affect "street sweeps," large scale purchase programs in privately negotiated transactions. It is very unlikely that an acquiror can buy over 85% of the outstanding shares in such an acquisition program. No street sweeps have ever come close to the 85% figure.

AND TWO-TIER TENDER OFFERS 20 (Apr. 19, 1985). In "negotiated" any-and-all tender offers (from a sample of 133) final bidder holdings averaged 88%, and in "non-negotiated" any-and-all tender offers (from a sample of only 26) final bidder holdings averaged 75%. *Id.* at Table 9. A non-negotiated offer is defined to include both friendly and hostile initial offers that ultimately conclude with the board supporting or acquiescing to the bid. Thus, the 88% average for negotiated bids includes 33 offers (25%) that were initially hostile. These figures are not conclusive. First, they do not exclude shares held by officers, directors or firm pension plans. Delaware's formula does exclude these shares, *see supra* note 36, and these exclusions need only to average about 12% for the average non-negotiated tender offer to qualify for the 85% cap. Of course, if directors who are not officers (and vice versa) hold stock that can be withheld in the face of a bid (a questionable assumption, perhaps, when a large premium is on the table), then this figure may increase significantly. *See supra* note 36. Account must also be taken of shareholders who are nonresponsive in all bids (3 to 5%). *See* Letter from Commissioner Joseph A. Grundfest to David A. Brown, Secretary, Council of Corporate Law Section of the Delaware State Bar Association (Dec. 18, 1987), *reprinted in* SMITH & FURLOW, *supra* note 17, at 179; Letter from Commissioner Joseph A. Grundfest to David A. Brown, Secretary, Council of Corporate Law Section of the Delaware State Bar Association (Dec. 22, 1987), *reprinted in* SMITH & FURLOW, *supra* note 17, at 191 (as of 1980, average holdings by the board of directors in the Fortune 500 were 10.6%, although it was 8.3% for firms subject to hostile bids. [Query: what is the ratio of directors to officers holdings?]; Average holdings by the top two officers (and presumably directors) were 6.3%; average holdings by the top officer were 4.8%). Second, the figures predate any pressure that bidders will feel to reach the 85% cap. And third, the figures predate many of the currently popular methods of raising substantial amounts of cash.

Considering data presented by the SEC and Dr. Greg Jarrell, the United States District Court for the District of Delaware concluded that "hostile tender offers retain a meaningful opportunity for success under . . . the exception." RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476, 482-83 (D. Del. 1988). On a sample that did not exclude stock owned by officer-directors, as § 203 does, and thus underestimated the number of takeovers that did get over 85% of the target's stock, the court noted that 50% of all hostile tender offers in the sample reached 85% share holdings, 64% of hostile any-and-all tender offers reached the 85% plateau, and 73% of hostile any-and-all tender offers that had at least 50% reached the 85% plateau. *Id.* at 482-83 nn.4, 5. The court expressly noted, however, that it would amend its conclusion in light of future data. *Id.* at 485.

Those drafting the Delaware statute were apparently all aware of testimony taken in Moran v. Household Int'l Inc., 500 A.2d 1346 (Del. 1985), on behalf of Household International which claimed that it was not uncommon for a tender offer to attract 90 to 95% of the outstanding shares. *See* Letter from A. Gilchrist Sparks III to Donald Pease (Dec. 29, 1987) (discussing new § 203). What was apparently lost in the translation, however, was that these percentages were for friendly deals. *See* Letter from Joseph A. Grundfest to David B. Brown, Secretary, Council of the Corporation Law Section of the Delaware State Bar Association (Dec. 18, 1987), *reprinted in* SMITH & FURLOW, *supra* note 17, at 179.

Moreover, the statute by itself may not in fact stop leveraged acquisitions that cannot attract 85% of the stock held by noninsiders. For example, some firms which purchase 80% of the target stock may be able to service their acquisition financing with their portion of any pro rata distributions of the target firm's assets (taking into account any extra taxes that must be paid because the distribution is a dividend). Other firms may be able to structure their financing to accommodate the three year waiting period.[139] At the margin, however, the statute will act to exclude firms that cannot purchase the stock necessary to satisfy the 85% cap and that cannot service their financing with immediate access to less than 100% of the target's cash potential.

Even stubborn and foolish resistance by a target board may be overcome if an offeror can stimulate sufficient arbitrage activity in the stock. Arbitrageurs take highly leveraged positions in the stock, solely to sell a short time later at a higher price. For example, an offeror could make a tender offer for 51% of the stock with a promise to cash out the remaining stockholders at above pre-tender offer prices. Typically, the tender offer will be over-subscribed, and many of those whose shares are prorated can be expected to vote in favor of the subsequent cash-out merger in order to cash out their speculative positions. Ironically, under this scenario, a bidder who cannot purchase 85% at the tender offer price is better off tendering for just 51% rather than a higher percentage, such as 60%. This is so because it may be easier to get a two-thirds vote of the remaining shareholders to effect the back-end merger since more arbitrageurs will be in the voting pool.

Undoubtedly, strategies will be designed to exploit apparent technical deficiencies in the statute. As these strategies appear, the Delaware legislature will most likely amend the act to eliminate them. Moreover, consistent with the pattern of the discussion in the text, firms can adopt private defenses to both strategies. Two strategies

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139. Martin Lipton says, "It is not difficult to arrange financing that doesn't require much debt service for the first three years." He points to zero coupon or deferred interest bonds or pay-in-kind preferred stock as currently popular examples. *See* Lipton, *supra* note 135, at 50. This statute may also encourage sophisticated bridge financing with low debt service for three years in anticipation of a conversion of the debt, at the end of three years, into more conventional financing when the acquiror is able to eliminate the minority shareholders. However, the costs of this specialized financing must be higher with § 203 than without it to compensate for the greater risks and uncertainties created by the three-year wait.

are now in discussion: first, a tender offer combined with a consent solicitation; and second, the use of a wholly-owned target subsidiary. In the first strategy, a bidder tenders for 51% of the stock conditioned on the receipt of written consents from shareholders sufficient to replace the board of directors with a slate favorable to the bidder. A firm can destroy the strategy by staggering the election of directors or eliminating the written consent procedure through an amendment to its certificate of incorporation. In the second strategy, a bidder buys 51% of the stock, gets control of the board, and creates a wholly owned subsidiary with a provision in its charter opting out of the statute. The bidder then transfers the parent's assets to the subsidiary, distributes the subsidiary's stock to all shareholders pro rata, and, finally, executes a squeeze-out merger with the subsidiary, eliminating all of the minority shareholders. Again, a firm could slow this process by staggering the election of its board of directors. Both strategies may also face court invalidations based on arguments that they are too "manipulative."[140]

The statute has significance, however, in that it reinforces, at the margin, target company takeover defenses that predate the statute. The two defenses that, with the statute, can most obviously lock-up a target are standstill agreements[141] with white squires and poison pill plans. In the former, target management places a large block of stock in the friendly hands of the white squire[142] under an informal or formal agreement (a standstill) that the third party will not tender the stock absent the assent of the target board. Available figures indicate that a standstill agreement on 4% of the target stock may often suffice to eliminate the risk of a bidder satisfying the statute's 85% cap.[143]

Standstill agreements are, however, somewhat risky. First, placing stock with a white squire under an informal agreement is risky because money can break down trust; the prospect of substantial

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140. *Cf.* Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978) (avoiding supermajority voting provision by merger is unlawful manipulation of corporate machinery). *See* SMITH & FURLOW, *supra* note 17, at 86-89, 90-91 (discussing strategies and techniques for working with § 203).

141. A standstill agreement limits the time during which a friendly party is allowed to acquire additional stock. SMITH & FURLOW, *supra* note 17, at 112.

142. A white squire is an interested shareholder who has the approval of the board. The white squire is therefore not subject to § 203 if it later turns hostile and acquires more shares.

143. *See supra* note 138 (discussing effect of shares held by director-officers and by non-responsive shareholders).

profits may override the white squire's promise.[144] Second, placing stock with a white squire under a formal agreement may backfire because courts may construe the stock to be under the control of the target board[145] and exclude it from the denominator in a calculation of the 85% cap. The task of planners, then, is to draft an agreement that rides the ridge of these two positions. The agreement should effectively constrain a white squire from tendering and be specifically enforceable. Also, the agreement should not qualify the stock under the statute as being controlled by the board for the purposes of the statute.[146]

Poison pill plans with a discriminatory "flip-in" may provide the optimal protection against the cap.[147] In a flip-in plan, the board distributes, as a stock dividend, rights to acquire firm stock at a large discount.[148] The rights are created to be contingent on a substantial acquisition of stock by an unapproved purchaser and to discriminate against the purchaser; that is, if a purchaser triggers the rights by purchasing a specified amount of stock, it cannot exercise rights attached to any stock that it has purchased.[149] The discrimination feature of the plan, together with the Delaware statute, works to effect a lock-up of a target firm. Once a bidder acquires over 85% of the stock of the target, any residual shareholders (other than officers and directors) can exercise their rights to purchase additional firm stock and reduce the bidder's ownership percentage to below

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144. SMITH & FURLOW, *supra* note 17, at 112-13.

145. *Id.* at 113. Section 203(a)(2) specifically excludes management-owned stock for purposes of determining the 85% threshold. *See* DEL. CODE ANN. tit. 8, § 203(a)(2) (1988). Therefore, the crucial definition is "ownership" in § 203(c)(8)(iii). *Cf.* DEL. CODE ANN. tit. 8, § 203(c)(8)(iii) (1988) (defining ownership). Do the director officers have an "agreement . . . for the purpose of . . . holding, voting . . . or disposing of such stock with any other person that beneficially owns . . . such stock"? If so, they own the parked stock.

146. *See generally* Lipton, *supra* note 135, at 49 (discussing the practical implications of new § 203).

147. *See* R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS: 1987 SUPP. at 54-55 (1987) (discussing flip-ins, flip-overs, and back-end (lollipop) plans); Fogg, *supra* note 106, at 25, col. 3. *See also* OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS (Oct. 23, 1986).

148. *See, e.g.*, *Amalgamated Sugar Co.*, 644 F. Supp. at 1232 (discussing the mechanics of a flip-in plan).

149. *Id.* Delaware and New York courts disagree on whether this discrimination is legal. *See supra* note 104.

the 85% cap. Moreover, the value of the acquiror's stock in the firm will suffer a substantial dilution.[150]

The existence of the pill will also, of course, have the planned effect of making it difficult for the bidder to acquire the initial 85% position (neutral of the exercise of any rights) because a substantial number of target shareholders will refuse to tender. In refusing to tender, the shareholders are anticipating an opportunity to exercise their rights as residual shareholders, thus acquiring firm stock at a large discount at the expense of the bidder.[151] Like all poison pill plans, the existing target board has the power to waive the rights, usually by redeeming them for an insignificant amount of money any time prior to the triggering acquisition[152] and, often, for a short time thereafter. In essence, the goal of a poison pill plan is to create an event so onerous that no one can afford to trigger the plan with an unapproved acquisition,[153] thus forcing all potential acquirors to seek the blessing of the existing board.[154]

Poison pills are not universally respected. Studies have found that such plans negatively affect stock prices when firms adopt them.[155]

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150. This discussion assumes that prior to being triggered, the rights are not included in the definition of ownership contained in DEL. CODE ANN. tit. 8, § 203(c)(8) (1988), because the rights have not vested. There is disagreement on this point. *See* SMITH & FURLOW, *supra* note 17, at 106-07. Once the rights are triggered, however, the holder of the rights must include those shares that the rights entitle him to buy in his calculation of whether he is a 15% shareholder for the purposes of the section. Thus, existing shareholders may find themselves, to their surprise, interested shareholders under the statute if an acquiror triggers a poison pill plan. *Id.*

151. The SEC found that discriminatory poison pill plans were instrumental in defeating tender offers in 64% of the cases, as compared to defeats in only 31% of the cases when pure flip-over plans were used. *See* OFFICE OF THE CHIEF ECONOMIST, *supra* note 147.

152. *See, e.g.*, *Revlon*, 506 A.2d at 177 (the Revlon board could redeem the rights for $.10 each); *Moran*, 490 A.2d at 1066, *aff'd*, 500 A.2d 1346 (Del. 1985) (the Household board could redeem the rights for $.50 each).

153. *See* Matheson & Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407, 476 (1986) ("[A]ny attempt to merge or consolidate with the target while the poison pill is in place is tantamount to financial suicide . . . .").

154. As Judge Posner opined in the Seventh Circuit's influential opinion in *CTS*, in order to acquire the company while the poison pill is in place, "you must buy out its management." *CTS*, 794 F.2d at, *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

155. Recent studies show that the Delaware Supreme Court case of Moran v. Household Int'l Inc., 500 A.2d 1346 (Del. 1985), led to the adoption, in less than three years, of over 500 poison pill plans. *See* Lee, *Poison Pills' Benefit Shareholders*

What is not clear, however, is whether one should read the studies as condemning all poison pill plans or as condemning inadequate court supervision of the use of poison pill plans.[156] The detractors of poison pills particularly dislike the fact that the adoption of poison pill plans does not require shareholder approval,[157] as does the adoption of shark repellent amendments.[158] Thus, directors can unilaterally adopt poison pills to supplement the Delaware statute. Some argue that this allows managers with a small ownership stake in their firms to avoid the difficulty of appealing to shareholders for their approval.[159] In this regard, it has been noted that firms adopting poison pill plans have a strikingly smaller average inside ownership (9.4%) than do other companies in the same industry (23.1%).[160] Yet, proxy fights waged by institutional investors against the adoption of poison pills, although attracting a large block of negative votes, have consistently failed.[161] To the extent that the Delaware statute reinforces,

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by Forcing Raiders to Pay More for Targets, Study Says, Wall St. J., Mar. 31, 1988, at 55, col. 3. Pills have been found to have a significant negative effect on stock prices, with discriminatory plans faring substantially worse than flip-over plans. *See* Jarrell, Brickley, & Netter, *supra* note 60, at 64-65. *See also* Malatesta & Walkling, *Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure*, 20 J. FIN. ECON. 347 (1988) (poison pill plans reduce shareholder wealth by -.93% on their announcement). *But see* Lee, *supra* (study conducted by Georgeson & Co., a proxy solicitation firm, suggests that in hostile bidding contests, poison pills helped maximize value for shareholders).

156. *See* Oesterle, *Negotiation Model*, *supra* note 89, at 123. Ryngaert found that stock prices rise an average of 3.4% when courts declare a plan invalid and fall an average of 2.2% when courts uphold a plan. Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988).

157. Authority for the issuance of poison pill plans comes from the directors' general authority to issue rights and other forms of equity as stock dividends. *See Moran*, 500 A.2d at 1351-52 (rights plan authorized by DEL. CODE ANN. tit. 8, §§ 151 & 157 (1974)). *See generally* Lowenstein, *supra* note 89 (shareholder approval for defensive tactics generally); Note, *supra* note 96, at 1039-49 (shareholder vote for poison pills specifically).

158. *Cf.* DEL. CODE ANN. tit. 8, § 242 (1987) (discussing requirements to adopt a charter amendment).

159. It was argued in *Moran* that the board adopted a poison pill rather than sponsoring a charter amendment out of the fear that a poison pill vote might have resulted in rejection of the plan. *See generally* Note, *Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholders: Toward a Shareholder Approval Rule*, 60 ST. JOHN'S L. REV. 94, 108 n.63 (1985).

160. Malatesta & Walkling, *supra* note 155, at 369, Table 6.

161. *See* GILSON, *supra* note 147, at 52-53. The average votes for the proposals (19.4%) were unusually large for shareholder proposals, so all claimed victory. Leading the battle against poison pills are some of the major institutional investors, including the $26 billion College Retirement Equities Fund. *See generally* Miller,

even encourages, the use of poison pills, the statute may be more problematic for bidders than expected.

C. *The Role of the Delaware Courts: The Statute Ain't Nothing Till They Call It*[162]

Although the Delaware statute, by itself, may not present a substantial deterrent to hostile takeovers, it does increase the effectiveness of already potent poison pill plans. The choice, by target managers, to first implement a poison pill plan and second, not to waive the plan, coupled with the three year moratorium in the statute, should, if left unchecked, block most unwanted acquisitions. In recent years, however, the courts have questioned whether target managers, in creating or refusing to waive takeover defenses, are acting in the best interests of their shareholders.[163] Delaware courts inevitably will

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Common Defense Against Takeovers Faces New Hurdle, Wall St. J., Nov. 4, 1986, at 26, col. 2 (discussing *big investors* proposing shareholder adopted resolutions opposing poison pills).

162. When I was clerking with a very fine trial judge, the judge became somewhat vexed with an attorney who, pressing very hard on a formalistic point of law, implying that the judge had no real choice in the matter, and deflecting the judge's attempts to understand the underlying policies, called counsel to the bench and, leaning over the bench, said the following:

> Son, in a discussion of three baseball umpires, the first said—"I call them as I see them," the second said—"I call them as they are," and the third, a wizened old-timer, said—"Hell, they ain't nothing till I call 'em." Son, which kind of umpire do you think I am?

163. For cases holding against target managers in takeovers, see Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 637 (1987); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984); Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988); Amalgamated Sugar Co. v. NL Indus. Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986); Plaza Sec. Co. v. Freuhauf Corp., 643 F. Supp. 1535 (E.D. Mich. 1986); Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985); Asarco Inc. v. M.R.H. Holmes, 611 F. Supp. 468 (D.N.J. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Robert M. Bass Group, Inc. v. Evans, Nos. 9953, 9909 (Del. Ch. July 18, 1988) (appeal pending); Tate & Lyle PLC v. Staley Continental, Inc., No. 9813 (Del. Ch. May 9, 1988); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

An intriguing study was recently made of the stock-price effects of important court decisions on poison pill plans: 15 of the 18 pro-target, pro-pill decisions had negative effects on the target's stock; 6 of 11 pro-acquiror decisions had positive effects on target stock price. *See* Jarrell, Brickley, & Netter, *supra* note 60, at 64 (citing a study by Ryngaert).

be faced with legal challenges to both a board's decision to adopt a poison pill plan to buttress the moratorium in the Delaware statute and its decision to not waive the plan and/or the statutory three year cooling-off period.[164] In other words, the Delaware courts had been faced with supervising the decisions of target boards before the adoption of the statute; the statute will not materially change their responsibility.[165]

The only real change brought about by the statute relates to the timing of the decisions of the target boards. The statute does not affect the nature of the essential inquiry into the managers' motives.[166] Target boards can choose: (1) to opt out of the statute within ninety days of its passage; (2) to sponsor a charter amendment to opt out of the statute; (3) to erect defenses that supplement the statute, with or without a shareholder vote;[167] and (4) to waive the firm-specific defenses and the statutory moratorium altogether. These choices can be motivated by self-interest or by an interest in serving their shareholders. Delaware courts, in evaluating target defenses, have shown a willingness to actively determine which motivation is controlling.[168]

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164. The Delaware Supreme Court has, before the enactment of the statute, validated poison pills adopted by target boards. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

165. The legislative synopsis that accompanies § 203 notes that the statute does not alter case law on the obligations of target directors in takeovers. *See* SMITH & FURLOW, *supra* note 17, at 95.

166. The Delaware Supreme Court has opined that its inquiry must focus on the entrenchment motives of the board at the time the defense is adopted. If the court concludes that entrenchment is not the board's overriding concern, the board's decision is protected by the business judgment rule. *See, e.g.*, *Moran*, 500 A.2d at 1350 (discussing the interplay between director implemented defensive tactics and director's fiduciary duties).

167. Two courts have considered poison pill plans in the context of § 203. BNS, Inc. v. Koppers Co., 683 F. Supp. 458 (D. Del. 1988); *In re* Fort Howard Corp. Shareholders Litig., No. 9991 (Del. Ch. Aug. 8, 1988). In both cases, target boards refused to redeem the poison pill rights in the face of tender offers contingent on such redemptions, and the courts upheld the board's decisions.

168. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173 (Del. 1986) (stating the "enhanced duty rule," shifting the initial burden of proof to the directors, before the court will apply the business judgment rule). *See generally* Oesterle, *Negotiation Model*, *supra* note 89 (discussing theory that target managers should be viewed as negotiating agent for target shareholders). *See also* Robert M. Bass Group, Inc. v. Evans, Nos. 9953, 9909 (Del. Ch. July 18, 1988) (appeal pending); Tate & Lyle PLC v. Staley Continental, Inc., No. 9813 (Del. Ch. May 9, 1988).

The effectiveness of the Delaware statute will, therefore, ultimately turn on the performance of the Delaware courts. The courts must decide whether they will actively supervise the acts of target managers under the new statute, when the appropriate time for doing so is, and what standards and presumptions will aid such decisions. The statute does nothing more than revest in the Delaware courts the matter of supervision. If one believes that the Delaware courts are too lenient in assessing the conduct of target managers[169]—that too many hostile takeovers are deterred or repelled—then one ought to believe that the statute will add only marginally to the problem. If, on the other hand, one believes that the Delaware courts are too harsh in assessing the conduct of target managers—that too many hostile takeovers succeed because target managers fear court discipline—then one ought to believe that the statute will increase, though only marginally, manager protections. In the end, the Delaware courts will define the parameters.

In five significant opinions on resisted takeovers, all within the last three years, the Delaware Supreme Court may have foretold how it will monitor the use of the new statute.[170] The cases contain five salient points:[171] First, the Delaware Supreme Court views a director's primary duty in takeovers (at least where the directors have chosen to sell the company) as running to shareholders, exclusive of other corporate constituencies.[172] Second, the supreme court is sympathetic to claims of shareholder coercion in tender offers and,

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169. This view has been the subject of intense debate. *Compare* Cary, *Federalism and Corporation Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) ("Delaware corporate decisions lean toward the status quo and adhere to minimal standards of director responsibility" and thus create a favorable climate for new incorporation) *with* Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982) (criticizing Cary's view of state corporation law and suggesting that his "race to the bottom" thesis is based on a misunderstanding of corporate form).

170. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Polk v. Good, 507 A.2d 531 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The supreme court decided a sixth case, Mills Acquisition Co. v. Macmillan, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,072 (Del. Supr. Nov. 2, 1988), after this article was written. The court invalidated a lock-up option on *Revlon* principles.

171. A possible sixth point is that T. Boone Pickens loses whenever he appears in court. *Compare* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (Pickens' entity defeated in takeover litigation) *with* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1986) (same). *See also supra* note 19.

172. *Revlon*, 506 A.2d at 182 (correcting some loose language in *Unocal*).

therefore, will not declare as per se unlawful modern defensive maneuvers by target boards of directors.[173] Third, the supreme court is sensitive to the conflicts of interest of target managers manifested in resisting takeovers.[174] Fourth, the court will give more deference to board decisions to erect takeover defenses before the appearance of hostile bidders (preplanning) than to board decisions either to erect or to use (refuse to waive) previously erected defenses in response to a specific and mature threat.[175] Finally, the court has substantially more sympathy for a board of directors that is trying to keep its firm independent than for a board that is fielding offers from competing bidders.[176] The five cases suggest that the court will approve most firm decisions, made before an actual takeover threat, to not opt out of the statute and to buttress the statute with supplementary defenses. However, in analyzing director action after a takeover threat has manifested itself, the court will judge whether the *use* of these defenses is reasonable in relation to the specific facts.

I have two quibbles with, and a major reservation to, the Delaware Supreme Court's approach to takeovers. My first quibble is with the court's insistence on categorizing its analysis under the

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173. The court has approved poison pills in Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (flip-over) and Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (back-end or lollipop plan); greenmail in Polk v. Good, 507 A.2d 531 (Del. 1986); self-tender offers in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (discriminatory plan) and Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); a large cash dividend in Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); a standstill agreement in *Ivanhoe Partners, id.*, and a street sweep by a white squire in *Ivanhoe Partners, id.* The court ruled that, on the facts of the case in *Revlon*, the use of a lock-up, a no-shop clause, and a cancellation fee favoring one bidder in an auction were unlawful, but the court was careful to note explicitly that its opinion should not be read as holding such tactics to be illegal per se. *See Revlon*, 506 A.2d at 183-84. In *Unocal*, 493 A.2d at 955 n.10, the court explicitly rejected the argument that target board's ought to be passive. *See Unocal*, 493 A.2d at 954.

174. In *Unocal*, the Delaware Supreme Court created a threshold test for the use of the business judgment rule. The test requires that the target board act in good faith after reasonable investigation, and that the measures adopted be reasonable in relation to the takeover threat posed. The board of directors is entitled to a presumption of good faith if a majority of disinterested directors approve the action in controversy. *See Unocal*, 493 A.2d at 955.

175. *Moran*, 500 A.2d at 1350.

176. *Revlon*, 506 A.2d at 182. The court's position distinguishing auctions between competing bidders from complete defenses from an unwanted bidder was reaffirmed in *Ivanhoe Partners. See Newmont*, 535 A.2d at 1344-45.

rubric of a duty of care.[177] The "threshold" test, allowing the court, among other things, to review the threat posed by a bidder and the reasonableness of any target response is, in essence, an open review of the merits of any defense.[178] It is inconceivable that target managers could fail the threshold test and win or that target managers could pass the test and still lose. While such semantical quibbles are normally of little consequence, the new Delaware limited liability statute—allowing corporations to exempt their directors from duty of care liability[179]—makes this categorization controversy extremely important. If the court continues to classify its analysis of takeover defenses under the duty of care doctrine, it will lose its power to assess damages against directors in takeover defenses as corporations take advantage of the limited liability provision. The section does not, however, affect the court's ability to grant injunctive relief.

My second quibble is with the court's apparent reluctance to weigh in its deliberations evidence of the specific personal stake of target officials in the outcome of a takeover. There seems to be no evidence more relevant to the issue of good faith than a target official's personal stake, yet, the court seems to be continuing its long standing antipathy to such an inquiry. The Delaware Court of Chancery opinion in *Tate & Lyle PLC v. Staley Continental, Inc.* may signal a change in that regard.[180]

My major reservation with the Delaware Supreme Court is its wholehearted, enthusiastic endorsement of "showstoppers," the absolute takeover defenses. The court believes that target shareholders are often better served if their managers completely reject acquisition

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177. The duty of care, as articulated by the court, requires a board of directors to make decisions after availing itself of all material information, thus rendering an "informed decision." *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). This duty is distinguished from the duty of loyalty, which focuses on the board's loyalty to shareholders as the primary constituency. *See* Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), *aff'd*, 5 A.2d 504 (Del. 1939) (seminal case in Delaware on corporate opportunity doctrine).

178. *See* Note, *Preliminary Injunctions in Delaware: The Need for a Clearer Standard*, 13 DEL. J. CORP. L. 107 (1988) (discussing the effect of this broad analysis in the context of preliminary injunctions in Delaware).

179. DEL. CODE ANN. tit. 8, § 102(b) (1986) provides in relevant part: "[T]he certificate of incorporation may also contain . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director."

180. No. 9813 (Del. Ch. May 9, 1988). The court in *Staley* invalidated a golden parachute that included compensation for non-management directors on the compensation committee that proposed the plan to the full board for approval. *Id.*

offers than if the managers negotiate a sale of the firm. In this respect, the court has been sold a false bill of goods. The court's belief can be traced to the *Unocal* case, in which the court cited a flawed study, compiled by a well known target lawyer. The study indicated that shareholders of targets in over 50% of the cases studied were better off if the target remained independent.[181] The study claimed that either the target stock later traded at higher market prices than the rejected offer or that a subsequent bidder appeared to offer a higher price.[182] Unfortunately, the overwhelming empirical evidence from studies by disinterested parties using sophisticated methodologies is to the contrary.[183] Target shareholders gain from resistance by their managers only if the managers increase the bid from the existing bidder or stimulate an auction between bidders.[184] If managers defeat an existing bid and no other bidders are interested, target shareholders suffer substantial losses, measured by the lost tender offer premium.[185] Data on the post tender offer stock prices for firms that successfully defended against takeovers show that stock prices return to pre-tender offer levels within two years.[186] Furthermore, managers who have blocked tender offer premiums typically are not able to offer stockholders more value later. In sum, the court is far too supportive of efforts by target managers to keep their corporations independent when confronted with respectable, even handsome, offers.

The problem is inherent in the Delaware Supreme Court's use of terms like "long-run" shareholder interests and firm "intrinsic

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181. *Unocal*, 493 A.2d at 956 n.11.

182. *Id.*

183. *See, e.g.*, Yen, *Merger Proposals, Managerial Discretion, and Magnitude of Shareholders' Wealth Gains*, 39 J. ECON. BUS. 251 (1987); Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y. LAW REV. 277 (1984).

184. *See* Giammarino & Heinkel, *A Model of Dynamic Takeover Behavior*, 41 J. FIN. 465 (1986); Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151 (1985). In a recent SEC study of 30 control contests, 46% of the targets used poison pill plans to remain independent and suffered average stock price declines of 17%. Those targets who used poison pill plans to stimulate auctions gained, on average, 14% in stock returns over those returns attributable to the initial bid. OFFICE OF THE CHIEF ECONOMIST, *supra* note 147.

185. Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests in Corporate Takeovers: Causes and Consequences* (A. Euerbach ed. 1988); Ryngaert, *supra* note 156, at 409, Table 11 (net of market returns for 21 firms in the six months after the defeat of a tender offer average a -14.4%).

186. Bradley, Desai, & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy*, 11 J. FIN. ECON. 183, 194 (1983).

value."[187] By employing such terms, the court excuses managers from maximizing current stock prices in the context of an acquisition, allowing them to resist an offer that is substantially above market. The court's basis for this is a prediction that future stock prices will be higher if the target stays independent, at least for the time being. While there is some logic to the court's analysis, it is not at all conclusive. Resistance to an acquisition can be justified on three grounds: First, the managers have valuable inside information that, if disclosed to their shareholders, would be destroyed; second, the managers believe that a second bidder will make a higher bid (in present dollars); and third, the managers believe that the initial bidder will pay more.

Any other justification for resistance falls in the category of artifice. A common articulation of one specific artifice is that a firm is undervalued in the market—not because the market is unaware of inside information, but because the market is currently fickle in its pessimism of marketwide, industrywide, or firm-specific information—and that target managers are protecting their shareholders from an opportunistic bidder who is taking advantage of a depressed market price. Yet, managers are hardly neutral evaluators of whether their firm is undervalued. Like most humans who are loyal to their sustaining institutions and who overvalue their own efforts, managers will invariably voice the opinion, whatever the market conditions, that the market has undervalued their firm. Moreover, there is a substantial body of research that suggests that even a neutral evaluator has only a 50% chance of being correct; that is, a neutral evaluator's odds of making better evaluations than the market are random.[188]

D. Hostile "Friendly" Bids: The Godfather's Offer[189]

The final backstop, which acts to protect even judicial supervision of target managers, is the raw power of a sweet offer. With state takeover statutes and target defenses, bidders simply condition an attractive offer on the removal of the impediments by the target

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187. *E.g.*, *Revlon*, 506 A.2d at 181 (discussing intrinsic value and stockholders best interests as support for the board's adoption of defensive tactics).

188. *E.g.*, B. MALKIEL, A RANDOM WALK DOWN WALL STREET (4th ed. 1985) (discussing the "random-walk" theory).

189. M. PUZO, THE GODFATHER (1969). Godfather offers are "cash offer[s] so rich that . . . the directors do not believe . . . they can reasonably refuse [them]." Gilson, *supra* note 28, at 775 (citing A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES & PLANNING 57-59 (1981)).

board—that is, the target must accept the bid as a "friendly" offer. The target board must waive supermajority voting requirements, redeem poison pills,[190] waive note covenants, and so on. In the context of the Delaware statute, a bidder can condition its tender offer on the board's removing any poison pill and waiver of the moratorium.

If the price is high enough, even reluctant target managers cannot walk away and leave their shareholder's money on the table without substantially impairing their personal reputations (and perhaps their own stockholdings). The power of these hostile friendly bids comes from the widespread publicity that surrounds public tender offers and the intense public scrutiny focused on the major players; the entire investment community takes an interest in the outcome.

At some point, the managers recognize that the price is simply too attractive to resist and that resistance will only lose them the favor of their shareholders, put them at risk in litigation, and cost them their personal value in the executive employment market. This is especially true if they defeat the bid and cannot raise post-offer stock prices to the level of the bid. Moreover, those managers who become publicly committed to raising stock prices after defeating an attractive bid may find themselves undertaking severe corrective actions aimed at streamlining the firm in order to get stock prices up. These actions will undoubtedly prove to be similar to those proposed by the original takeover bidder, thus exposing these managers to the embarrassment of undertaking actions that they had explicitly resisted in print.

Irresistible bids, when successful, may not be friendly in a commonsense definition of the term; the bidder has, in essence, put the target managers in a hammerlock and has demanded and received the classic "uncle" response. There can be no doubt that the elimination of bids that succeed without any target manager approval will have negative effects at the margin, for example, by reducing the monitoring effect of the control market. However, there may be some legitimate doubt as to the seriousness of that impact, given the success of those who begin as unwanted suitors but ultimately are able to force a friendly deal.

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190. In the recent battle between Campeau, Macy's, and Federated, Campeau had conditioned its tender offer for Federated stock on the Macy's board redeeming its poison pill. *See* Campeau Corp. v. Federated Dep't Stores, 679 F. Supp. 735 (S.D. Ohio 1988). *See also* BNS, Inc. v. Koppers, 683 F. Supp. 458 (D. Del. 1988).

IV. THE CONSTITUTIONALITY OF THE DELAWARE STATUTE

A. *The Political and Legal Context*

The Delaware statute was only one day old when it was challenged in two separate court actions as being unconstitutional.[191] Several takeover statutes in other states have also been born into litigation, immediately becoming a part of the numerous actions that typically swirl around takeover resistance.[192] In responding to these challenges, the Delaware courts must determine whether the Delaware statute is within the constitutional limits described by the Supreme Court in two cases, *Edgar v. MITE Corp.*,[193] and *CTS Corp. v. Dynamics Corp. of America*.[194] Moreover, waiting in the wings is Congress,[195] which is subject to current urgings from the Securities and Exchange

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191. *See* Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988); Campeau Corp. v. Federated Dep't Stores, 679 F. Supp. 735 (S.D. Ohio 1988). *See also Decker Loses in Delaware*, N.Y. Times, Feb. 25, 1988, at D6, col. 3 (discussing *Black & Decker Corp.*). *Delaware's New Anti-Takeover Law is Contested by Campeau, Black & Decker*, Wall St. J., Feb. 3, 1988, at 26, col. 3. Campeau Corp., bidding for Federated Department Stores, and Black & Decker Corp., bidding for American Standard, filed actions challenging the constitutionality of the law. In the Black & Decker suit, the judge refused to enjoin the law on the grounds that there was no showing that the statute would harm Black & Decker's offer. Black & Decker, if they had bought control of American Standard, would have had time to cause American Standard to opt out. The statute permitted directors to opt out from coverage ninety days from February 2.

192. *See, e.g.*, Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837 (1st Cir. 1988); Campeau Corp. v. Federated Dep't Stores, 679 F. Supp. 735 (S.D. Ohio 1988); TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022 (W.D. Okla. 1987).

193. 457 U.S. 624 (1982) (invalidating Illinois statute which imposed a substantial burden on interstate commerce).

194. 107 S. Ct. 1637 (1987) (upholding Indiana statute which was consistent with the Williams Act and which did not violate the commerce clause).

195. Numerous takeover reform bills have been introduced in Congress in the past session. The only one that has come out of committee approval is a comprehensive tender offer reform bill, Senate Bill 1323. *See* S. 1323, 100th Cong., 1st Sess. (1987). The bill, introduced by Senator William Proxmire, was approved September 30, 1987 by the Senate Banking Committee. When the bill reaches the Senate floor, perhaps by April of this year, observers expect a dispute over federal preemption of state takeover legislation. The original bill had a "reverse preemption" clause, allowing states to override the Williams Act. This language, however, was deleted in committee. Senators William Armstrong and Phil Gramm announced that they were considering offering an amendment on the Senate floor that would give the SEC authority to preempt state takeover legislation, but Senator Proxmire made it known that any such amendments would force him to block all action on tender offer reform. *See* Special Report, *supra* note 3, at 70; Special Report, *Senate Showdown on State Takeover Laws Expected as Banking Committee Sends Major Reform Bill to Floor*, 2 Corporate Counsel Weekly (BNA) 8 (Oct. 7, 1987).

Commission that the *CTS* decision gives too much latitude to state takeover legislation (and that the Commission should be given the power to preempt state statutes).[196] If the courts do not void some of the newer, more extreme state statutes, Congress may act to correct what it perceives as overly permissive court action.

Some of the latest state statutes leave no doubt that at least some federal corrective action will be necessary. Initially, several states were content to replicate the Indiana Control Share Acquisition statute, which the Supreme Court had explicitly approved.[197] Thereafter, state legislatures have shown little hesitancy, when spurred by the pleas of local firms, labor unions, and taxpayers, in enacting increasingly more extreme statutes.[198] North Carolina and Ohio have

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196. The Securities and Exchange Commission (SEC) has been active in voicing its objections to state takeover legislation. The SEC filed an amicus curie brief in *CTS* against the Indiana statute. Since the *CTS* opinion, the chairman of the SEC has testified on several occasions before Congress, urging Congress to give the SEC the authority to preempt state legislation. *See Ruder Defends Position on Preemption of State Takeover Laws*, 19 Sec. Reg. & L. Rep. (BNA) 1525 (Oct. 9, 1987); *Ruder Calls for SEC Authority to Preempt Some State Takeover Laws*, 19 Sec. Reg. & L. Rep. (BNA) 1383 (Sept. 18, 1987). During the state legislative hearings on the Delaware statute, three of the five SEC Commissioners wrote letters urging the state not to pass the legislation. Hays, *supra* note 17, at 10, col. 1.

197. For example, Florida, Nevada, and North Carolina have promulgated laws very similar to the Indiana statute. In all, a total of 14 states had adopted control share acquisition statutes as of Oct. 1, 1987. *See The Battle Over Tender Offer Reform: From the States and the Courts to Congress*, 20 Sec. Reg. & L. Rep. (BNA) 68 (Jan. 15, 1988).

198. Many of the newest state takeover statutes are passed at the urging of specific firms involved in hostile takeover attempts. Arizona (Greyhound); Florida (Harecourt, Brace, Jovanovich); Indiana (Arvin Industries); Massachusetts (Gillette); Minnesota (Dayton Hudson); Missouri (TWA); New York (CBS); North Carolina (Burlington Industries); Ohio (first Goodyear and then Federated Department Stores); Washington (Boeing); Wisconsin (Heilman). *See, e.g.*, Editorial, *Expropriation at Home*, Wall St. J., Oct. 9, 1987, at 24, col. 1; *States Rush to Thwart Takeovers*, Chicago Tribune, June 28, 1987, § 7, at 4, col. 1. Indeed, some lawyers appear to be counselling their clients that state legislation ought to be considered as a first line of defense in takeover contests.

For an illustration of the pressure that one local firm can put on a state legislature, consider the attempt of the Dart Group to acquire Dayton Hudson. The Dart Group, an organization with a reputation for acquiring substantial stock positions in several companies on a hostile basis, purchased a "substantial" stake in Dayton Hudson following a private inquiry concerning a possible acquisition of the company. *Dayton Hudson Stake Acquired By Dart Group*, Wall St. J., June 22, 1987, at 3, col. 1. Dayton's first line of defense was to request a special legislative session to strengthen Minnesota's antitakeover law. *Dayton Seeks Anti-takeover Aid*, Minneapolis Star & Tribune, June 19, 1987, at 1A; *Talk of Session Indicates Dayton Hudson Political Clout*, Minneapolis Star & Tribune, June 20, 1987, at 1M; *Dayton's*

enacted several waves of takeover provisions, accepting the propositions demanded by local firms. Indeed, the states feed off each other; when one state has the courage to pass yet another, more extreme statute, other states inevitably follow suit.

The new and more extreme statutes often come at the specific request of individual local firms that are being targeted by out-of-state bidders.[199] Indeed, one suspects that many of the new statutes may have been drafted in targeted company board rooms by corporate counsel.[200] The legislatures acknowledge the marginal constitutionality of these newer provisions but pass them in the hope of generating litigation fodder; bidders must contest the statutes in court, and this expenditure of time and money may help delay or otherwise discourage a pending takeover. As some states continue to push the boundaries of the most recently decided Supreme Court case, our federal courts will inevitably and continually have to invalidate some of the more blatantly self-serving statutes.[201] If the courts balk, Congress may have to step in.

Call to Legislature Echoes Goodyear's Pleas to Ohio, Minneapolis Star & Tribune, June 20, 1987, at 2M. While hearings on the proposed legislation were held, the environment in which the bill was brought before the legislature clearly indicates that the amendments to the statute were passed in a hasty manner (only one week from the initial disclosure of the Dart Group's Dayton's holdings) and without thorough consideration of the recent developments in this area. *Perpich Holds Off On Special Session: Public Hearings Will Come First*, Minneapolis Star & Tribune, June 23, 1987, at 1A. Dayton Hudson's amendments to the bill gave it as complete a protection from hostile bids as any corporation has yet achieved through such means. The amendments prohibit a hostile bidder from selling assets and using the money to pay the costs of the takeover, making it enormously difficult to finance the takeover of a company for the $6 to $7 billion dollars it would take to acquire Dayton. *Perpich Signs Anti-Takeover Bill*, Minneapolis Star & Tribune, June 26, 1987, at 1A. "The Legislature approved only the provisions that Dayton Hudson proposed or endorsed. All attempts to make changes over the company's objections were voted down by big margins . . . ." *Id.* at 12A, col. 1.

199. *See infra* note 201 (Ohio statute to protect Federated from Campeau).

200. In Washington, a Boeing spokesman admitted that the company had submitted a "proposal" to lawmakers on how the new law should be structured. The Washington legislature met in emergency session, approved the bill, and the governor signed it immediately. *See* Caprino, *More States Adopt Antitakeover Bill, But Do They Work?*, ASSOC. PRESS, Sept. 15, 1987 (available on Nexis). Washington's experience is not unique: The Massachusetts statute, protecting Gillette, was signed by the Governor in the Gillette offices! The Arizona control share acquisition statute, written to protect Greyhound Corp., was introduced, adopted, and signed into law in three days. The Minnesota law adopted at the urging of Dayton-Hudson Group was introduced, adopted, and signed in one day. The Illinois business combination act was introduced, adopted, and signed within two days. Berg, *Takeover Restrictions Not in Public Interest*, Legal Times, Sept. 28, 1987, at 26.

201. Some lower federal courts are warming to the task. The United States

In this milieu, the Delaware statute looks tame. It is a moderate version of its parent, the New York statute (which itself is less extreme than the redemption statutes), and it has none of the newest wave of extensions. The statute is, however, more severe than many pure control share acquisition statutes and some fair price statutes. Thus, the issue remains whether the Delaware statute is inside or outside the basic constitutional boundaries established by the Supreme Court.[202] The best answer is, perhaps: Who knows?

District Court for the Western District of Ohio granted a preliminary injunction against the latest Ohio takeover law. *See* Campeau Corp. v. Federated Dep't Stores, 679 F. Supp. 735 (W.D. Ohio 1988). The law, entitled the Foreign Business Acquisitions Act, requires foreign (out of country) corporations to file an application with the state disclosing their plans for financing an Ohio acquisition and their intentions for selling target assets. Once the disclosure is filed, Ohio has thirty days to decide whether the acquisition would be detrimental to Ohio residents. *See* OHIO REV. CODE ANN. § 1710.01-.05 (Anderson 1988). The judge held that the statute is discriminatory on its face, and, since it applies to protected firms that are not incorporated in Ohio, creates a risk of inconsistent state regulation. *See Campeau*, 679 F. Supp. at 739.

The United States Court of Appeals for the First Circuit affirmed a district court's preliminary injunction of a Massachusetts takeover law in Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837 (1st Cir. 1988). The Massachusetts Take-Over Bid Regulation Act requires that bidders disclose their intent to acquire a target before making a 5% or more acquisition of target stock. The penalty for failing to disclose is a one year lock-out, i.e., the bidder cannot make a takeover attempt for one year. *Id.* at 840. The court said the disclosure requirement was constitutional under the commerce clause but that the draconian penalty was not. Moreover, the court opined that the disclosure requirement was preempted by the Williams Act, which requires disclosure within ten days of a 5% purchase. *Id.* at 845-48.

The United States District Court for the Western District of Oklahoma decided that an Oklahoma Central Share Acquisition Statute that applied to protect non-resident firms violated the commerce clause. TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022 (W.D. Okla. 1987).

The United States District Court for the District of Nevada granted a preliminary injunction at the request of Batus, Inc. against certain provisions of a Nevada statute governing takeover bids. Batus, Inc. v. McKay, 684 F. Supp. 637 (D. Nev. 1988). The law provided that shares may be deposited pursuant to a takeover bid between 10 and 60 days after the first invitation to deposit shares. The court opined that the 60 day limit substantially frustrated the goals of the Williams Act and violated the free flow of interstate commerce. *See Batus*, 684 F. Supp. at 640.

202. At least one court thinks it is outside. The United States District Court for the Eastern District of Wisconsin recently ruled that the Wisconsin business combination act, which is very similar to the Delaware statute, "frustrates the purpose of the Williams Act" and is unconstitutional. RTE Corp. v. Mark IV Indus., Inc., No. 88-C-378, slip op. at 8 (E.D. Wis. May 6, 1988), *vacated as moot*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,789, at 98722 (June 22, 1988). The court distinguished the Wisconsin statute, which it termed a business

It appears that no one, nary a lower federal court nor a commentator, was even close to foreseeing the result in the *CTS* case.[203] Observers reading the relatively recent *MITE* opinion took it for granted that almost all second generation statutes were unconstitutional. States continued to pass takeover acts after the *CTS* opinion as constitutional long shots, primarily to give local targets something to sue on in court (to effect delay and thereby stretch the bidder's financing to the breaking point). The unpredictability of the *CTS* decision[204] ought to cause all sensible and responsible people to decline from making a public prediction on what the Supreme Court will do with the Delaware statute. I predict that the statute will be upheld (but it ought not be).[205]

B. The Commerce Clause

The test under the dormant commerce clause, as traditionally stated,[206] requires a finding that the state regulation is rationally

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combination statute, from other forms of state antitakeover laws (control share statutes and fair price statutes) and found that it "enhance[d] the power of a company's board of directors, by giving it, without shareholder approval, the statutory right to block a business combination for three years irrespective of its shareholders' preferences." *Id.*, slip op. at 6. According to the court, the Wisconsin statute gives target management "a virtual veto power over the outcome of a tender offer contest" that cannot stand. *Id.*, slip op. at 9. *See also Wisconsin Takeover Law Ruled Unconstitutional by District Court*, 20 Sec. Reg. & L. Rep. (BNA) 774 (May 20, 1988) (discussing *RTE*).

203. Even the more optimistic commentators thought *MITE* left room only for mild disclosure statutes. *See, e.g*, Note, *State Regulation of Tender Offers: Legislating Within the Constitutional Framework*, 54 FORDHAM L. REV. 885 (1986).

204. Professor Donald Langevoort gently calls it a "change of heart." Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on* CTS Corp. v. Dynamics Corp. of America, 101 HARV. L. REV. 96, 97 (1987).

205. As of the time of this writing, two judges in the United States District Court for the District of Delaware have concluded that the statute is constitutional. In RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988), the court, on a motion for a preliminary injunction to prevent acquisition of Staley, held that RP did "not have a reasonable probability of eventually succeeding in its claim that Section 203 is unconstituitonal, either under the Supremacy Clause or under the Commerce Clause." *Id.* at 488. *See Delaware District Court Rejects Constitutional Assault on Takeover Law*, 20 Sec. Reg. & L. Rep. (BNA) 735 (May 13, 1988). In BNS, Inc. v. Koppers Co., 683 F. Supp. 458 (D. Del. 1988), the court denied the hostile bidder injunctive relief when the court found that § 203 would probably pass constitutional muster. *BNS*, 683 F. Supp. at 473. In *Black & Decker Corp.*, 682 F. Supp. at 773, although the court did not rule on the constitutionality of § 203, it did find that American Standard could have caused Black & Decker to opt-out of the statute in the period during which its offer was open. *But see supra* note 201.

206. L. TRIBE, AMERICAN CONSTITUTIONAL LAW 408-09 (2d ed. 1988). The

related to a legitimate state concern, and that the burden imposed on interstate commerce by the regulation is outweighed by the significance of the state's interest in enforcing the legislation.[207] Applying this test to the Delaware takeover statute, the questions metamorphose into: First, is the relationship of Delaware to firms covered in the statute sufficient to justify the regulation? Second, if so, does the statute place excessively severe restrictions on takeovers?

1. The Coverage of the Statute

Addressing the question of whether Delaware has the power to regulate firms covered by the statute, the loose language of both relevant Supreme Court opinions makes it difficult to predict the constitutionality of the Delaware statute. Ultimately, one's analysis must turn on an interpretation of one word—"Moreover"—which is used in the *CTS* opinion.[208] The invalidated Illinois statute applied to nonresident corporations with only a minor presence in the state.[209] In contrast, the validated Indiana statute applies only to resident corporations with both a substantial operation (facilities and assets) and a substantial ownership (shareholder) presence in the state.[210]

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traditional formulation is often called the Pike test, named for the case in which it was cogently formulated and adopted. Pike v. Bruce Church, Inc., 397 U.S. 137 (1970). The test, however, has a formidable opponent in Prof. Donald Regan. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091 (1986) [hereinafter Regan, *Making Sense*] (arguing the Court should not, and in fact does not, balance the state interest against the burdens on interstate commerce; rather, the Court should prevent states from engaging in purposeful economic protectionism). Professor Donald Regan's article was cited by both the majority and by Justice Scalia, in his concurrence, in *CTS*, 107 S. Ct. at 1648, 1653, indicating that the Court may be moving to Professor Regan's alternate classification system. *See also* Regan, *Siamese Essays: (I)* CTS Corp. v. Dynamics of America *and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865, 1868-69 (1987) [hereinafter Regan, *Siamese Essays*].

207. Pike v. Bruce Church, Inc., 397 U.S. 137, 143 (1970).

208. *CTS*, 107 S. Ct. at 1652.

> But this Act applies only to corporations incorporated in Indiana . . . Indiana has a substantial interest in preventing the corporate from becoming a shield for unfair business dealing. *Moreover*, unlike the Illinois statute invalidated in *MITE*, the Indiana Act applies only to corporations that have a substantial number of shareholders in Indiana.

Id. at 1651-52 (emphasis added).

209. ILL. REV. STAT. ch. 121 1/2, para. 137.52-9 (1979) (held unconstitutional in commerce clause challenge in Edgar v. MITE Corp., 457 U.S. 624 (1982)).

210. IND. CODE §§ 23-1-17-1 to -17-9 (Supp. 1986) (upheld by the U.S. Supreme Court in *CTS*, 107 S. Ct. at 1637).

At issue, then, is what level of corporate presence, in between these two requirements, will suffice.

The Delaware statute applies only to resident corporations, regardless of an operating or an ownership presence.[211] Indeed, since few corporations have either an operating or ownership presence in Delaware, either qualification would reduce the statute to a curio. Many of the latest statutes in other states, on the other hand, apply to nonresident corporations with a specific operating and ownership presence in the state.[212] Since the goal of these provisions is primarily to protect local facilities, the requirement of an operating presence is far more important to state legislators than the requirement of an ownership presence (which is contrary to the Supreme Court's view on the relevant significance of the two factors[213]). The ownership requirement is thus set at fairly low levels, if it is included at all.

A precise reading of the *CTS* case suggests that Delaware is likely to be correct and these other states are likely to be incorrect.[214] The Court implied that the validity of the Indiana statute hinged on a state's legitimate interest in protecting shareholders of domestic corporations, wherever located, and that the Indiana statute's additional requirements of firm presence in the state were supportive but not necessary.[215] In support of the state's interest in shareholders of domestic corporations, the Court noted the historic acceptance of state incorporation and the internal affairs doctrine, which looks to the state of incorporation as the dominant, if not exclusive, source of law on corporate structure.[216] The necessary corollary of the internal affairs doctrine is that state corporate codes can affect nonresident shareholders. The Court also noted that its concern with the potential for inconsistent state regulations was allayed by a majority of state statutes, which apply only to resident corporations,

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211. DEL. CODE ANN. tit. 8, § 203 (1988).

212. See the control share statutes of Arizona, Florida, Massachusetts, North Carolina, and Oklahoma. ARIZ. REV. STAT. ANN. §§ 10-1211 to -1217 (1987); FLA. STAT. § 607.109 (1987); MASS. GEN. L. ch. 110D, §§ 1-8 (1988); N.C. GEN. STAT. §§ 55-90 to -98 (1987); OKLA. STAT. tit. 18, §§ 1145-1156 (1988).

213. *See supra* note 194 (holding of *CTS*).

214. *See* RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476, 488 (D. Del. 1988); BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 470 (D. Del. 1988) (holding Delaware statute will pass constitutional muster).

215. In other words, the word "moreover" denotes an extra and unnecessary addition to the already discussed crucial fact, that of state incorporation. *See supra* note 208.

216. 107 S. Ct. at 1650-52.

because most firms have only one place of incorporation.[217] Those newer statutes that apply to nonresident corporations, even when conditioned on a substantial operating presence in the state, seem discordant with both Court comments. These statutes are not supported by, and may be in conflict with, the internal affairs doctrine and, in addition, they create the potential for simultaneous and inconsistent state regulations.[218]

2. The Discriminatory Effect of the Statute

a. *The Basic Standard*

Assuming that Delaware can pass some form of takeover legislation applicable to all Delaware corporations, there remains the issue of whether the Delaware legislation furthers a legitimate state interest. At its core, the commerce clause is a prohibition on state statutes that are economically protectionist,[219] that is, statutes that impose an economic cost on out-of-state parties with the intent to disadvantage those in business competition with in-state parties. This discrimination can take a variety of forms, but typically it involves restricting out-of-state competitors' access to local markets[220] or restricting access by out-of-state buyers to scarce local resources.[221] Identifying protectionist legislation, however, is not always easy; there can often be some ostensibly redeeming purpose (i.e., protecting local customers from fraud or some safety hazard) to legislation that may, in fact, favor local suppliers.[222]

Traditionally, the Supreme Court has assessed the constitutionality of a statute by balancing a state's legitimate regulatory interest against any adverse effect on interstate commerce. In *CTS*, the Court manifested renewed interest in focusing on discrimination as the

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217. *Id.* at 1649.

218. At least one lower federal court has already so held. *See* TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022 (W.D. Okla. 1987) (invalidating the Oklahoma statute).

219. *See* Regan, *Making Sense*, *supra* note 206, at 1173-74.

220. Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511 (1935) (refusing a milk-selling license to a supplier with out-of-state sources unconstitutional burden on interstate commerce).

221. H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525 (1949) (preventing Massachusetts milk supplier from establishing a receiving plant in New York unconstitutional burden on interstate commerce).

222. *E.g.*, California v. Thompson, 313 U.S. 109 (1941) (safeguarding members of the public from fraud and overreaching consistent with commerce clause).

essential test; if the statute primarily fosters economic protectionism for local interests, it is unconstitutional "without further inquiry."[223] Thus restated, the test seems to consist of two steps: First, does the statute effect a protectionist discrimination? And second, assuming that it does not, does the statute nevertheless burden interstate commerce in a manner not justified by some overriding legitimate state interest? A negative answer to either question renders the statute unconstitutional.

b. *If the Indiana Statute Is Not Protectionist, Then the Delaware Statute Is Probably Not Protectionist*

Focusing on economic protectionism, it would be implausibly simplistic to hold, as the Court did in *CTS*, that the Indiana statute does not discriminate against out-of-state parties simply because it applies equally to all potential bidders.[224] Given that holding, however, the Delaware statute should be treated likewise, because, the Delaware statute, like the Indiana statute, does not discriminate against out-of-state bidders. While the inquiry could stop here, the Court's relatively unsophisticated treatment of the discrimination problem in the context of takeover statutes leaves certain issues unresolved. Thus, the rest of this section addresses two issues: First, it argues that the Supreme Court was incorrect in declaring the Indiana statute to be nondiscriminatory; and second, (assuming that my analysis of discrimination applies), it considers whether the Delaware statute is also discriminatory.

The Court's focus in *CTS* is too narrow in two respects. First, and foremost, it overlooks the competition between existing managers and bidders for control of the firm. Second, it fails to consider, as Justice White does in the dissent, both the competition between local and out-of-state employees for job opportunities and the competition between local and out-of-state taxing districts for subjects to tax.[225]

The first argument turns on a distinction between the local market and the players. The protected market in this case is control of firms; existing managers, despite the fact that they are in place, are competitors in that market. To the extent that their position is

223. *E.g.*, Brown-Forman Distillers Corp. v. New York State Liquor Auth., 476 U.S. 573, 579 (1986) (discriminating against interstate commerce or favoring of in-state interests is unconstitutional).

224. *CTS*, 107 S. Ct. at 1652.

225. *Id.* at 1655-56 (White, J., dissenting).

solidified by the statute, the statute discriminates in their favor. This suggests that the Indiana statute in the *CTS* case could be viewed, and perhaps ought to be viewed, as an effort by the Indiana legislature to intentionally discriminate between in-state (existing managers) and out-of-state (potential managers) parties in a competitive market for corporate control. Thus viewed, the Indiana statute should have been struck down as unconstitutional under the commerce clause. For states other than Delaware, bidders are almost always out-of-state concerns (whether defined by physical location or by state of incorporation) and existing managers are almost always in-state parties. In this context, an alternative construction of state legislative intent that saves the statute—the legislature intended to protect shareholders of Indiana corporations, most of whom are out of state—is difficult to sell.[226]

The second argument supporting a finding of discrimination is that the Indiana legislature intended to protect in-state resources from leaving the state, to the detriment of out-of-state employees and out-of-state taxing districts. In short the state is attempting to lock in assets that are located in the state.[227] This discrimination should also be unconstitutional, although some commentators argue that a slight shift in emphasis may save the statute. Professor Donald Regan suggests that if a state statute were motivated substantially by concern over the disruption of established economic relations, it would not constitute unlawful discrimination under the commerce clause.[228] In other words, the state is not attempting to lock in assets absolutely in the state, but rather is providing a mechanism for minimizing the disruption and dislocation caused by major business restructurings. Presumably, if such regulation does not discriminate between economic disruptions caused by intrastate and interstate relocations of capital, and if it does not operate to lock in assets to disadvantage out-of-state workers and taxing districts, the legislation

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226. Somewhat ironically, the Indiana statute's limited application to Indiana incorporated firms (they must have substantial assets in the state) could support an argument that the drafters intended to protect local managers and employees, not shareholders of Indiana firms. *See* Langevoort, *supra* note 204, at 107. The requirement, however, is better explained by the drafters' attempt to satisfy the uncertain language of *MITE*.

227. This is an unconstitutional attempt to limit access by out-of-state buyers to scarce local resources. *See, e.g.*, Philadelphia v. New Jersey, 437 U.S. 617 (1978) (under the dormant commerce clause, New Jersey could not restrict access of New York to landfills in New Jersey).

228. Regan, *Siamese Essays*, *supra* note 206, at 1872.

is constitutional. The statute would, in effect, operate as a substitute for the milder forms of plant-closing legislation that require advance notice of closings and expenditures by the firm to mitigate the effects of worker relocation.[229]

In the context of tender offer legislation, however, the argument is most likely to be an artifice. First, since most bidders are out-of-state, protecting existing relations usually is at the expense of potential out-of-state relocations. Whenever local facilities are established and there is a threat that they will be relocated or liquidated out-of-state, any legislation that retards the closing or liquidation of facilities will harm those out-of-state parties who would be benefited by a relocation of the capital languishing in existing local facilities. Second, and more significantly, if dislocation costs are the core concern of the legislature, there are more direct ways of dealing with the problem. Plant-closing legislation (requiring advance notice of closings) or other forms of labor legislation (retraining programs or severance provisions)[230] more directly address the problems created by plant closings or major personnel changes. Takeover statutes are a very crude device for limiting dislocation costs. Such statutes allow friendly control changes that can and often do effect major relocations, while disallowing hostile control changes, not all of which effect major relocations. Given the availability of more direct methods of addressing relocation disruption, one must conclude that some states, in passing takeover statutes, are really attempting to lock in assets already in the state rather than to mitigate the effects of major business restructurings.

The Delaware legislature, however, does not seem to have the problems of justification that should have been (but, in fact, were not) a cause of trouble for Indiana's legislature. The Delaware statute is unique in that it applies principally to firms with their principal headquarters in other states. As a result, Delaware is perhaps the only state able to make the claim that its legislature could not have intended its statute to discriminate against out-of-state parties in favor of in-state parties. Neither bidders nor potential targets that are incorporated in Delaware have a significant physical or ownership presence in Delaware. So, while Indiana ought to have trouble justifying its statute as neither discriminatory against out-of-state

229. ME. REV. STAT. ANN. tit. 26, § 625B (Supp. 1986-87) (requiring employers to provide a one-time severance payment to employees in event of plant closing).

230. *See, e.g.*, *id.* (requiring notice of closing).

players in the control market nor against out-of-state employees or taxing districts, Delaware can smugly assert that it has no similar problems of proof. If the commerce clause test is hinged solely on a finding of local protectionism, the Delaware statute has a uniquely favorable position because it cannot be said to be protective of a Delaware-based constituency.[231] This is true unless, of course, one

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231. Under a construction of the commerce clause that depends entirely on a finding of protectionist discrimination, is there a constitutional limitation on Delaware's ability to regulate the affairs of firms that have no physical assets or owner location in the state? Professor Donald Regan seems to say no. *See* Regan, *Siamese Essays*, *supra* note 206. If so, can Delaware pass, as part of its corporate code, a provision prohibiting all factories of firms incorporated in Delaware, wherever located in the United States, from purchasing from out-of-state suppliers or hiring out of state workers? Professor Regan seems to say that the commerce clause would allow it, but argues that limits on Delaware legislation must come from limits on extraterritorial legislation found elsewhere in the constitution.

Regan has suggested that the extraterritorial problem for takeover legislation may be resolved by a declaration of "location": We can declare that control changes are located in the state of incorporation and, presumably, factory purchasing or hiring is located at the site of the factory. Control change regulations are therefore local regulations, while factory purchasing and hiring regulations are not. On the surface this approach, as Professor Regan recognizes, appears to be only formalistic. We ought to be uncomfortable defining away the extraterritorial effects of takeover statutes by declaring that firm control changes are somehow located in the state of incorporation when the bidder, the firm operating facilities and the headquarters, and most all of the firm shareholders are located out of state. Professor Regan, tentatively suggests a justification of this fiction on the grounds of avoiding inconsistent and overlapping regulations. This suggestion is plausible but not very satisfying. *See id.* at 1869. At minimum the justification seems to require that we increase the formalism because a location of control changes in the state of incorporation not only allows Delaware to pass a takeover statute affecting shareholders and firm assets located exclusively in other states, but also precludes other states, where all the shareholders and assets are physically located, from passing any regulations.

The flaw in the position is that an argument based on inconsistent state regulation does not itself conclusively determine which states should regulate which firms. Presumably we would be uncomfortable with a constitutional rule that sanctions parceling out exclusive regulatory authority over individual firms by random drawing or by the first letter in the corporate name, but either rule would eliminate inconsistent state regulations. If the elimination of inconsistent regulation is the dominant concern, one could argue that a more sensible system of regulation (than one that allocates regulatory authority to the place of incorporation) would be a system that allocates such authority based on exclusivity in shareholder or asset location. Why not locate control changes in the one state with the most resident firm shareholders or in the one state with the most firm assets? In sum, there must be more to the extraterritorial principle than the avoidance of inconsistent state regulation.

The classic answer to the extraterritorial question posed above refers, in the context of corporate codes, to the choice of the governed; firms and their shareholders

includes Delaware corporate lawyers and the Delaware treasury, but even so considered, the legislation cannot be said to discriminate against out-of-state lawyers.

Delaware, however, should not escape so easily. By virtue of its statute, Delaware is, in effect, a stand-in or an agent for other state legislatures when it enacts blatantly protectionist legislation. The Delaware legislature, instead of the Indiana legislature, is doing explicitly what Indiana should itself not be able to do—that is, protecting Indiana managers from out-of-state competitors in the control market for firms with their headquarters in Indiana. By virtue of the expediency of incorporating in Delaware, should firms enjoy the protection of potentially identical legislation? Suppose Delaware were willing to provide Indiana this "service" for a lucrative commission—incorporation fees from firms physically located in Indiana that, together with fees from firms located in other states, support the Delaware state treasury and the local bar. In theory, can Delaware maximize its revenues by passing a statute that effects discrimination on behalf of local firms in other states? Or can one argue that Delaware, as a de facto agent of Indiana, should not be able to do what Indiana itself cannot do, that is, favor local managers in the competition for control of firms located in Indiana?[232]

Also troubling is the thought that Delaware can provide firms located in Indiana with a service that the Indiana legislature may have refused to provide. As an example, assume that firms incorporated in Indiana with local facilities and local ownership ask the Indiana legislature to enact takeover legislation to protect local managers, employees, and taxing districts at the expense of the Indiana shareholders. Assume further that the Indiana legislature declines,

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could have chosen to be governed by the laws of another state, the state with the most shareholders, for example, but they did not do so. They chose to be governed by the law of Delaware instead and we respect their choice. This suggests a second criterion that has bearing on extraterritoriality: Among possible systems of non-conflicting state regulation over firms, we tend to respect the choice of the participants as long as all substantial players have an adequate voice. If all the substantial players are local and can participate in the political process, then adequate voice may perhaps be presumed, but the inquiry is more problematic when the substantial players are all located outside a state's boundaries, as they are with Delaware corporations. Once the analysis turns to the question of whether the legislation is legitimate in light of all the parties, the inquiry reverts to an analysis very similar to the one in the text: is the legislature furthering shareholder interests?

232. The argument does not apply to all corporation code provisions, but only those provisions that would be unconstitutional as illegal discrimination *if* promulgated by states in which firms are physically located.

favoring instead the interests of shareholders or deciding to enact a milder law than the firms requested. As a result, assume that the Indiana firms reincorporate in Delaware and the Delaware legislature provides takeover legislation protecting the local Indiana interests, the very interests that the Indiana legislature had itself refused to provide. This scenario is far from fictitious. California, for example, having recognized the futility of adopting its own takeover statute when most firms located in California are incorporated in Delaware, may take the extraordinary step of asking Congress to preempt all state legislation in the area and set minimum standards at the federal level.[233]

In sum, because the Indiana statute escaped careful analysis by the Supreme Court on the discrimination issue, the Delaware statute will probably escape on similar reasoning. Yet even if the protectionist effect of the Indiana statute had been more thoroughly plumbed, it can be legitimately maintained that the Delaware statute would survive nonetheless because of Delaware's unique position as the shell-home of our major corporations. I, however, lean towards rejecting this position as well. In any event, the Delaware statute reveals one of the problems that results from remolding the dormant commerce clause into a test that rests exclusively on a finding of protectionism. If the traditional commerce clause test, which looks generally for negative effects on interstate commerce, still has life, the Delaware statute is constitutional only if it furthers a legitimate state interest.[234] Inevitably, then, we must come to the second part of the commerce clause test, an assessment of the state interest embodied in the statute.

c. *The Court Probably Will Find (But Ought Not to Find) That the Delaware Statute Serves a Legitimate State Interest*

Traditionally, Delaware's primary interest in creating and amending its corporate code has been to establish a set of basic

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233. A bipartisan California Senate commission is urging state legislators to pass a resolution urging Congress to enact legislation that sets minimum corporate governance standards. *See California Legislature Asked to Back Preemption of State Takeover Statutes*, 20 Sec. Reg. & L. Rep. (BNA) 78 (Jan. 15, 1988). The commission shelved proposed takeover legislation designed to increase California's surveillance and control over takeovers because it would have been "rendered ineffective by less stringent Delaware law [regulating target board of director behavior]". *Id.* Some of the recommendations flavor the commission's position on takeovers. It recommends, among other things, that Congress pass a requirement that shareholders must approve all poison pills and that poison pills expire in three years, unless the shareholders reapprove the pill or pass a limitation on supermajority rules. *Id.*

234. *See RP Acquisition Corp.*, 686 F. Supp. at 488.

structural rules for its firms with which the participants are most comfortable—that is, a set of rules that the participants themselves would have negotiated had not the cost of such a large-scale negotiation been prohibitive.[235] The Delaware legislature, however, for many of the same reasons that make a private negotiation prohibitive, is more accessible to firm managers than to firm shareholders and other nonshareholder constituencies. Fortunately, most aspects of the Delaware corporate code present no substantial problems in this regard. For the most part, it is in the joint interests of the firm's managers and shareholders to adopt basic structural provisions that maximize firm value. But when conflicts between managers and shareholders arise, as in the case of provisions establishing methods of executive compensation or of provisions establishing methods of executing contracts between managers in their personal capacity and the firm, we are less comfortable if it appears that firm managers have the upper hand in dealing with the Delaware legislature. Yet even in these matters, managers' interests in their professional reputations, and their interests in firm earnings and share prices (through compensatory bonus and option programs), provide some restraint on the degree to which managers will push for lopsided legislation. On the other hand, the efficacy of mechanisms for ousting managers when they have significantly diminished firm value by their poor or corrupt performance will inherently split managers and shareholders into separate interest groups.[236] Effective policing mechanisms will have substantial value to shareholders and are unlikely to be received enthusiastically by managers.[237] To the extent that managers have

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235. The Governor of Delaware, Michael N. Castle, made the following remark, among others, when he signed the new act:

> Delaware is not the home of a majority of the nation's major corporations by accident. Our corporate law has been and continues to be the best; the lawyers in corporate practice are outstanding; and the Court of Chancery has an incomparable record for fairness and consistency. Delaware takes its responsibility seriously . . . .

Statement by Governor Michael N. Castle Regarding House Substitute 1 for House Bill 396, signed February 2, 1988, *reprinted in* SMITH & FURLOW, *supra* note 17, at 339. It is interesting that he omitted any reference to the Delaware Supreme Court.

236. *See generally* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 16 (1986) (discussing the separate interests of shareholders and managers).

237. Professor Michael Jensen sums the problem up as follows:

> [C]onsider the simple situation in which a principal (stockholder) hires an agent (managers and board of directors) to take some actions on his or her behalf . . . . The principal may want to delegate a wide range of

more influence with the Delaware legislature, one would expect managers to limit the efficacy of the more powerful policing mechanisms.

One of the most powerful policing devices is the threat of a hostile acquisition.[238] Any effort by managers to derail this threat through legislation ought to be viewed with healthy suspicion. Unless the Delaware legislature can show that it is not sacrificing shareholder interests in passing the statute, the statute ought to be struck down as unconstitutional. If the statute is not struck down, managers will have profited from the poor representation of shareholder interests in the Delaware legislature. The statute's burden on interstate commerce ought not to be justified on the grounds that it lines the pockets of a discrete group that has substantial advantages in accessing the Delaware legislature.[239] Rather, it must be clear that the Delaware legislature intended to pass legislation in the shareholder's best interest and that there is a supportable basis in fact for the legislation actually doing what the legislature intended it to do.[240] The key to the statute's constitutionality, then, ought to be whether the statute is intended to serve, and does, arguably, in fact serve the interests of the shareholders of Delaware corporations. The *CTS* opinion can be read without strain as consistent with this approach.

> decision rights to the agent. In no event, however, will it be sensible for the principal to delegate the ultimate control rights to the agent: the rights to hire, fire, and set the compensation of the agent. . . . If the principle were to delegate the control rights . . .the agent would become the effective owner of the decision rights (although he probably could not alienate them) and could be expected to use them in his own interests.

Jensen, *supra* note 79, at 42.

238. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173 (1981) (asserting tender offers are a method of monitoring the work of management teams).

239. *See* TRIBE, *supra* note 206, at 408-13 (discussing the theme of political representation that often underlies commerce clause analysis). *Cf.* J. ELY, DEMOCRACY AND DISTRUST 73 (1980) (discussing effect of interpretivist approach of constitutional analysis).

240. The major difficulty with an approach based solely on the intent of the legislature is that it does not address the effect of the legislation. *See* Regan, *Making Sense*, *supra* note 206, at 1152, 1160. The difficulty in the approach is best illustrated by example. Assuming that the Delaware legislature had the interests of shareholders in mind when it passed the statute, suppose that the evidence illustrates unequivocally that share prices declined substantially as the result of the passage of the legislation—in other words, the legislature was mistaken on the impact of the statute. Does the failure of the legislature to rescind the statute make the statute, though originally constitutional, now invalid; or is a statute, once constitutional at origin, always constitutional?

There is some question, however, concerning just how specifically the language which approves the Indiana statute in *CTS* should be read. The Court's language can be read on two levels: First, that the Indiana statute is one of several plausible attempts to protect shareholders or, second, that the Indiana statute provides the only legitimate form of protection short of giving special voting rights to noninterested shareholders. The first reading seems to be the more plausible; the Court appears more concerned with the right of states to allocate power within chartered corporations than with specifically how the power ought to be distributed. If so, the Delaware statute again appears to be on solid ground.

If, however, the Supreme Court is more sensitive to the problem of unequal access of the managers and the shareholders to the Delaware lawmakers, then the Court may want to police the allocation of power between the two groups in state takeover regulation. Indeed, I hope, but do not expect, that this would be the case. If so, the Delaware statute would seem to be on thinner ice than the Indiana statute, mainly because shareholder voting is less important under the Delaware statute than under the Indiana statute.

Under the Indiana statute, shareholders can opt out of the statute by charter amendment before a control share acquisition occurs. After a control share acquisition has occurred or is pending, the acquisition can be approved by a majority vote of preexisting shareholders (excluding shares held by officers, inside directors, and the acquiror).[241] While one can argue that the vote to opt out, which can only be initiated by the target board, is heavily influenced by the target board through its control of the firm proxy machinery, it is also true that after a control share acquisition occurs, the Indiana statute makes shareholder participation mandatory.[242]

On the other hand, shareholder voting is secondary in the Delaware statute. The statute vests primary control of the process in the target board, which has the power to waive the moratorium.[243] Bidders who cannot wait three years to effect a back-end merger are not likely to bypass board disapproval, and depend instead on the act's supermajority provision, which provides that two-thirds of the disinterested shareholders can also approve a back-end merger.[244]

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241. IND. CODE § 23-1-42-5 (Supp. 1986).
242. *Id.* § 23-1-42-9.
243. DEL. CODE ANN. tit. 8, § 203(a)(1) (1988).
244. *Id.* § 203(a)(3). The vote also depends on board approval.

Most tender offers will be conditioned on a board waiver, not a shareholder vote: if the board grants a waiver, the vote is unnecessary; if the board refuses, it is a foregone conclusion that they will also refuse to send the matter to the shareholders for their approval. In sum, the method of forcing a shareholder vote under the Delaware statute is substantially different from the Indiana procedure in that it requires a bidder to make a large initial acquisition and take a substantial risk before the shareholder vote.[245] An acquiror must buy enough stock to control the board of directors and cause the board to submit to all disinterested shareholders a proposal to allow a merger.[246]

Indeed, it may be disingenuous for Delaware to argue otherwise. Delaware's first circulated proposal for takeover legislation, in June of 1987, was a control share acquisition statute.[247] The proposal received heavy criticism from those convinced that the Indiana statute was an ineffective check on leveraged acquisitions, and those responsible for drafting the statute conceded to this claim.[248]

Their charge against the Indiana statute has two parts. First, the statute takes control of a target's defense away from target managers and vests it in target shareholders because acquirors can force a shareholder vote.[249] By conditioning any tender offer on a favorable vote which may be fifty days away, the bidder need not have financing in place or even be seriously committed to the acquisition—he may just want to publicize the company's availability for sale. Second, the shareholder vote, when taken, will always favor the bidder. After the announcement of a potential acquisition, arbitrageurs will, it is argued, acquire shares (either before the record date or, if after the record date, with proxies attached) and, along with institutional investors, vote for a short-term profit.[250] In sum,

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245. I am assuming, of course, that under the Indiana statute, shareholders are facing an offer contingent on their approval.

246. The shareholders can, on their own, initiate a vote to amend the firm's bylaws to opt-out of the section, but this does not help any potential bidder who is known at the time of the vote. *Id.* § 203(b)(3).

247. *See* Sontag, *supra* note 51, at 19-20.

248. Black, *supra* note 17, at 18, col. 3 (Mr. Lewis Black is a member of the Council of the Corporation Law Section of the Delaware Bar Association, the body primarily responsible for drafting Delaware business law).

249. *Id.*

250. Invoking the play of arbitrageurs is a smokescreen and overlooks the point that shareholders who sell to arbitrageurs would themselves have decided to favor the offer—that is, they would have voted for the bid had they held their shares.

the statute may *help* put a firm in play.[251] In any event, we can only speculate on whether the Court will demand that shareholder participation be part of any constitutional statute and, if so, whether the Court will be satisfied with the possibility under the Delaware statute that shareholders can vote to effect a waiver of the moratorium.

C. *The Supremacy Clause*

Under the *CTS* opinion, the constitutionality of the statute under the commerce clause and the issue of preemption by the Williams Act appear to merge to a substantial degree. Both standards are met by a persuasive argument based on target shareholder welfare. Although the basic preemption question is distinguishable—does the

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251. *See* GILSON, *supra* note 147, at 194-98.

The Indiana statute may not be as porous as its detractors claim. It does contain two significant restraints: First, the additional thirty day delay (the Williams Act requires that cash tender offers remain open for only 20 days) gives target managers more time to take defensive action, including fighting a proxy contest, the adoption of poison pill plans, mounting share repurchase programs or management buyouts, and finding a more suitable bidder, i.e., a white knight. *See* Bartlett, *Beware of State Takeover Laws*, FORTUNE, Nov. 9, 1987, at 179.

> The trouble is what will happen in those 50 days: Both sides will wage a vigorous proxy fight, and the history of proxy contests shows that they promote enormous amounts of litigation . . . . Tender offers will remain open not for 50 days, but perhaps 150 . . . . Arbs want deals concluded quickly; the longer one continues, the lower the rate of return on the funds they have committed. Moreover, the potential targets, at least the foresighted ones, will tuck away stock in friendly hands . . . . The mandated vote by disinterested shareholders could . . . enhance the power of the old-boy network.

Id. at 179, 182. *See also Corporate Raiders Predict Hard Times for Hostile Bids: High Court Decision on Indiana Law May Have "Killed" Their Game*, Wall St. J., Apr. 23, 1987, at 6, col. 1; *Justices Uphold States' Curbs on Takeovers*, Wall St. J., Apr. 22, 1987, at 2, col. 2; *Institutions Assail Top Court's Decision on Takeovers as Costly for Shareholders*, Wall St. J., Apr. 24, 1987, at 41, col. 1. Second, the Indiana statute gives appraisal rights to shareholders who vote "no" and subsequently lose. These rights entitle them to the highest price paid per share by the acquiror. This sets up a back-end dilemma, reducing the incentive of shareholders to vote in favor of the acquisition. If the acquiror has already bought its control shares, a residual shareholder would vote "no," hoping that others vote "yes" thereby allowing him, through his appraisal rights, to claim a premium for his shares. If the acquiror has not bought his control shares but is tendering contingent on a favorable vote, and the tender offer is not an any-and-all offer, then a shareholder again would vote "no," hoping others would vote "yes," thus guaranteeing himself the full tender offer price (which might be less if he tenders and the offer is over subscribed and he receives only a pro rata share of the premium). Thus the appraisal rights discourage two-tier offers and favor any-and-all tender offers. *See* Booth, *supra* note 45, (fuller discussion of Indiana statute).

state regulation frustrate the purposes of, or conflict with, federal legislation[252]—in the context of takeover legislation, the Supreme Court appears to have held that states can, consistent with the Williams Act, protect shareholder welfare in takeovers. In *CTS*, for example, the Court used, in large part, the same basic analysis of the effect of the Indiana statute on shareholder welfare under its commerce clause analysis as it did under its preemption analysis.[253] In sum, an argument based on benefits to target shareholders, if accepted, seems, at present, to surmount both constitutional challenges.[254] Of course, Congress could choose to amend the Williams

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252. Congress expressly gave states the power to regulate tender offers in §28 (a) of the Securities and Exchange Act of 1934, 15 U.S.C. §78bb(a) (1982), as long as the state legislation does "not conflict with" the Williams Act or any SEC regulations promulgated thereunder. *See CTS*, 107 S. Ct. at 1653 (Scalia, J., concurring); *MITE*, 457 U.S. at 630-32 (plurality opinion of White, J.). The only part of the analysis unique to the preemption argument is the Court's analysis of the effect of the Indiana statute's time requirements on the time requirements of the Williams Act.

The Delaware statute, which deals exclusively with back-end mergers, should have less of a problem than the Indiana statute in this regard, which imposes time requirements on the front-end acquisition (which may be a tender offer). The SEC, in an amicus curiae brief on the New York business combination act before a United States District Court for the Southern District of New York, recognizes that a bidder can comply with the Williams Act and a state statute that affects only back-end mergers. *See SEC Says New York Takeover Law Violates Commerce, Supremacy Clauses*, 20 Sec. Reg. & L. Rep. (BNA) 379 (Mar. 11, 1988).

The SEC argues, however, that the New York statute "frustrates the purpose" of the Williams Act and ought to be preempted, and has taken the same position on the Delaware statute. *See Delaware Takeover Law is Unconstitutional, SEC Says*, 20 Sec. Reg. & L. Rep. 638 (Apr. 29, 1988). *See also* Brief of the Securities and Exchange Commission, Amicus Curiae, at 22, RP Acquisition Corp. v. Staley Continental, Inc., 476 F. Supp. 686 (D. Del. 1988) (No. 88-190).

The SEC argument on frustration of purpose has two parts: first, that *any* rebalancing of rights in tender offers frustrates the careful balance established by the Williams Act; and second, that the state statutes take too much power away from target shareholders, frustrating the central purpose of the Williams Act. The first argument has been rejected in *CTS* (the SEC simply refuses to give it up), and the second argument, in the author's view, is also applicable to a commerce clause analysis and is therefore dealt with in the text under that section, although the author recognizes, as noted in the text, that the arguments may be distinguishable.

253. *Compare CTS*, 107 S. Ct at 1645 *with id.* at 1649-52.

254. An illustration of the parallelism in the arguments comes from Batus, Inc. v. McKay, 684 F. Supp. 637 (D. Nev. 1988). The Nevada District Court declared the Nevada Takeover Act unconstitutional becaue it put an absolute 60 day limit on tender offers. Noting that it was possible to comply technically with both the Williams Act and the Nevada statute, the court held that the limitation eroded the balance of the Williams Act "without any apparent benefit to the

Act and break the parallel constructions. At present, then, it appears that the argument in the prior section on shareholder welfare applies here as well. There are, however, two possible constructions of *CTS* that separate the merits of commerce clause arguments from the merits of a preemption argument. Both would make the preemption test the tougher of the two.

First, the courts interpreting *CTS* could decide that, under the commerce clause, states have the power to regulate allocations of power among corporate participants, and that the courts should not step in to readjust the imbalance. Since the Williams Act does attempt to protect target shareholders to some degree, the courts could find those statutes that severely harm target shareholders by favoring other corporate constituencies, although constitutional under the commerce clause, are preempted by the Williams Act. In other words, while the commerce clause defers to the balancing of rights by states in a takeover, the Williams Act creates a specific balance that cannot be upset by state statutes. I do not, however, believe that courts have such a narrow view of the purposes of the commerce clause. The analysis earlier in the text on the poor access of shareholders to the state legislatures should and will weigh heavily in a commerce clause analysis.

Second, courts interpreting *CTS* could conclude that states, under the commerce clause, can justify legislation only as *some form* of protection for target shareholders and that the Williams Act proscribes only *one* method of protection (target shareholder autonomy) that could be frustrated by states enacting *other* methods of protection (target management control). The SEC seems intent on pushing this theory.[255] Whether the differences in shareholder participation between the Indiana statute and the Delaware statute have constitutional significance will depend on how literally one reads the language in *CTS* in its preemption analysis. The court could be said to have established a four-part test with each part being of equal importance, or a single test, with the use of particularized but nonexclusive reasoning in applying the test to the Indiana statute.

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shareholder." *Id.* at 640. The court continued, "While the effect on interstate commerce is great the court perceives no substantial state interest to be protected by preserving the sixty-day limitation." *Id.* The court therefore concluded that the 60-day period which did not protect resident shareholders, violated the commerce clause. *Id.*

255. *See supra* note 252 and accompanying text.

If one favors reading language in the opinion as estabishing a four-part test, a plausible interpretation of the *CTS* decision requires that state statutes: (1) protect independent shareholders "from the coercive aspects of some tender offers";[256] (2) by allowing "shareholders to evaluate the fairness of the offer collectively,"[257] (which means, at minimum, that the statute "[should not] allow the state government to interpose its views of fairness between willing buyers and sellers of shares of the target company"),[258] but in so doing the statute must not (3) "give either management or the offeror an advantage in communicating with the shareholders about the impending offer";[259] or (4) impose "unreasonable delay" upon the offeror.[260] The Delaware statute does not meet, at a literal level, criterion two or three because it is designed to have target boards act on behalf of shareholders rather than to establish a shareholder voting mechanism for approving tender offers. Indeed, one can argue, under the second criterion, that empowering managers to evaluate the fairness of an offer is very similar to empowering state officials to evaluate the fairness of the offer, since both groups have interests that conflict with the interests of shareholders.[261] Accordingly, any statute that relies on managers to protect shareholders from coercive tender offers is more akin to the invalid Illinois legislation than the valid Indiana legislation.

If, on the other hand, one reads the first criterion noted above—protecting shareholders from coercive tender offers—as the sole test, and the later language as representing discussion of why the particular statute at issue in the case (the Indiana statute) satisfied the basic test, then there is room for arguing that the Delaware statute meets the requirements of the case. Delaware need only justify its statute as another legitimate approach to the shareholder collective action problem. As noted earlier, this justification will depend on the argument that target managers, acting as negotiating agents for the shareholders as a group, are an effective solution in that they unify

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256. *CTS*, 107 S. Ct. at 1646.
257. *Id.*
258. *Id.*
259. *Id.*
260. *Id.* at 1647 (citing *MITE*, 457 U.S. at 639).
261. The Wisconsin District Court in *RTE* held that the Wisconsin business combination act was preempted on this ground. *See supra* note 202. "The Wisconsin law, by vesting existing management with the power to block a tender offer, frustrates the purpose of the Williams Act which is to ensure investor choice with respect to the acceptance of tender offers." *RTE*, No. 88-C-378, slip op. at 8.

the shareholder response to potentially coercive tender offers.[262] As also noted earlier, the role of section 203 in takeovers may well depend on whether the Delaware courts will police against self-serving behavior by target managers purporting to act on behalf of shareholders. Ultimately the constitutionality of the Delaware statute may depend on the role played by the Delaware Supreme Court.

V. CONCLUSION

Financial economists are adamant: Structural blocks to hostile takeovers more often than not reduce the share value of potential targets and entrench incumbent management.[263] They are especially suspicious of those devices that are put in place without shareholder ratification—poison pill plans, discriminatory repurchase programs, and most state antitakeover legislation. It would be a simple matter for Delaware to require shareholder ratification of section 203; the legislature could replace the opt-out provisions with opt-in provisions as a few states have done. But even shareholder ratification of takeover defenses has led to share price declines.[264] In sum, those who support takeover defenses in the name of shareholder welfare have a heavy burden of proof. Theoretically, the shareholders' collective action problem in responding to takeovers justifies some form of protection,

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262. Both of the District of Delaware decisions which have ruled on the constitutionality of the new Delaware statute have held that the SEC's narrow view of preemption by the Williams Act is not sound. BNS v. Koppers, 683 F. Supp. 458 (D. Del. 1988); RP Acquisition Corp. v. Staley Continental, Inc., 476 F. Supp. 686 (D. Del. 1988). Nevertheless, the *BNS* court refused to go to the opposite pole when it rejected Delaware's contention that any advantage given to management in the name of shareholder protection was in accordance with the Williams Act. *BNS*, 683 F. Supp. at 468. Instead, the court interpreted *CTS* as permitting incidental pro-management measures undertaken to benefit shareholders "so long as it does not prevent an appreciable number of hostile bidders from navigating the statutory exceptions." *Id.* at 470. As a result, the *BNS* court was unable to "*on this record* find that the advantage [given incumbent management] outweighs the benefits conferred on shareholders." *Id.* (emphasis added). Similarly, the *RP Acquisition Corp.* court applied the *BNS* rationale and found that "hostile tender offers retain a meaningful opportunity for success under the 85% exception." RP Acquisition Corp. v. Staley Continental, Inc., 476 F. Supp. 686 (D. Del. 1988).

263. *See* Jensen & Warner, *The Distribution of Power Among Corporate Managers, Shareholders, and Directors*, 205 FIN. ECON. 3, 9-11, 15-16 (1988) (discussing various papers presented at a conference held at the University of Rochester on May 28-30, 1987).

264. *Id.* at 11 (discussing anti-takeover amendments to corporate charter); *id.* at 10 (discussing dual-class stock reorganizations).

but too often this need is a public pretext for pandering to management self-interest. The Delaware statute is another case in point.