect of a management veto, potential bidders may refrain from making investments in target corporations, or takeover bids against these corporations. A number of bids that would have been profitable under the old laws will be unprofitable given the uncertainty and potential costs associated with the new statutes.

B. The Effects of Deterrence on Takeover Activity

The new state laws will definitely make hostile takeovers more difficult to accomplish in the forseeable future. It is difficult to estimate the exact impact of the statutes on takeover activity, but it is likely to be significant. There are several studies that help in making an estimate of the likely reduction in takeover activity under the new laws. One (Jarrell and Bradley, 1984) examines the effect of the Williams Act, the primary federal law governing takeover transactions, on the gains from takeover activity. The authors document a substantial reduction in the frequency of takeover bids, and a corresponding wealth loss to shareholders. The authors suggest that the reduction in shareholder wealth arising from the Williams Act was caused by the additional time and uncertainty it imposed on the takeover process. Minimum offer times, in particular, gave target managements more time to undertake defensive measures against takeover bids. Yet the Williams Act was neutral by the standards of the new state statutes, in that it did not vest additional authority directly with target management. It is therefore likely that the new state laws will have a larger deterrent effects on takeovers than Jarrell and Bradley find to have resulted from the imposition of federal takeover regulation.

Additional evidence on the potential deterrent effects of the new state laws comes from recent literature on the effects of antitakeover provisions on takeover activity. Two recent studies have examined how firm-specific antitakeover amendments, that vest more power with target management, affect takeover frequency and shareholder wealth. Pound (1987) examines the effects of so-called fair price and supermajority antitakeover amendments on takeover activity. He finds that these amendments significantly decrease the frequency of takeover bids, while not elevating shareholder gains in those takeovers that do occur. He also finds some evidence that management uses these amendments for their own protection and gain when faced with unwanted bids. Ryngaert (1987) finds a similar effect associated with so-called poison pill takeover defenses. He finds that pill plans significantly decrease the frequency of successful takeovers against target firms.

It is possible that state antitakeover laws will have an even more significant effect than will firm-specific antitakeover amendments and poison pill plans on takeover activity. The reason is that firm-specific defenses impose some minimum fiduciary duties on management. In the case of poison pills, for example, the CTS decision placed limits on managerial discretion in enacting rights plans defenses during takeover contests, explicitly recognizing that in some cases they could be used against shareholder interests. State laws, by contrast, vest a new level of default authority with target management. Management does not have to take additional active steps to resist bids, with the attendant liability risk that is supposed to act as a check on their use of discretionary power.

Available evidence on the effects of state antitakeover amendments on takeover bids is in its infancy. However, some preliminary evidence does exist that confirms a significant new deterrent effect from the amendments. In their recent study of modern takeover defenses, Pound, Netter, Poulsen, and Jarrell (1987) note two important takeover bids that were stopped in large part by the imposition of new state laws. This is significant evidence, showing that the new laws have rendered some specific takeover bids unprofitable that were previously profitable undertakings. In addition, a recent SEC study of the Ohio antitakeover law shows that its passage caused significant harm to shareholders in Ohio corporations (Ryngaert and Netter, 1987). This is once again consistent with a deterrent effect.

C. Deterrence and Corporate Investment

The deterrent effects of the new state statutes will also extend to a second realm: large investments by active shareholders in corporations will be reduced. Large investments in major corporations are documented to have salutary effects for shareholders and the efficiency of the corporation. Large investors serve several important economic purposes even if they never launch takeover bids against firms or otherwise attempt to gain control. First, they have an economic incentive to act as monitors, assessing managerial performance more closely than do small, dispersed shareholders. Second, they have sufficient power to negotiate with management when problems arise either with managerial performance, or with apparent conflicts of interest within the corporation. Large shareholders are not always welcomed by management as these roles tend to reduce managerial discretion. But they are important influences on corporate efficiency.

Several theoretical and empirical studies demonstrate the salutary effects of large shareholders on managerial incentives, corporate efficiency, and shareholder wealth. Shleifer and Vishny (1986) present an analysis of the potential efficiency gains that large investors bring to the corporate environment, and show that it is large. Ruback and Mikkelson (1986) and Holderness and Sheehan (1986) document empirically that investors acquiring more than five percent ownership in large corporations increase value and economic efficiency. They show that this is true even in the absense of a subsequent takeover bid. Holderness and Sheehan (1985, 1987) further document that large investors -- including majority investors -- are not passive participants in the corporation. Rather, they generally use their power and expertise to suggest strategic and structural changes to management in order to increase corporate performance.

New state antitakeover laws will decrease the frequency with which investors take these types of large positions in major corporations for several reasons. First, under the Indiana law, accumulation of a significant position leads to the loss of voting power -- to disenfranchisement -- and thus negates the power of the large shareholder to monitor the corporation and effect change. Second, both types of laws severely restrict the large investors' ultimate courses of action, should management be unresponsive in the future to suggestions for change. Large investors assume substantial risk by purchasing large stakes in the corporation, and one compensation for assuming this risk is the potential of a takeover bid should managerial performance deteriorate significantly. To the degree that the new state laws diminish this possibility, they leave large investors with no recourse should managerial quality deteriorate and adversely affect their investment.

D. Effects of State Statutes on Corporate Productivity

A major argument advanced by some proponents of new state legislation is that by deterring takeovers, these new laws will increase the productivity of corporations and thereby aid in economic growth. Several arguments are made. First, it is argued that the threat of takeovers forces managers to focus on short-term performance in order to keep stock prices high, and thus deters productive investment in plants, equipment, and research and development. Second, it is argued that takeovers often occur against health corporations, and cause social and economic dislocation including plant closures and job losses.

In the past three years, both of these arguments have been refuted by a large body of empirical research. Generally, the research shows that on average, takeovers are productivity-increasing, and are undertaken against firms whose performance has fallen significantly below par. Moreover, the evidence shows that takeovers are most often launched against firms that are laggards in making productive investments in plants, R & D, and productivity.

Several studies have examined the argument that takeovers prevent firms from making productive investments. Lehn and Jarrell (1985) and Pound, Lehn, and Jarrell (1986) examine the characteristics of targets of hostile takeovers compared to variety of groups of "control" firms. The authors find that hostile takeover targets are generally characterized by lower levels of investment in research and development than are their industry peers. They also find that hostile targets are characterized by lower capital expenditures per share. Thus, the argument that takeovers reduce profitable investment appears to be incorrect. If anything, the reverse is the case: takeovers occur when firms are failing to make the investments needed to stay competitive.

Several other, more recent studies have examined whether takeover targets tend to be worse or better performers than other firms at the time of the takeover contest. The studies find that targets are characterized by declining pre-takeover performance, measured by a wide variety of economic indices. Martin, Loderer, and McConnell (1987) find that takeover targets tend to be characterized by a long history of declining performance relative to firms in the same industry. Morck, Shleifer, and Vishny (1987) find that targets tend to be characterized by low performance, as measured by whether assets are being utilized as efficiently as they could be in the pre-takeover regime. These findings suggest takeovers to be productivity-enhancing.

Martin, Loderer, and McConnell also present important evidence suggesting that post-takeover changes in targets' internal organization are related to their pre-takeover performance. Specifically, they find that top management tends to change after takeovers, in targets whose pre-takeover performance was declining. In contrast, little management change is found in those targets whose pre-takeover performance is at or above industry norms. This suggests that management changes occur when takeovers are aimed at improving an under-performing firm. The evidence also shows that some takeovers occur for "synergistic" reasons, in which two healthy firms find mutual efficiency benefits from entering into a business combination. In these cases there is no "punitive" effect on target management as a result of the takeover.

The evidence on job loss from takeovers is more preliminary than are the foregoing results, but militates in the same direction. Measuring takeovers' effects on job loss presents difficult methodological problems. But existing studies (Medoff, 1986) show that takeovers do not result in more job loss. Some plant closings and other economic adjustments are more vivid in the presence of takeovers, as public attention is drawn by the takeover transaction itself. But far more job loss occurs as a matter of normal business practice in firms and industries not characterized by takeover activity.

Overall, the new state takeover statutes cannot be supported on the premise that by deterring takeovers, they will increase the economic productivity of job base in the state or the nation as a whole. Indeed existing evidence suggests that if anything, precisely the opposite will be the case. By insulating firms from the need to be responsive to investors, the new state laws are likely to make firms slower to adapt to change in world and national markets. This will protect organized vested interests -- both current management and current workers -- but will not help either the consumers, the labor force, or managers taken as a whole.

E. Effects on Management Incentives

The new state laws create a perverse combination of changes for corporate managements, which are likely to be inimicable to their interests in the long run. First, they insulate managements from having to make active decisions about whether to defend against some takeover bids. Second, and concurrently, they set up rigid new limits to managerial discretion that may tie managers' hands in the longer term.

Prior to the generation of state laws, a management wishing to resist a takeover bid had to expend significant costs -- reputational and resource costs -- in order to accomplish its goal. Lawsuits were a common form of takeover defense designed to force bidders to withdraw their unwanted bids by imposing additional costs on the process (Jarrell, 1985; Rosenzweig, 1987). More recently, many managements have engaged in restructuring of corporations in order to ward off hostile bids (Dann and DeAngelo, 1987; Pound, Netter, Poulsen, and Jarrell, 1987). These types of takeover defenses may sometimes be in shareholders' interests and sometimes against them. But under the old default state guidelines, managements had to make active decisions to pursue any defensive strategy that imposed significant costs on the bidding firm.

The need to make such an active commitment entails numerous benefits relative to the blanket deterrence provided by the new state laws. First, managers must signal to the market, by active decision, their opinion about the current bid. This conveys information to the market about the motives and quality of management and the value of the firm. Several studies have suggested that management's defensive commitments convey significant and important information to the market (Pound, 1987; Shleifer and Vishny, 1986; Jarrell, 1985). Shareholders learn about the motives and effectiveness of information to isolate particularly good or bad managements, and in assessing the profitability of particular takeover bids.

Second, by deterring some bids from ever occurring, new state laws also deprive shareholders of important information about the potential value of their firm. Many studies have shown that takeover bids convey significant information to the market about firm value (Bhagat, Brickley, and Lowenstein, 1987; Pound, 1987; Bradley, Desai, and Kim, 1983; Bradley, 1980). Without the new state statutes, more bids would occur. Some of them would prove too low, and therefore be defeated by managements' discretionary defensive actions. But the mere presence of a bid informs shareholders about the value that an important outside investor places on the firm's assets. With the new state statutes some of the informational effect is lost along with deterred takeover bids.

Ultimately, managers may find the lack of flexibility that is implied by the new state statutes to be restrictive and even eviscerating. The laws remove from managers an important area of discretion in assigning voting rights (in the case of the Indiana law) and reacting to takeover bids (under both types of laws). Corporate management is likely to be most efficient when its options are limited only by the bounds set by the corporate charter -- and thus explicitly by the corporation's own shareholders. The imposition of blanket deterrents to takeover activity are unlikely, in the long run, to increase managerial welfare.

F. The New Statutes and the Problem of Shareholder Coercion

Another primary argument that has been advanced to support the new state takeover statutes is that management must be given more power under law in order to protect target firm shareholders from exploitation. This argument rests on the presumption that target shareholders are frequently coerced into tendering their shares and selling the target firm, when in fact they would prefer to keep the target separate. This problem is said to arise from the dispersed structure of share ownership in large corporations. Dispersed share ownership means that target shareholders have no way to bargain as a group with a potential acquirer. Faced with a bid, no individual shareholder feels any power to prevent the bid from being successful by not tendering his shares. Moreover, shareholders may believe that by not tendering, they will lose the tender offer premium, while having no deterrent effect on the bid. Thus all shareholders may tender into offers that they do not in fact want to accept, because they have no alternative.

This problem has been argued to create a need to vest more power with management to block takeover bids. Proponents of new state statutes (and other antitakeover devices) argue that an empowered management can represent the interests of shareholders and deter bids that shareholders would prefer not to accept. The New York style laws accomplish this by preventing a hostile acquirer from effecting a business combination at all without the formal approval of management. The Indiana style laws accomplish this by forcing any large shareholder who violates management dictates to seek voting enfranchisement from other shareholders. The idea in this case is that outside shareholders should have the right to decide whether they want to confer voting power -- and some element of control -- to the large shareholder, independent of each individual shareholder's decision whether to sell shares.

There are three problems with using this reasoning to justify the new state statutes. The first problem is that a matter of law, the coercion problem should be precluded by existing state corporate codes. Delaware and most other state codes explicitly prevent a majority shareholder, or any group of shareholders acting as a majority, from taking any action that would expropriate the minority. This prevents any successful bidder from expropriating the wealth of non-tendering, minority shareholders. If the successful bidder (and now controlling owner) cannot expropriate the wealth of non-tendering shareholders, then there can be no significant coercion, because there are no costs from refusing to tender into an inadequate offer. Shareholders are only coerced if they believe that by refusing to tender into offers that are inadequate, they may lose wealth because control will be transferred and they will be denied the tender offer premium.

The second reason that the coercion argument cannot be used to support the new state statutes is empirical. A large body of existing evidence provides evidence that coercion does not appear to be a major problem in most takeover contests. Specifically, the literature shows that there is in fact no loss from refusing to tender into an offer (Bradley, 1980). Comment and Jarrell (1987) also measure directly whether offers that are structured so as to be potentially coercive -- particularly partial and two-tier tender offers -- expropriate the wealth of minority shareholders. They provide evidence that all shareholders -- including non-tendering shareholders -- gain substantially even in two-tier tender offers. This evidence makes the coercion argument even harder to sustain, by showing that potentially coercive tender offer instruments have not typically been coercive in practice.

A third important problem with using the coercion argument to justify the new state laws is that viewed analytically, the coercion problem does not suggest solutions that resemble either the New York or Indiana-style laws. The coercion problem, to the degree that it exists, leads to a specific kind of economic distortion, that requires a specific cure. Bebchuck (1986) studies the coercion problem in detail. He shows that the efficient solution is to let all shareholders -- including those who tender their shares to the large shareholder -- vote on whether to give the large shareholder voting rights in the firm. Neither of the new types of state antitakeover laws in fact accomplishes this goal. Bebchuck's analysis shows that these types of remedies may not only fail to fix the coercion problem, but -- if drastic enough -- may make the coercion problem worse.

It is likely that the two new types of state statutues represented by the New York and Indiana laws lead to a worse economic solution than would occur with no additional shareholder protection at all. The New York law gives management enormous power to veto all bids, even in cases where a majority of shareholders would approve an acquisition. This power is not tied in any way to shareholders' preferences. This clearly does not directly address the coercion problem, but rather creates a potentially huge new problem based on conflict of interest between shareholder and management interests.

The Indiana law creates a more subtle but perhaps more troubling set of problems. The Indiana law appears to correct the coercion problem by giving shareholders a vote on whether to give control to a hostile acquirer. The problem is that under this and similar statutes, the wrong shareholders are given the right to vote. Bebchuck's analysis shows that this vote should be taken by all shareholders. The Indiana law, by contrast, gives this vote only to shareholders who have not tendered their shares to the potential acquirer.

The Indiana voting rule creates a singularly perverse incentive. Under the law, the only shareholders who have the right to vote on a takeover attempt are those shareholders who are by construction least likely to support it. Suppose, for example, that a bidder makes a bid for all shares in a target, at $20 per share. Suppose that this bid results in the bidder owning 85% of the target firm. Under the Indiana law, the only shareholders who now have the right to vote on acquisition of the target are the 15% who did not tender. By definition, these are likely to be the shareholders who believed that $20 per share was too low a price for the target firm. 85% indicated by tendering that the $20 per share price was fair. Bagwell (1987) shows that a number of problems, including different expectations and different tax liabilities among shareholders, mean that shareholders who refrain from tendering will be those with the highest valuations of the firm.

Under Bebchuck's solution to the coercion problem, all shareholders undertake two actions at the same time: tender, and vote on the offer. Under this solution, no shareholder faces the prospect of losing the takeover premium should the offer go through. But concurrently, each shareholder may express his "true" feelings about the adequacy of the offer. The offer is only allowed to proceed if it receives a majority of outstanding votes, regardless of how many shareholders tender. This -- and not the New York or Indiana-style solutions -- is the only correct approach to dealing with the coercion problem.

G. The New State Laws and the Structure of Corporate Governance.

In addition to their direct effects on takeover activity, corporate investment, corporate productivity, and shareholder choice, the new state antitakeover laws also contain fundamental and adverse implications for the role of shareholder voting in corporate oversight. The laws adversely affect both the structure of shareholders' voting rights, and to the use of the proxy voting system as a vehicle for overseeing management.

The New York law, restricting all takeover activity not approved by target management, effectively revokes completely the right of shareholders to decide about a fundamental -- indeed the fundamental -- aspect of corporate structure and control. By preventing takeovers, the New York law also puts new pressure on the proxy voting system. Under the law, the only strategic option open to an acquirer facing a hostile target management is to launch a proxy contest. Proxy contests have long been thought to be a very inefficient means of gaining corporate control and influencing corporate management, due to problems in structure of the proxy voting system. Recent evidence has begun to document inefficiencies in the proxy voting system, including a significant pro-management bias in proxy voting laws and behavior (Pound, 1988a,b; Brickley, Lease, and Smith, 1987; Heard and Sherman, 1987). To the degree that the New York law forces bidders into use of proxy fights, it introduces more stress into an already poorly performing voting process, and introduces new costs and inefficiencies into the process of corporate control.

The Indiana law mirrors and extends these adverse consequences for the structure of shareholder voting. First, the law breaks with virtually all state tradition in corporate law by departing from neutrality in the allocation of voting rights among common stockholders. The law's specific, arbitrary revocation of voting rights associated with large shareholdings opens the door to further manipulations of voting rights law, with detrimental implications for the stability of corporate oversight and corporate structure. Moreover, the Indiana law potentially creates a legal conflict between federal exchange listing standards and the voting rights provisions of state law. Voting rights listing standards are moving, under the current SEC, towards a universal one-share, one-vote requirement. Any corporation covered by an Indiana-style law is by definition in violation of this standard. This could lead to a major conflict between state and federal jurisdiction in the voting rights arena.

Like the New York law, the Indiana law also places new emphasis, and new stress, on the problematic process of proxy voting. As is true under the New York statute, the law may discourage outside shareholders from launching takeover bids, and instead lead them to launch proxy contests. Under the Indiana law, a potential acquirer facing a recalcitrant management may mount a proxy challenge to avoid triggering the "disenfranchisement" threshold at which his shares lose their voting power. But more important, and unlike the New York style statutes, the Indiana law also effectively creates proxy contests whenever a shareholder does indeed choose to cross the ownership threshold -- either due to a tender offer, or simply due to acquiring a large stake in the target corporation. This is because the law requires shareholders to vote to decide whether large shareholders should be entitled to vote. To the degree that the proxy voting system is inefficient and even biased toward management, this puts stress on the voting system and creates significant additional costs.

Thus, both the Indiana and New York style statutes place direct stress on the system of shareholder voting in addition to the costs they create by deterring takeovers and active corporate investment. Both laws force more takeover conflicts to be resolved through the voting system directly. Empirical evidence suggests that this system is, under current laws and regulations, probably the least reliable means for translating shareholders' preferences into corporate policy. Indeed were this not the case, proxy contests would be used by potential acquirers more often, instead of more costly tender offer acquisition offers. Forcing more governance conflicts into the proxy voting system is likely to create significant legal and economic problems, and further weaken the effectiveness of shareholder oversight.

IV. Realistic Alternatives for State Legislation

In the short term, states concerned with responsible policy formulation should probably wait for a response from the federal government before pursuing new initiatives in takeover legislation. However, it is important to recognize that from an economic viewpoint, there are alternatives for states to pursue in regulating the process of corporate control that do not have the adverse consequences of either the New York or Indiana style antitakeover statutes. This section briefly reviews several prominent alternatives.

A. Let Corporations and Shareholders Choose Their Own Protections

The most obvious, and probably the best policy response from states to the takeover question is to recognize that corporations and shareholders should be free to set their own protections and guarantees in the area of corporate control. In the past few years, most major changes in the structure of corporate charters that secure as much or more protection from management and shareholders than do either of the new types of state antitakeover laws. Examples are supermajority amendments, classified board amendments, and dual-class recapitalization schemes. Dual class recapitalizations are in fact a more significant takeover deterrent than any current state law, as they effectively remove from outside shareholders the right to vote on all important decisions relating to corporate control.

Corporations are already free to make these types of changes under the laws of most states, and evidence shows that they use this power to produce a wide variety of results. Some corporations remain relatively unprotected, while others have revoked all power from outside shareholders. This evidence both suggests that there is no need for sweeping statewide changes in corporate law. Individual corporations can and do set their own processes and protections as a part of the contract between shareholders and management.

This does not imply that there is no further role for changes in state takeover laws. Rather, it suggests that one appropriate focus for new policy should be on making sure that the solution arrived at in each corporation is in fact efficient and reflective of shareholder and management preferences. For example, state laws could give outside shareholders the explicit right to make proposals for new charter changes, or the rescission of old charter provisions, on the management proxy. This would reduce the costs of negotiation between shareholders and management. State laws could also require that corporations disclose annually the structure of their corporate charter to shareholders. Currently, this information is provided only when a significant charter change is proposed. At other times, it is often difficult or impossible for outside shareholders to determine the current structure of the corporate charter in matters relating to corporate governance and corporate control.

One important policy approach is thus to encourage corporation-specific solutions to the takeover problem. This approach encourages efficiency to the degree that shareholder voting actually serves to reflect shareholder preferences. While recent evidence raises concerns about the efficiency of the voting process, voting in individual corporations is certainly a preferable alternative to sweeping policy changes at the state level.

B. Adopt the "Vote and Tender" Solution

A simple and direct policy change, that directly addresses possible inefficiencies in the takeover process, is suggested by Bebchuck's analysis of the coercion problem in hostile takeovers. The change would require that shareholders vote on tender offers at the same time that they tender. This law, as argued in Section III.E., directly addresses a potential distortion that may exist in the tendering decision. The Indiana and New York style takeover laws claim to address this problem but in fact fail to do so. As argued in Section III.E., adopting the vote-and-tender rule would improve the efficiency of the takeover process, and give shareholders a better voice in takeover decisions, without imposing large new costs on the system. A variant of this policy currently governs control transactions under British law.

C. Merit Regulation of Takeover Activity

There may be some takeover bids that carry significant adverse consequences for particular states' economies, workforces, taxpayers, or natural resources. The State of California has grappled with several of these types of takeovers in the past year. Some of these types of takeovers may involve genuine external costs -- that is, costs not borne by either the bidding or the target firm -- and thus cause genuine efficiency concerns. It is reasonable to ask how states should deal with specific takeover bids that fall into this category.

A first response is that the structure of state government creates a mechanism that reacts to specific and problematic takeovers. Several states have actively intervened to slow or stop particular takeover transactions over the past year. The impetus for such action usually comes from ad-hoc activity in the state legislature. An important question for policy is whether a more formal channel for reviewing problematic, specific takeover transactions should exist. There are arguments in favor of such a system. Leaving such authority to de facto operation of the legislative system may be a very imperfect and costly way of identifying genuinely problematic takeover bids. The current system may prevent some bids from proceeding that are in fact efficient, while failing to stop some bids that are in fact problematic.

It would be a dangerous precedent to create formal state review of individual takeover transactions without careful consideration of whether such a system could function effectively and free from bias and political influence. Such a system might also be viewed as unconstitutional. But it is also possible that some process of state review, and the enunciation by states of specific problems that might cause the review process to be invoked, might be a preferable approach to dealing with specific, problematic takeovers than are either sweeping new state takeover restrictions, or the current ad-hoc legislative process.

D. Utilize Existing Federal Authorities

Finally, it is important not to diminish the importance of existing federal authorities for addressing particular problems in the takeover arena. The Department of Justice and the Federal Trade commission are charged with preventing business combinations that could lead to excessive market power. Business combinations in many industries must be approved by one or more federal authorities (for example, communications and power generation). These authorities should ensure that certain economic inefficiencies that could result from some specific takeover bids do not occur. State vigilance, and active cooperation with these federal authorities, can help to militate against particular inefficient takeover transactions. However, states should also resist the temptation to induce federal authorities to impose costs on the vast majority of efficient takeover transactions, even if these transactions are unpopular with certain vested interests.

CHAPTER IV

WHAT ARE THE LIMITATIONS FOR THE STATE UNDER CTS?

BY SUSAN HENRICHSEN

LIMITATIONS ON STATE TAKEOVER LAWS

Introduction

In Edgar v. MITE Corp., 457 U.S. 624 (1982), the Supreme Court declared an Illinois statute regulating tender offers unconstitutional on commerce clause grounds. Subsequently, lower courts struck down a number of state laws regulating takeovers. The states, in turn, attempted to find new approaches and many states passed so-called "second-generation" takeover laws.

In April, 1987, the Court reached a very different conclusion with respect to one of the "second-generation" laws. In CTS Corp. v. Dynamics Corp. of America, 95 L.Ed.2d 67 (1987), the Court upheld Indiana's Control Share Acquisition Act against both commerce clause and supremacy clause challenges. Since that decision, still more states have passed takeover laws; a majority of the states now have such provisions.

The Edgar v. MITE Case

The Supreme Court in Edgar v. MITE Corp., 457 U.S. 624 (1982), struck down an Illinois statute regulating takeovers. The only thing a majority of the justices agreed on was that the Illinois law violated the commerce clause. Five justices (Justices Burger, White, Stevens, O'Connor and Powell) reached this conclusion, while three (Justices Burger, White and Blackmun) determined the Illinois law was preempted by the Williams Act, a federal law regulating tender offers. Three justices (Justices Marshall, Brennan and Rehnquist) found the case moot and consequently said nothing at all about the substantive issues.

Although the majority opinion discussed preemption, only three justices found the Illinois law was preempted by the Williams Act. This conclusion of Justices White, Burger and Blackmun (the plurality) was based on their finding that the Illinois law frustrated the purposes of the Williams Act. The plurality concluded the Congressional aim was neutrality as between the bidder and incumbent management. Since the Williams Act struck a balance between the interests of the offeror and the target corporation, any state law that upset this balance would be preempted. Id. at 632-634.

Susan Henrichsen is Deputy Attorney General for the State of California.

Three provisions in particular in the Illinois statute gave offense. The Illinois law provided for a 20-day pre-commencement period, between the filing of a registration statement with the Illinois Secretary of State and commencement of the tender offer. During this period, the offeror could not discuss the terms of the offer, although management of the target corporation would be free to voice their views. Second, the statute provided for a hearing on a tender offer, without providing a deadline within which the hearing must be held, raising the possibility of an indefinite delay in the tender offer. Finally, the substantive fairness of the tender offer was to be reviewed by the Illinois Secretary of State; the plurality concluded Congress had intended that shareholders be free to make their own decisions. Id., at 639-640.

The CTS Case

CTS Corp. v. Dynamics Corp. of America, 95 L.Ed.2d 67 (1987) involved a different statute, drafted to avoid the defects of the Illinois law, and a very different result. In CTS, Indiana's Control Share Acquisition Act was upheld against both commerce clause and supremacy clause challenges.

The Indiana law provides that "control shares" in an "issuing public corporation" will not have voting rights unless such rights are granted by a vote of the majority of the disinterested shareholders at the next regular shareholders' meeting. The person holding such shares can require a special meeting to be held within 50 days if he or she files an "acquiring person statement," requests the meeting and agrees to pay the expenses of the meeting.

The Indiana law applies to any corporation incorporated in Indiana, unless the corporation amends its articles or bylaws to opt out of the Act. The law applies only to an "issuing public corporation," defined as an Indiana corporation with:

1) one hundred or more shareholders;
2) its principal office or substantial assets in Indiana; and
3) either:
    a) more than ten percent of its shareholders in Indiana;
    b) more than ten percent of its shares owned by Indiana residents; or
    c) at least ten thousand shareholders in Indiana.

A "control share" is defined as a share that, but for the provisions of the act, would provide voting power equal to or greater than any of three thresholds: 20 percent, 33 1/3 percent, or 50 percent. The effect of the Indiana law is that a person acquiring 20 percent or more of the voting power of an Indiana corporation that meets the "issuing public corporation" definition has no voting power unless such power is granted by a vote of the disinterested shareholders.

The District Court held that the statute was preempted by the Williams Act and that it violated the commerce clause, and the Court of Appeals affirmed. The Supreme Court reversed, concluding that the Indiana statute did not conflict with the provisions of the purpose of the Williams Act, and that its limited effect on interstate commerce was justified by Indiana's interest in "defining the attributes of shares in its corporations and in protecting shareholders." Id. at 88.

Crucial to the Court's decision was its finding that the purpose of the Indiana law was "to protect the shareholders of Indiana corporations," a purpose accomplished by allowing the shareholders to determine collectively whether the proposed change in control is desirable. Id. at 86.

In its preemption analysis, the Court noted that although it was not bound by the MITE plurality, "the Indiana Act passes muster even under [that] broad interpretation of the Williams Act." Unlike the Illinois law that may have operated to favor management over bidders, the Indiana statute protects independent shareholders against both those parties. By placing investors on an equal footing with the bidder, the Indiana law promotes one of the purposes of the Williams Act. Id. at 80.

The law's stated purpose of protecting shareholders was also essential to the Court's commerce clause analysis. The Court noted that the creation of corporations is a matter of state law as is the definition of the rights acquired by purchasers of a corporation's shares. The Indiana law, in defining or restricting voting rights, for the legitimate purpose of protecting independent shareholders, was within the state's traditional power and province. Id. at 86.

In sharp contrast to the MITE opinion, the Court in CTS expressed no devotion to the goal of maintaining a market for corporate control unfettered by state regulation. The Court in the latter case was not concerned with the value of takeovers. Other than a reference to the potentially coercive effect of some takeovers, the Court's discussion of their value is largely limited to a footnote, observing that the "type and utility of tender offers vary widely." Id. at 87, fn. 13.

Finally, unlike the MITE majority, the Court in CTS is seemingly unconcerned over the potential deterrent effect of the Indiana law on tender offers. While citing a lack of evidence for the claim that the Act will limit the number of successful tender offers, the Court nevertheless concedes the Act will likely deter such offers to some degree. Id. at 81, fn. 7, and 88. This result, however, alters neither the preemption nor the commerce clause analysis, as both the mechanism and the purpose of the Act are within the state's traditional powers and interests of prescribing the attributes of shares in its corporations and protecting shareholders. Ibid.

Permissible State Action

Existing State Laws

In structuring a state takeover law, three principal issues must be addressed and decided: the substantive provisions of the law, the target corporations to which it shall apply, and the control transactions that shall trigger the law's provisions. State laws currently in effect have resolved these issues in different ways.

Although state takeover laws differ somewhat in their definitions and application, in general such laws impose specified requirements or restrictions on an "acquiring person," defined as one who acquires in excess of a specified threshold level of a target corporation's voting stock. The substantive provisions of such laws are generally drawn from one or more of four principal approaches, discussed below.

Indiana'a law is typical of the "control-share" approach. Such a law provides an acquiring person's shares shall not have voting power unless such power is conferred by a vote of the shareholders.

The "business combination" or "freeze-out" law regulates specified business combinations between a corporation and an acquiring person. In general, such laws prohibit business combinations such as mergers, liquidation or sale of assets for five years after an unfriendly takeover.

The "fair price" law is probably the most common, either alone or in conjunction with one of the other approaches. Such a law protects shareholders who are bought out in the second state of a two-tiered tender offer by requiring payment of a "fair price" to those remaining shareholders, unless the shareholders or board of directors vote otherwise.

The least common approach is the "control-share cash-out" law. Such a law requires a person who exceeds a specified ownership threshold to purchase any shareholder's shares, upon demand.

The second issue to be dealt with is the definition of the "target corporation;" that is, the corporation which is the subject of the takeover or tender offer. Two criteria employed by most current state takeover laws are the corporation's place of incorporation and its economic ties to the state.

Most states have applied their laws only to "domestic" corporations -- those incorporated in the state. At least five states, however, including Arizona, Massachusetts, Minnesota, North Carolina and Washington, have enacted takeover laws that also apply to out-of-state corporations with a substantial economic presence in the state. Those laws generally apply only to those out-of-state corporations that have substantial assets, a significant number of shareholders, and their principal office or primary place of business in the state.

Even those states whose laws apply only to domestic corporations have generally included some economic criteria as well. The Indiana law, for example, applies to domestic corporations that have their principal office or substantial assets in Indiana and that have more than 10 percent of their shareholders in Indiana, more than 10 percent of their shares owned by Indiana residents, or at least 10,000 shareholders in Indiana.

The final issue is the question of which acquisitions or control transactions shall trigger the law's provisions. For most states, this has simply been a question of choosing a threshold percentage of voting power. The law's provisions then apply whenever any person or entity acquires in excess of that percentage of a corporation's voting stock. A threshold of 20 percent, used in the Indiana law, if fairly common.

Validity of Current State Laws Under CTS

MITE provides some guidance as to what states may not do, while CTS sets forth some guidelines for what states may do. Clearly, a statute of the type struck down in MITE, which directly regulates tender offers by submitting them to indefinite delays and allowing state officials to prevent such an offer from going forward, goes too far.

The law upheld in CTS was cast in a completely different light. The Court characterized that law as one defining the attributes of shares in a states' corporations, and compared it to other statutes of unquestioned validity which also affect voting rights and changes in control, such as provisions for classified boards or cumulative voting. The purpose of the law was one legitimately within a state's interest; namely, shareholder protection.

Of the four types of laws discussed above, it is obvious a control-share acquisition law, applicable to domestic corporations with some shareholders in the state, is permissible. Even though such a statute may result in some delay in the consummation of a tender offer, such a delay will not render the statute invalid, so long as the delay is not unreasonable. The Court in CTS found the consummation of a tender offer within the 60-day maximum of the Williams Act, a not unreasonable delay. CTS Corp. v. Dynamics Corp. of America, supra, 95 L.Ed.2d at 83.

It also seems likely that fair-price laws would be upheld. Such laws clearly are for the the purpose of shareholder protection and are specifically designed to alleviate the potentially coercive aspects of tender offers discussed critically by the Court. Id. at 87. Furthermore, such laws are probably less burdensome on interstate commerce than the control-share type statute.

The validity of control-share cash-out laws is less clear. Again, the purpose is shareholder protection, and the provisions of such laws are rationally related to that purpose. It seems unlikely the Court would find such laws preempted by the Williams Act, since they favor neither bidder nor management, and promote the purpose of protecting independent shareholders. Such laws may, however, place a more significant burden on the market for corporate control. Neverthless, under the reasoning of CTS, such laws might well be permissible.

The most questionable of the four approaches discussed here is that of the business combination or freeze-out type statute. Such a law prohibits transactions such as mergers or sale of assets between a corporation and an acquiring person for five years after the acquisition unless the acquisition was approved by the board of directors. Unlike the approaches discussed above, this approach places a great deal of power in the hands of the target corporation's management, at the expense of both the bidder and the independent shareholders. It might therefore be struck down on preemption grounds.

Although the business combination law deals with a subject matter that is commonly within the area of state regulation (that is, mergers and sale of assets), it does so in a manner that can hardly be characterized as promoting shareholder welfare or autonomy. The law permits a board of directors, by refusing to consent to an acquisition, to prevent an acquiring person from exercising control for five years and allows the independent shareholders no say in the matter whatsoever. Such a law might very well be vulnerable to a challenge on commerce clause grounds.

These problems might be alleviated by eliminating any reference to approval of the initial acquisition by the board of directors and by providing that the prohibited transactions may take place upon approval of the independent shareholders. Such a change would maintain balance between the bidder and management and provide shareholder protection, making the law far less vulnerable to claims of preemption.

Such a law would still be far more likely to deter tender offers than the Indiana law upheld in CTS. An offeror under that law could know, prior to completing a tender offer, whether or not its shares would have voting power. Under the business combination law, however, an acquiror would not know whether or not a transaction could be carried out until the transaction was proposed and put to a vote, long after the initial acquisition.

Applicability of State Laws to Out-of-State Corporations

The most uncertain issue for states after CTS may well be the question of the permissible reach or jurisdiction of state takeover laws. This is a complex subject, discussed only briefly here.

The Illinois law struck down in MITE applied to out-of-state corporations, so long as the corporation had 10 percent of the class of securities subject to the tender offer owned by Illinois residents and had its principal office and at least 10 percent of its stated capital and paid-in surplus in Illinois. The impact of the law on out-of-state corporations and thus on interstate commerce was a part of the Court's basis for striking down the law. It should be noted, however, that the substantive provision of the Illinois law were probably a sufficient basis for the Court's decision; the Illinois law would probab`y have been struck down even if it applied only to target corporations incorporated in Illinois.

The Indiana law applies only to Indiana corporations. The emphasis in CTS on a state's power to create corporations and to define the attributes of shares in its corporations seems so fundamental to the Court's reasoning, that there is little in CTS to support the proposition that state takeover laws may properly be applied to out-of-state corporations.

A state takeover law appclicable to out-of-state corporations is vulnerable to attack on one of the most fundamental commerce clause grounds; namely, that it adversely affects interstate commerce by subjecting activities to inconsistent regulations. The Massachusetts law may have avoided this pitfall by applying its law to out-of-state corporations only if their state of incorporation has no such law. If a state law sets economic criteria that can only be met in one state (e.g., applying the law assets or with their principal office in the state) and incorporates the Massachusetts provision as well, then only one state's law would apply.

The benefits of a law applicable to out-of-state corporations would still have to outweigh its effects on interstate commerce. The Court in CTS found the Indiana law's effect on interstate commerce "justified by the State's interests in defining the attributes of shares in its corporations and in protecting shareholders." Id. at 88. Although the first of these interests is missing where a law applies to out-of-state corporations, the second could still be present. Such a law is not likely to survive a commerce clause challenge unless some significant portion of the corporation's shares or shareholders are located in the state.

Finally, the greater the number and the more significant the contacts of the out-of-state corporation with the state seeking to impose its law, the more likely the law would withstand constitutional challenge. It could be argued that the interest a state has in regulating the affairs of a different nature, than its interest in the affairs of an out-of-state corporation which is a substantial presence in the state. A law may therefore be less likely to be struck down if it includes such criteria as principal office and substantial assets, as well as significant numbers of shares of shareholders, in the state.

CHAPTER V

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF FEDERAL REGULATION? WHAT IS THE IMPACT OF DELAWARE INCORPORATIONS ON CALIFORNIA'S SOVEREIGNTY AND CORPORATE LAW?

BY ROBERT MONKS AND WILLIAM LERACH

Preemption is a term that technically refers to the explicit (or implicit) assertion by the federal government of jurisdiction in an area that had previously been left to action by the states. But in the case of corporate law, one state has de facto preempted the other forty-nine. California corporation law has in practical effect been "preempted" by Deleware. The second-smallest state geographically, Delaware is now "home" to the bulk of the Fortune 500. The legal function of the law of corporations allows a company to have nothing more than a mail drop to designate Delaware as its domicile, thus permitting its insiders to take advantage of the many corporate protections and benefits that Delaware provides to corporate management and directors. This problem has been exacerbated in recent years as many of the largest companies previously organized under California law reincorporated in Delaware -- Potlatch, Occidental Petroleum, Times Mirror, Disney and Wells Fargo among them. The main physical presence of these companies remain in California. Many, if not most, of their employees are California residents. The only difference is the legal fiction of filing some documents that transforms the company into a Delaware corporation. California is now the georgraphical domicile of a large number of the "Fortune 500" but the legal domicile of only three.

There is no obligation that a corporation have any real connection with the state from which it receives its corporate charter; there is also no requirement that a corporation doing business in a particular state also be incorporated in that state. Thus, from the beginnings of the existence of large corporations following the Civil War, the corporation laws of the various states have been involved in a "race to the bottom"[1] in order to attract the franchise tax revenues and legal business resulting from being a desirable corporate haven. Under the Constitution, of course, each state is obligated to give "full faith and credit" to the laws of the other states since an action that is legal in one state, such as a marriage of 16-year-olds, is valid in all

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Robert Monks is President of Institutional Shareholder Services, Inc., in Washington, D.C. He has served as the Director of the Federal Retirement Thrift Investor Board and as Administrator of the Department of Labors Office of Pension Welfare.

William Lerach is partner in the Law Firm of Milberg, Weiss, Bershad, Specthrie and Lerach, in San Diego, CA. Milberg Wiess has been actively engaged in commercial litigation emphasizing securities and anti-trust class actions for almost twenty years.

the others, even in ones that do not permit marriage under age 18.

Delaware has successfully consolidated its position as the most desirable home for major American corporations in recent years. Delaware's Chamber of Commerce would say that this has been the result of having a very skilled corporate bar and an experienced judiciary who are capable of responding to corporate needs in a predictable and rapid manner. Less enthusiastic observers, however, recognize that Delaware is in the profitable business of selling its special commodity -- its corporate law[2] -- which is uniformly attractive to managements, directors and the corporations themselves at the expense of shareholders nationwide.[3] This includes recent legislation which continued Delaware's decades-long history of accomodating corporate interests: corporations can now eliminate directors' liability in cases of negligent breaches of their fiduciary duty.[4] In another step backward towards the corporate Dark Ages, Delaware is currently contemplating whether or not it should clone legislation in the wake of <u>CTS Corp. v. Dynamics Corp. of America</u>, in order to remain competitive with the other states that have done so. To protect its state's virtual monopoly of incorporations, the Delaware Bar Association has just approved draft legislation that goes beyond the Indiana law upheld in <u>CTS</u>. See "Compromise Near in Delaware," December 21, 1987, <u>New York Times</u> at 22, attached hereto as Exhibit D. "Perhaps there is no public policy left in Delaware corporate law except the objective of raising revenue." Cary, <u>Federalism and Corporate Law; Reflections upon Delaware</u>, 83 Yale L. J. 663, 684 (1974), attached hereto as Exhibit E.

It is increasingly evident that the current corporate abuses are made possible by the failure of the states to enact or enforce rigorous corporation laws. The traditional justification for the usually worthwhile experimentation stimulated by competition among the states is, or has become, seriously flawed.[5] Competition only works if the states must bear the costs of the benefits they provide to entice corporations. Imagine, for example, that a state had the authority to exempt corporations from all federal environmental laws. Many states would enact this legislation to encourage corporations to incorporate there, while safe in the knowledge that most of the factories would be located elsewhere. Economists call this an externality, and that is the problem with state corporation law.

Delaware can make its laws as permissive as it wants because it bears such a tiny proportion[6] of the consequences, and even that proportion is vastly outweighed by the benefits of the tax revenue. The "race to the bottom" continues as Delaware enacts legislation eliminating directors' personal liability for much of their fiduciary duty. State after state responds to the prospect of takeover of a local company with self-serving and anti-takeover legislation in a frenzy of competitive charter-mongering. One particularly compelling drama took place in Massachusetts when Ronald Pearlman's second attempt at "greenmailing" the Gillette

Company was followed within 48 hours by a comprehensive enactment passed by both houses of the Legislature, with Governor Dukakis signing the bill in Gillette's offices!

"In contrast to the pro-management bias of Delaware law, California has traditionally emphasized protection of the interest of shareholders and creditors." The Pseudo-Foreign Corporation of California, 28 Hastings L. Rev. 119, 120 (1976), Exhibit G. Yet the workings of our federal system place California in an uncomfortable and anomalous situation. Notwithstanding its extraordinary commercial importance, California is but one of the 50 franchises within the Constitutional scheme, many with more laissez-faire or protectionist attitudes toward corporate behavior. California's healthy notions of public interest and appropriate corporate governance to safeguard its resident shareholders' rights[7] has no effect, therefore, on what Delaware does. In addition to the dictates of federalism per se is the "internal affairs doctrine," a choice-of-law rule that has normally resulted in the forum state applying the law of the state of incorporation to suits among stockholders, the corporation and its board and officers. California has never blindly followed the internal affairs doctrine,[8] and the doctrine itself is subject to a long-recognized exception -- "the local law exception" -- whereby the law of a state other than that of incorporation is applied because that state has the dominant interest in having its local law applied. Restatement (Second) Conflict of Laws, Section 309, attached hereto as Exhibit I;[9] Wilson v. Louisiana - Pacific Resources, Inc., 138 Cal. App. 3d 216, 224. 187 Cal. Rept. 852 (1982). Furthermore, it is clear that California can exercise its muscle over "pseudo-foreign" corporations -- those incorporated elsewhere but doing a substantial amount of their business here -- pursuant to the limited provisions of Corp. Code Section 2115.

The alternatives, then, to the current situation are the following:

1) Do nothing and acquiesce in preemption of state corporation law by Delaware. This would, in effect, prevent California from wielding any power over the governance of large corporations, even those located in the state. Such state interests as "cumulative voting" would cease to have impact on any corporations that chose to change their domicile.

2) Amend the California statutes so as to be competitive in the "race to the bottom." In view of California's traditions of having a substantive agenda for corporate governance, this is not a tolerable choice. Morever, given Delaware's obsession with and tradition of maintaining its corporate policy based on revenue production and pride in retaining its primacy in incorporations, many managements will choose Delaware as the more attractive state anyway, no matter what level California sinks to in order to compete. There is absolutely no reason for California, with its long

tradition of shareholder protection and fiduciary stewardship, to defer unduly to Delaware's statutory framework.

3) Actively seek federal preemption. This would involve a determination that California cannot take action directly to have the desired impact on corporate governance provisions; that is desires, nonetheless, to continue to have impact in this field; and that it reluctantly concludes that the only way to do this is by encouraging increasing federal corporation law. California has a conspicuously effective delegation in both houses of Congress and could have substantial influence on any laws that are passed.

The question of whether the public interest is best served having one federal or several state corporation laws has been debated since the beginnings of the Republic. At the constitutional convention, Alexander Hamilton raised the question whether to provide specially for a federal corporation power limited however to situations where the states did not have the apparent power to accomplish a particular desired objective. The motion was defeated 8 to 3. Federalizing corporate law has been the cry of the "reformers" right up to the recent proposals of Ralph Nader. The states have resisted all efforts in this direction with continuing success. The only incursions of federal fiat on the state preserve are contained in the Securities and Exchange Act of 1934 with its provisions relating to fraud and proxy voting practices, amended by the Williams Act relating to takeovers. The State Bar Associations and their congressional allies have repeatedly beat back further federal involvement. But the crash of 1929 led to the first federal preemption of state corporate laws, and the current concerns over the October 1987 drop in market prices may provide another catacylsmic impetus for further legislation, although the particular culprits for Black Monday are less readily identifiable than the causes for 1929's crash.

Under these conditions, some new federal legislation may be possible. Through its federal legislation, California could have an impact on the creation of such laws and thus indirectly regulate corporations with headquarters in California as well as those doing business there. Realistically, however, it must be recognized that any federal legislation would naturally be the result of accomodating competing national interests. The end result of federal preemption could be a watering-down of shareholder rights incompatible with California's public policies.[10]

4) Reassert a strong state interest in governing corporations present in California, employing Californians and attracting Californians' investments, even if they are technically located elsewhere. California's current impotence over these pseudo-foreign corporations is intolerable. It would be ironic if the only way California can have an impact on the standards for corporate governance to be applied to the companies located within its borders is to work for them at the federal level.

The CTS decision strongly endorsed states' roles in determining their own corporate destinies.[11] California can seize this opportunity to maintain and strengthen its role as corporate watchdog. The obvious first step is to restore Section 2115 -- upheld in Wilson v. Lousiana-Pacific Resources -- to its former vigor by eliminating the listing exemptions that eviscerate that statute and defeat its whole purpose of governing pseudo-foreign corporations that attempt to elude California's strictures. Second, even it its original form, Section 2115's tests calibrating property, payroll and sales factors are too complex and cumbersome for easy and straightforward application and are capable of manipulation by corporations wishing to escape California law. A clear dark line separating truly foreign corporations from Delaware ones patently present in California should be devised.

This Commission should, then immediately address the modification and streamlining of Section 2115 and, particularly, the elimination of the listing exemptions which have virtually become the rule.[12]

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1 This phrase is usually attributed to former law professor and SEC Chairman William Cary, who, in 1975, "looked over the [Delaware Chancery Court's] decisions, noted that they seemed to favor management over shareholders and concluded that Delaware was pampering corporate officials in its courts just to keep the franchise fees flowing in." Delaware's Sedate Chancery Court Is A Major Corporate Battleground, Wall Street Journal, May 10, 1984 at 33, attached hereto as Exhibit A.

2 The consumers of this commodity are corporations, and . . . Delaware, like any other good businessman, tries to give the comsumer what he wants. In fact, those who will buy the product are not only consulted about their preferences, but are also allowed to design the product and run the factory.

Law for Sale: A Study of Delaware Corporation Law of 1967, 117 U. Pa. L. Rev. 861, 862 (1969), attached hereto as Exhibit B.

Delaware's own law celebrates its successful marketing of its corporation law:

> WHEREAS, the State of Delaware has a long and beneficial history as the domicile of nationally known corporations; and
> WHEREAS, the favorable climate which the State of Delaware has traditionally provided for corporations has been a leading source of revenue for the State; and
> WHEREAS, many states have enacted new corporation laws in recent years in an effort to compete with Delaware for corporate business; and
> WHEREAS, there has been no comprehensive revision of the Delaware Corporation Law since its enactment in 1898; and
> WHEREAS, the General Assembly of the State of Deleware declares it to be the public policy of the State to maintain a favorable business climate and to encourage corporations to make Delaware their domicile . . .

Law of December 31, 1963 v. 54, ch. 218 [1963] Del. Laws 724 (emphasis added).

3 Delaware's take from corporation franchise taxes continues to escalate dramatically: $60.5 million in 1978, $76.5 million in 1982 and $121 million in 1985. U.S. Dep't of Commerce, Bureau of the Census, Gov't Finances, GF79, No. 1, State Government Tax Collections, 1979 and 1978 at 16 (1979); 1982 and 1981 at 16 (1982); 1985 and 1984 at 12 (1985), attached hereto as Exhibit C. In 1987, Delaware's corporation affected 18% of the states taxable income. See "Compromise Near In Delaware," December 21, 1987, New York Times at 22, Exhibit D. As a consequence of this franchise subsidy, individual and corporate taxes in Delaware are quite modest.

4 "[T]he new Delaware law to protect endangered directors is producing sighs of relief [in corporate boardrooms]." Herzel, Sepro & Katz, From the Boardroom -- Next to Last Word on Endangered Directors, January-February 1987, Harvard Bus. Rev. at 39, attached hereto as Exhibit F. In the last legislative session, California fashioned a far more balanced and equitable bill to limit directors' liability.

5 As is all too apparent to state legislators across the nation, Delaware has controlled both the pace and direction of statutory corporate law in the twentieth century. Delaware's position in corporate law stems largely from the fact that Delaware law is considered more favorable to management than the law of any other state. Thus, to prevent corporations from deserting to the healthful climes of Delaware law, state legislators have been forced to relax local laws regulating

internal corporate affairs, and statutory protection of the public, shareholders, and corporate creditors has often been sacrificed.

The Pseudo-Foreign Corporation in California, 28 Hastings L. J. 119 (1976) (footnote omitted), attached hereto as Exhibit G.

Since corporations have been able to circumvent a state's corporations code merely by incorporating in another state, there has been no incentive for a state to enact a relatively strict code. Similarly, attempts by states to regulate corporate activities more stringently have been undermined by those states which have enacted "enabling" type codes. Under the spectre of their domestic businesses incorporating or reincorporating elsewhere, with the concomitant loss of charter fees, franchise taxes, and control over corporations which transact business in the state, restrictive states have amended their laws to make them more enabling.

Oldman, California Regulates Pseudo-Foreign Corporations -- Trampling Upon the Tramp?, 17 Santa Clara L. Rev. 85, 104-05 (1977), attached hereto as Exhibit H.

6 Professor Cary zeroed in on the absurdity of the "present predicament in which [Delaware] a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders, thereby increasing its revenue." Cary Federalism and Corporate Law at 701 (emphasis added), Exhibit E.

7 California's policy is to protect the public from fraud and deception in securities transactions. The Corporate Securities Law of 1968 was enacted to effectuate this policy by regulating securities transactions in California and providing statutory remedies for violations of the Corporations Code, in addition to those available under common law.

Hall v. Superior Court, 150 Cal. App. 3d 411, 417, 197 Cal. Rptr. 757 (1983) (all cases cited herein are attached hereto as Exhibit J).

[Directors'] dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director . . . not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420-21, 241 P.2d 66 (1952).

footnotes (continued)

8 "Since there are a substantial number of significant differences among the corporate laws of California, New York and Delaware regarding the manner in which corporate internal affairs are conducted, the application of the internal affairs doctrine to [a pseudo-foreign corporation] results in significant social cost. That cost is the pseudo-foreign corporation's ability to ignore the public policies of the state of its principal place of business."

Trampling Upon the Tramp at 100-104 (emphasis added), Exhibit H.

9 Section 309 reads as follows:

The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in [Restatement (Second) Conflict of Laws] Section 6 to the parties and the transaction, in which event the local of the other state will be applied.

10 As Professor Cary observed:

In my opinion, however [federal incorporation] is politically unrealistic. It has been raised many times in Congress and in the literature but has no public appeal. American business would unanimously reject such a convenient vehicle for government control of the major industries of this country . . . I do not advocate or even conceive of, federal incorporation as an imminent possibility except in the event of a catastrophic depression or a corporate debacle.

Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L. J. 663, 700 (1974), Exhibit E.

11 The Supreme Court's decision in CTS materially changed the rules in a manner that could arguably justify federal intervention given the confusing and contradictory way that states have reacted to the CTS decision, which could have a negative effect on interstate commerce. The SEC's Office of the Chief Economist has evaluated the impact of an Ohio antitakeover statute on the value of shares in 36 companies with headquarters in that state. The Ohio law depressed stock prices by an average of two percent, with losses ranging from $754 million to $1.45 billion. This, by the way, refutes completely the arguments that anti-management to the detriment of shareholders.

12 At a minimum, if Section 2115 is perceived as too sensitive a political issue for this legislative session, the Legislature should clearly express its intent that courts of this state should not be limited by the dictates of Section 2115 and that the conflicts-of-law analysis sketched on Page 8 can be used in its place.

CHAPTER VI

TAKEOVER LEGISLATION: VIEW FROM THE INVESTMENT INDUSTRY

BY W. PETER SLUSSER

STATE REGULATION OF CORPORATE CONTROL CONTESTS

There is a distinction between the propriety of state involvement in securities laws regulating takeovers, and a traditional subject of state jurisiction, the regulation of the internal affairs of a corporation. Without seeing the specifics of a proposed state takeover act, it is not possible to comment on the position the securities industry would take with regards to a particular bill. However, the following principles would, we believe, guide the approach of the securities industry to this subject.

CURRENT STATE REGULATION OF TAKEOVERS

Consider the rather anomalous feature of the current debate about state anti-takeover statutes. Virtually without exception, all of the provisions of state anti-takeover bills could be individually adopted by shareholders of a corporation as amendments to the corporate charter. Since shareholders, the owners of the corporation, have an obvious interest in enhancing the value of their investment, if the provisions of such bills were as self-evidently beneficial to the companies as the proponents allege, shareholders would rush to propose and adopt amendments incorporating the substantive features of such bills.

It seems very curious to the securities industry that the lobbyists and the officers of major corporations should be petitioning the states to provide them with the "protection" offered by such bills, when it appears that the selfsame protection could be obtained merely by submitting appropriately drafted charter amendments to a vote at a meeting of shareholders. The fact is that the supporters of such bills are evidently not willing to subject such proposals to a shareholder vote. We are left with the question, who then stands to gain from the proposals? That the proponents wish to circumvent shareholders and pre-empt them from voting on such provisions, suggests that they are a good deal less sure of the benefits to shareholders from the passage of such bills than they are of the benefits to incumbent management.

Most of the recent state anti-takeover bills are based on the assumption that once a person has acquired a significant ownership interest in a corporation, say 10 or 20%, this position will likely mean that the ability of the Board of Directors to bargain

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Peter Slusser is Managing Director of Merger and Acquisitions for Paine, Webber, in New York, New York

with that person will be somewhat constrained. We find it neither surprising nor objectionable that a party with a 20% interest in a corporation may have a considerable influence on the affairs of that corporation. Indeed, since shareholders are the owners of the corporation and as a matter of law are the primary group for whose benefit the affairs of the corporation are run, we would object if such a party were automatically precluded from having such an influence.

CURRENT EXAMPLES OF INAPPROPRIATE STATE REGULATION

A patchwork quilt has been created by state anti-takeover statutes. New York was the first state to adopt a "five year freeze out" statute. This prohibits a "resident domestic corporation" (defined as a firm incorporated in New York with both its principal executive offices and significant business operations in the state, and which as at least ten percent of its stock owned beneficially by New York residents) from engaging in a business combination with an interested shareholder (a beneficial owner of twenty percent or more of a firm's voting stock) for a period of five years after the interested shareholder crosses the twenty percent ownership threshold, unless the board of the resident domestic corporation has approved either the business combination itself or the stock purchase bringing the interested shareholder above the twenty percent threshold.

Such a statute disenfranchises shareholders in charge of control situations, since decisions are placed solely in the hands of the Board of Directors. If the Board does not view the acquisition favorably, business combinations are absolutely forbidden for five years, no matter how shareholders may regard the matter.

A very different approach was taken by that portion of the Indiana statute under review in CTS Corporation v. Dynamics Corporation of America (107 S. Ct. 1637). That statute provides that if a bidder buys shares of a corporation that is subject to the statute, and if such a purchase would bring the bidder's voting power in the "target" above a certain threshold (20, 33 1/3 or 50%) the bidder may acquire the voting rights of the acquired shares only with the approval of a majority of the corporation's "disinterested shares," i.e., those not owned by the bidder or management. This is typically called a "control share" statute.

Although a majority of the Supreme Court found that the statute was constitutional since they viewed it as an investor protection measure consistent with the Williams Act, another portion of the statute (which was not under review in the case before the Court) adopted the New York five year freeze out provision as well, indicating that shareholder protection was not the sole or even the primary concern of the statute.

Other states which have adopted control share statutes have differed considerably from Indiana's approach. For example, Ohio's Control Share Acquisitions Act applies to Ohio corporations having their principal places of business, principal executive offices or substantial assets within Ohio. The law, however, does not require the presence of any Ohio shareholders. North Carolina's recently adopted anti-takeover statute dispenses with Indiana's domestic incorporation requirement and applies to corporations incorporated in other states but having more than forty percent of their fixed U.S. assets, more than forty percent of their U.S. employees, and more than ten percent of their shareholders resident in North Carolina. Still another state that has adopted an anti-takeover statute, Pennsylvania, applies it only to Pennsylvania corporations, but does not require additional contacts, such as a principal place of business or the presence of shareholders within the state.

It is often argued by proponents of state anti-takeover statutes that such laws are a traditional area for state legislation. In fact nothing is farther from the truth. In 1965 when Congress began work on various legislative proposals which ultimately resulted in passage of the Williams Act, not a single state had any sort of a takeover statute, although at that point states had been regulating corporations for more than 170 years. It is true that the Williams Act does not deal with state anti-takeover laws, but that is because at the time state laws on the subject did not exist. Just shortly before the enactment of the Williams Act, Virginia became the first state to adopt such a statute. Almost all state takeover statutes currently on the books are less than five years old, and most of them were enacted after a local corporation had sensed that it might become a target.

Notwithstanding our arguments above, if a state insists upon passing a takeover statute, before the securities industry court can support such a bill it must have certain characteristics. The securities industry would insist on a fair and even handed approach to takeover legislation, which is consistent with federal law. The Williams Act carefully adopts a policy of neutrality as between bidder and targets, and crafted provisions designed to provide full disclosure to shareholders.

Congress was interested in maintaining a balance of power between corporate managers and corporate acquirors, and ensuring that shareholders had sufficient information to make their own judgment concerning the merits of a proposal. Such an approach is essential to any state legislative proposal that would govern takeovers. Consequently, it is most unlikely that "freeze out" state statutes would ever receive the support of the securities industry. Nor are "control share" bills likely to be supported, because as a practical matter they always seem to contain provisions which tilt the balance in favor of incumbent management.

For example, the portion of the Indiana statute upheld in CTS permitted only "disinterested" shares to vote on the question of whether a so-called control block of stock should be given voting rights. While on the surface this may seem evenhanded, upon analysis the "tilt" of the provision becomes obvious. For instance, would anyone seriously contend that in a contested election between a Democratic candidate and a Republican candidate that only citizens registered as independents should be permitted to cast a ballot, since Democrats and Republicans would be biased in favor of their own candidate? Just as an effort to disenfranchise fellow citizens with a party affiliation from voting in such an election would be absurd, it is likewise absurd to disenfranchise fellow shareholders from voting in a change of corporate control situation because they may be predisposed to vote for one side or the other. Just as any citizen has an interest in good government and the selection of the best possible candidate for political office, so too every shareholder has an interest in an efficiently run corporation and the selection of the best possible management.

The practical effect of such provisions is to favor incumbent management, particularly since the management of many "target" corporations often have a small ownership interest in their own firms. No state permits only "disinterested" shareholders to vote on such matters as the election of directors or merger agreements, but if such an approach were as beneficial as claimed, there would be every reason for states to enact such provisions.

Shareholders protection is the focus of the securities industry. We object to placing solely in the hands of one side the power to decide if an offer may be made to shareholders. A bill requiring shareholder approval of certain actions taken in response to a takeover bid moves closer to a position that the securities industry could support. This is best addressed, however, through those provisions of state corporate law that deal with shareholder voting.

IF LEGISLATION IS TO BE ADOPTED MODIFYING THE REGULATION OF TAKEOVERS, IT SHOULD BE FEDERAL LEGISLATION

By virtue of the Commerce Clause of the Constitution, and the practical need of regulation to reflect the interstate nature of the business, there is no role for the states in the regulation of takeovers.

If there is one proposition about the current federal regulatory scheme for tender offers which is manifest in the legislative history of the Williams Act, and the Williams Act itself, it is that the Act is neutral as between a tender offeror and a target corporation. The provisions of the Williams Act focus on assisting shareholder, not the management of either the target or the offeror. The sponsor of the Act, Senator Harrison Williams, made this point explicitly: "We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids. S. 510 (the Senate Bill which became the Williams Act) is designed solely to require full and fair disclosure for the benefit of investors." (113 Cong. Rec. 24664 (1967) Remarks of Senator Williams.) The Edgar v. Mite and CTS decisions have not really altered that view in so far as the Supreme Court has continued to hold that the states cannot adopt laws that frustrate the purpose of Congress in adopting a national scheme of regulation. Without a national standard, protection of local, parochial interests occurs, often to the detriment of shareholder rights.

The answer is for the federal government to reassert its role. There are two reasons for this: (1) state anti-takeover laws will make it impossible to achieve the goals of the Williams Act and (2) such laws Balkanize the economy and create the equivalent of domestic trade protection laws.

States are justifiably concerned about employment and business within their own borders. But they are free to create an attractive business climate through a myriad of perfectly legitimate means, such as tax incentives, development and job training assistance, the creation of specialized research centers at state universities and so on. What a state should not be permitted to do is to declare a blockade against commerce among the states.

The securities industry supports Congressional action that would clearly preempt the states from regulating corporate control contests. Such a preemption would imply a more active role for the SEC in establishing the appropriate level of investor protection and neutrality between bidders and targets, so as to allay the legitimate concerns of state legislators for the welfare of companies doing business in their states and shareholders investing in those companies. Amendments to the federal laws may be necessary to insure a "level playing field" between parties to a contested offer, full disclosure of all material facts pertaining to offers and management responses to offers, and sufficient time being granted to investors to properly study offers and for management to review, analyze and respond to offers.

Explicitly preempting the states from regulating corporate takeovers does not violate the concept of "states rights," but instead asserts the national interest in a nationwide free market with appropriate shareholder safeguards. The choice is clearly presented to Congress; it must either preempt the states, or it must be prepared to see the Williams Act rendered a nullity by state legislatures cajoled into enacting takeover restrictions tailor-made to accommodate the interests of incumbant management.

CHAPTER VII

TAKEOVER LEGISLATION: A VIEW FROM PENSION FUNDS AND INVESTOR GROUPS

BY JANICE HESTER

Introduction

Both public and private pension funds now occupy a unique position in the U.S. economy. Institutional investors, such as pension funds and endowment funds now account for the great majority of securities ownership in this country. These funds represent a significant resource for raising the necessary capital corporations require to fund and operate business enterprises.

This provides jobs and other benefits to the general community, such as payrolls which can be taxed to provide goods and services to the public. The funds, though enormous in size, actually represent the interests of millions of small investors. For all practical purposes, the funds must be thought of as perpetual. For instance, the funding period for public pension funds is presently 30 to 50 years. In addition to the long-term nature of the funds, recent emographic changes in the general population have resulted in many pension funds having significant unfunded obligations: The general population is aging, therefore the number of persons receiving benefits from the funds is increasing while the number of active or working members is declining, with the result that many funds have a deficiency in funding.

These unfunded obligations often number in the tens of billions of dollars and cannot be offset by contribution increases from members and employers. The investment return and investment allocation posture of the funds becomes important under these circumstances.

Anti-Takeover Legislation and Stock Ownership

Due to the long-term investment horizon of public pension funds and the concerns over providing benefits to an ever aging population, stock ownership has become an important component of the investment management plans of such funds across the country.

For example, the California State Teachers' Retirement System had a 25% limitation on stock ownership until legislation was passed to allow the use of the prudent man rule regarding investments in 1984. Actuarial studies, encompassing historical rates of return for various investment vehicles, wage inflation, projected benefit obligations, and general inflation suggested that the only way to alleviate the unfunded obligation and have sufficient assets to pay future benefits was to increase the percentage of

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Janice Hester is Corporate Affairs Advisor for the California State Teachers Retirement System.

equity investments. A well-known study of the general market by Ibbottson and Sinquefield concluded that over a long period of time, the last fifty years, common stocks provided a superior rate of return to both corporate and government bonds. The size of public pension funds argues against high turnover of individual securities.

Each time a security is sold or purchased, a commission must be paid. In addition, the positions that the funds hold in individual stocks are quite large and influence the prices of the securities which are targeted for investment or sale. This has led to an even greater percentage of both the equity and fixed income segments being indexed. For example, 79% of the equity segment of the California State Teachers' Retirement System's portfolio is indexed or passively managed. This means that the only way changes are made within those accounts is through takeovers, mergers, tender offers or involuntary liquidations, and bankruptcies. The turnover in passively managed accounts is less than five percent annually. This consideration argues for pension fund trustees being in favor of offers to buy their stock, whether such offers are sanctioned by management or hostile towards management or not.

The enactment and adoption of management sponsored state anti-takeover legislation and defensive anti-takeover corporate charter measures are unnecessary and unfair interpositions by management and its supporters between buyer and seller, in what is commonly thought to be a free market economy. Furthermore, a fundamental right of any investor is the right to sell or retain an investment. It is investors who bear the risk of management's competence in running these corporations; and they bear this risk with their own capital. Although consideration of employees, suppliers, customers, community interest is certainly proper, the investor's interest should receive preference. In order to run a profitable and successful business, management should consider the above aspects. This is what investors, especially shareholders pay management to do. Presumably if management is doing its job well, and with profits, dividends, and/or market appreciation responding accordingly, shareholders will be satisfied and not desirous of selling their stock. If on the other hand, as is so often the case, assets are undervalued and it appears that incumbent management is a new management to shepherd their investments. Although management argues for defensive protections on the grounds that community interests will be harmed if they are not allowed, the evidence for this claim is not persuasive. Management causes plant closings, bankruptcies, moves operations to other states, causing dislocation of workers and hardships on particular dependent communities as well as bidders. Such decisions are made due to business and market concerns; the identity of the person responsible for implementing such decisions has no bearing. In addition, such legislation further isolates management from both its investors and employees. It is no longer accountable. If management is shielded from competition, who will be able to protest when market share is being lost due to sharp foreign competition, or when environmental concerns such as asbestos or pollution are hurting a particular company? In the long-run, granting this protection may cause all the hardships it is designed to prevent. It is neither to the benefit of shareholders, nor labor, governmental bodies or social and community interests to leave the power of management to run unchecked.

Finally, it should be recognized that anti-takeover legislation, and defensive charter amendments do nothing to protect the jobs or employees or the interest of the community, suppliers or customers. This legislation protects the jobs of management. If more favorable legislation is passed in another state, management will reincorporate yet again. Management is not arguing for plant closing legislation or layoff prevention for lower level employees, including upper and middle management. This legislation is circled around the top ten or twelve persons in corporations which often have thousands of employees.

Summary

It is clear that the U.S. society and economy are changing in important ways. The average age of the population is increasing. This will mean that pension funds and retirement programs will face even greater demands for benefits in the future. For the majority of Americans, pension funds are now the investment vehicle; individual ownership of securities is on the decline. The size of these funds seems overwhelming, but is should be remembered that they represent the interests of millions of small investors.

If these funds are not able to earn an adequate investment return to cover benefit demands, taxpayers will have to provide for the deficiency. In the most recent bull market, takeovers were an important part of the wealth which was realized in the stock market. This wealth effect spreads to the rest of the population, whether shareholders spend it on goods or reinvest it in another corporation. Thus, takeovers are beneficial to the general economy as well as to shareholders. It should be remembered that management isn't asking for legislation to eliminate takeovers, only to give it more of a bargaining chit in the process. Both labor and shareholders should oppose any further attempts by management to isolate itself, and avoid being held accountable for its actions.

The long-term investment requirements of pension funds makes stock ownership a necessity, and in ever increasing precentages relative to total portfolio value. This argues for maximizing the investment return and an important component is the ability to take advantage of takeovers, mergers and tender offers.