

NOTES

FEDERAL LIMITATIONS ON TARGET DEFENSIVE TACTICS: APPLYING *EDGAR v. MITE CORP.* TO THE "PRIVATE CONDUCT" OF TARGET DIRECTORS

Delaware's takeover statute¹ stands in stark contrast to the takeover legislation invalidated in *Edgar v. MITE Corp.*² and the "second generation" statutes enacted in its wake.³ The Delaware statute only modestly regulates the takeover process, and avoids many of the provisions struck down in *MITE*. Delaware, moreover, has resisted the trend toward enacting strong legislation to protect local businesses from takeover threats.⁴ Nevertheless, neither Delaware's nor its corporations' interests remain unprotected in corporate control contests.

Sanctioned under Delaware law target defensive tactics⁵ provide corporate management with ample means to repel most hostile takeover bids.⁶ In takeover contests, the interests of target management and the

1. DEL. CODE ANN. tit. 8, § 203 (1983). The Delaware statute requires a bidder to deliver to the target corporation a written statement of its intention to make an offer and other information twenty to sixty days prior to making the offer. *Id.* at § 203(a)(1). The statute prescribes a minimum offering period of twenty days, during which bidders must extend shareholders withdrawal and pro rata rights. *Id.* at §§ 203(a)(2) & (3). Competing bidders may commence bids simultaneously with the original bidder, even though they file notice within twenty days before the original bid commences. *Id.* at § 203(b)(1). Moreover, once the original bidder commences its offer, subsequent bidders may stipulate shorter offering periods to end concurrently with the original bid. *Id.* at § 203(b)(2).

2. 457 U.S. 624 (1982). In *MITE*, the Supreme Court invalidated the Illinois Business Takeover Act on commerce clause grounds. *See infra* notes 15-18 and accompanying text.

3. *See infra* notes 19-22 and accompanying text. "Second generation" refers to post-*MITE* legislation designed to remedy perceived constitutional defects the decision exposed.

4. Despite the fact that two federal district courts declared the statute unconstitutional, Delaware declined to revise its legislation. *See Burlington N., Inc. v. The El Paso Co.*, No. 82-818 (D. Del. December 28, 1982); *Dart Indus., Inc. v. Conrad*, 462 F. Supp. 1 (S.D. Ind. 1978). Since *MITE*, the states have adopted several different forms of takeover regulation. *See generally* Thompson, *Defining the Realms of Federal and State Regulation of Tender Offers*, *supra* p. 1057.

5. As used in this Note, "target defensive tactics" refer to statutorily authorized actions incumbent management undertakes in response to actual or anticipated takeover attempts to defeat or substantially deter these threats. *See generally* A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, & PLANNING* 113-57 (1981); M. LIPTON & E. STEINBERGER, *TAKEOVERS AND FREEZEOUTS* §§ 6.01-09 (1986).

6. *See generally infra* notes 36-53 and accompanying text.

state of incorporation tend to coincide.⁷ Many takeover statutes, in fact, grant incumbent management wide discretion to exempt takeovers from their provisions.⁸ Ultimately, however, the state retains control over target defensive tactics through shareholder suits against incumbent management.⁹ Assuring management sufficient tools to fight takeover attempts, while retaining some control over its actions, thus provides the states an alternative method of regulating takeovers. To date, this form of takeover regulation has eluded scrutiny under the principles of *Edgar v. MITE*.¹⁰

The irony of this situation apparently did not escape the plaintiffs in *Moran v. Household International Inc.*,¹¹ who challenged target defensive tactics approved under Delaware law. The plaintiffs argued that the constitutional limitations *MITE* imposes on state takeover statutes should also limit statutory authorization of target defensive tactics.¹² The Delaware Supreme Court summarily rejected plaintiff's argument, stating only that statutory authorization of private conduct does not constitute "state action" to which constitutional restrictions apply.¹³

This Note examines the constitutional issues raised in *Moran*. Part I discusses the effect of *Edgar v. MITE* on state takeover regulation. Part II discusses the analysis and effect of target defensive tactics under Delaware law. Part III then dismisses the private conduct objection the Delaware Supreme Court registered in *Moran*, and develops a rationale for applying dormant commerce clause limitations to target defensive tactics. Finally, part IV applies the constitutional analysis enunciated in *MITE* to tactics sanctioned under Delaware law. This Note concludes that target defensive tactics that effectively preclude shareholder decisions on the merits of a takeover violate these principles.

7. In fact, takeover legislation often undoubtedly results from pressure incumbent management exerts upon the state legislatures. See Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUDIES 251, 288 (1977).

8. See, e.g., IND. CODE ANN. §§ 23-1-43-18, 23-1-43-19 (West Supp. 1985); MD. CORPS & ASS'NS CODE § 3-603(c) (1985).

9. See generally *infra* notes 24-35 and accompanying text.

10. But see *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983).

11. 500 A.2d 1346 (Del. 1985).

12. *Id.* at 1353.

13. *Id.*

I. STATE TAKEOVER REGULATION AND *EDGAR V. MITE CORP.*

Concern with the threat posed to local businesses by takeover attempts prompted legislatures in several states to enact statutes regulating takeovers.¹⁴ The earliest of these statutes required pre-commencement notification and disclosures with respect to tender offers for businesses incorporated within, or having some connection with, the particular state. Some states also provided for administrative hearings into substantive aspects of tender offers. Many statutes exempted offers specifically approved by the target's board of directors.

In *Edgar v. MITE Corp.*¹⁵ the Supreme Court invalidated the Illinois Business Takeover Act, an archtypical "first generation" takeover statute, on dormant commerce clause grounds.¹⁶ Illinois sought to justify its legislation as an attempt to protect local investors and to regulate the internal affairs of Illinois corporations.¹⁷ The Court determined, however, that the statute promoted neither interest sufficiently to outweigh the substantial burdens it imposed on interstate commerce by inhibiting nationwide tender offers.¹⁸

Following *MITE*, several states reformulated their takeover statutes. To reduce the effect of their takeover regulation on interstate commerce

14. See generally Profusek & Gompf, *State Takeover Legislation After MITE: Standing Pat, Blue Sky, or Corporation Law Concepts?*, 7 CORP. L. REV. 3, 6-8 (1984); Steinbrink, *Reemergence of State Takeover Statutes*, 17 INST. ON SEC. REG. 443, 447-48 (1985).

While most states sought to protect local businesses in general, some states enacted legislation designed to thwart specific takeover attempts of corporations within the state. For example, Utah sought to block the rumored Arab takeover of Kennecott Copper Corp. See Comment, *Edgar v. Mite Corp.: Is the Preemption of State Takeover Statutes Complete*, 1983 UTAH L. REV. 415, 422-23. More recently, Missouri enacted legislation to protect Trans World Airlines, Inc. from Carl C. Icahn's takeover attempt.

15. 457 U.S. 624 (1982).

16. U.S. CONST. art. I, § 8, cl. 3, empowers Congress to regulate interstate commerce. The Court has long recognized that the commerce clause limits the states' ability to regulate certain aspects of interstate commerce. See, e.g., *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851). *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970), represents the Court's current commerce clause analysis:

Where the [state] statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will of course depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities.

Id. at 142 (citation omitted).

17. 457 U.S. at 644.

18. *Id.* at 646.

most states narrowed jurisdictional coverage of their statutes.¹⁹ Substantively, some states merely deleted provisions similar to those found objectionable in *MITE*,²⁰ but many states sought to regulate takeovers by altering corporate decision-making procedures in takeover attempts.²¹ Although formulated to protect target shareholders, these statutes, by design and effect, seek to enhance the position of incumbent management in takeover contests.²² Lower federal courts uniformly have invalidated one type of second-generation statute and the Supreme Court will soon render its decision on the issue.²³

19. Most states now apply their takeover regulation only to businesses incorporated in, and having some substantial connection with, the state. *See, e.g.*, MO. ANN. STAT. §§ 351.015(11); 351.407 (Vernon Supp. 1986); OHIO REV. CODE ANN. §§ 1701.01(Y); 1701.83.1 (Page 1985).

20. *See, e.g.*, MINN. STAT. ANN. § 80B.01 (West Supp. 1986); NEB. REV. STAT. § 21-2418 (1983). The Court of Appeals for the Eighth Circuit upheld the amended Minnesota statute. *See Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984). The Minnesota legislature eliminated pre-commencement notification and substantive review by state officials. Its statute applies only to corporations having at least 20% of their shareholders residing in Minnesota and substantial assets the state.

21. So called "control share acquisition statutes" require shareholder approval of transactions resulting in certain levels of voting power. *See, e.g.*, MINN. STAT. ANN. § 302A.671 (West Supp. 1985); MO. ANN. STAT. § 351.407 (Vernon Supp. 1986); OHIO REV. CODE ANN. §§ 1701.831-832 (Page 1985). Other states require shareholder approval only of transactions occurring after a person gains "control" of the corporation. *See, e.g.*, MD. CORPS. & ASS'NS CODE ANN. §§ 3-601-3-603, 8-301(14) (1985); MICH. STAT. ANN. §§ 21.200 (780)-(784) (Callaghan Supp. 1985); PA. STAT. ANN. tit. 15, § 1409.1(C) (Purdon Supp. 1985). A new "third generation" statute limits the voting power of shares held in excess of twenty percent of a corporation's outstanding shares. WIS. STAT. ANN. § 180.25 (West Supp. 1986).

In addition to requiring a shareholder vote for such transactions, several states require the bidder to wait five years before consummating such a transaction. *See, e.g.*, IND. CODE ANN. § 23-1-43 (Burns 1986); N.Y. BUS. CORP. LAW § 912 (McKinney 1986).

Some states also extend appraisal remedies to shareholders dissenting from "control" transactions. *See, e.g.*, PA. STAT. ANN. tit. 15, § 1910 (Purdon Supp. 1985). Most state corporation statutes provide appraisal remedies to dissenting shareholders in mergers. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (1983); REV. MODEL BUS. CORP. ACT § 13.02(a)(1) (1984).

22. This is done in two steps. First, the statutes establish such stringent restrictions that a proposed tender offer becomes too expensive or risky to the offeror. *See supra* note 21. Then, the statutes provide exemptions for transactions approved by target directors. All statutes exempt transactions pursuant to the merger provisions of the state's corporation statute. *See, e.g.*, IND. CODE ANN. §§ 23-1-43-18, 23-1-43-19 (West Supp. 1985); MD. CORPS & ASS'NS CODE § 3-603(c) (1985). Some states also permit the target corporation's incumbent directors to exclude transactions from the statutory requirements. *See, e.g.*, N.Y. BUS. CORP. LAW § 912(c)(1) (McKinney 1986).

23. *See Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986); *Fleet Aerospace Corp. v. Holderman*, 796 F.2d 135 (6th Cir.), *aff'g*, 637 F. Supp. 742 (S.D. Ohio 1986); *Terry v. Yamashita*, 643 F. Supp. 161 (D. Haw. 1986); *APL Limited Partnership v. Van Dusen Air Inc.*, 622 F. Supp. 1216 (D. Minn. 1985); *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985). Each of these cases involved control share acquisition statutes.

II. CORPORATE TAKEOVERS AND THE DELAWARE BUSINESS JUDGMENT RULE

Takeover attempts implicate a fundamental issue of corporate governance—the distribution of power between the owners and managers of corporations. By allowing shareholders to oust corporate management through extra-corporate procedures, tender offers represent shareholders' most effective method of combating ineffective management.²⁴ Target defensive tactics, however, often enable incumbent management to prevent the shareholders from considering a takeover bid altogether.²⁵ Thus, the rules governing target defensive tactics play a critical role in regulating takeovers.

State corporation law empowers the board of directors to manage the corporation's "business and affairs,"²⁶ and imposes upon directors a duty to act in shareholders' best interests.²⁷ When shareholders challenge "disinterested" board decisions, the courts employ the business judgment rule to determine director liability.²⁸ Although takeover contests create conflicts of interest between corporate directors and shareholders,²⁹ the courts nevertheless evaluate target defensive tactics under the business judgment rule.³⁰

24. See generally Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5-7 (1978).

25. See, e.g., *infra* text accompanying notes 36-51.

26. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1983); REV. MODEL BUS. CORP. ACT § 8.01(b) (1984).

27. See, e.g., *Guth v. Loft*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).

28. Although often expressed in terms of deferring to the board's judgment, the business judgment rule actually represents the applicable standard of care for corporate directors: if the directors exercise appropriate care in reaching a decision, the court will uphold the directors' decision. See Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

29. Takeovers, particularly in the form of tender offers, permit shareholders to sell their shares at a substantial premium over the existing market price. Often, however, successful bidders replace management and directors. Indeed, many bidders expect to gain only by replacing ineffective management. See generally Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1168-74 (1981).

30. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). For critical evaluations of the development of the business judgment rule applications to target defensive tactics, see Chernoff & Raymond, *Hostile Takeovers and the Ever-Narrowing (Expanding) Business Judgment Rule*, 17 INST. ON SEC. REG. 41 (1985); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 813 (1981); Goelzer, Walter, Cohen, Brown & Lopez, *Recent Developments in Battles for Corporate Control: The Business Judgment Rule, and Exchange Act Section 14(e)*, 17 INST. ON SEC. REG. 11 (1985); Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980 (1982).

Recently, the Delaware Supreme Court, beginning with *Unocal Corp. v. Mesa Petroleum Co.*,³¹ examined the proper application of the business judgment rule in the takeover context. When confronted with a takeover bid, the target board of directors must reasonably and in good faith investigate the offer.³² If it determines that the bid threatens the corporation's best interests, the board has the power and the duty to oppose the offer.³³ However, it may adopt only those measures "reasonable in relation to the threat posed."³⁴ In assessing the threat a bid poses, management may consider the interests of creditors, customers, employees, and the community.³⁵

Applying this analysis, the Delaware Supreme Court has approved several highly effective defensive tactics. In *Unocal*, the court upheld a discriminatory self-exchange offer Unocal employed to defeat Mesa Petroleum's takeover bid. Characterizing Mesa's bid "as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail,"³⁶ Unocal mounted an exchange offer for roughly half of its own outstanding stock.³⁷ The offer excluded Mesa-held shares. This exclusionary provision effectively increased by one-third the cost of Mesa's

31. 493 A.2d 946 (Del. 1985); see also *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

32. *Unocal*, 493 A.2d at 954. The court recognized that "an enhanced duty" arises from "the omnipresent specter" that directors may act in their own interests. *Id.* Thus, the board must show "reasonable grounds for believing a danger to corporate policy and effectiveness existed because of another person's stock ownership." *Id.* at 955. A good faith and reasonable investigation, however, satisfies this burden. *Id.* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), establishes a "gross negligence" standard of care with respect to the board's investigation.

33. The *Unocal* court acknowledged that directors have no power to act "solely or primarily out of a desire to perpetuate themselves in office." 493 A.2d at 955. This statement represents a traditional restriction on target defensive tactics. See *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964) and cases cited therein; cf. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir. 1981) (plaintiff must show that "impermissible motives predominated" the board's decision). The *Unocal* court maintained, however, that requiring "good faith and reasonable investigation" ensures that directors act "for the welfare of the corporation and its shareholders." 493 A.2d at 955.

34. *Unocal*, 493 A.2d at 955.

35. *Id.* at 955-56; compare PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1985). In *Revlon*, the Delaware Supreme Court held that even though the directors may legitimately consider these constituencies, "some rationally related benefit" must accrue to the shareholders. 506 A.2d at 176.

36. *Unocal*, 493 A.2d at 956. "Two-tiered tender offer" refers to two step acquisition technique. In this case, Mesa initiated a cash tender offer for 37% of Unocal's publicly held stock at \$54 per share. It simultaneously proposed to exchange debt for the remaining outstanding shares after it completed the first step transaction, a transaction purportedly valued at \$54 per share. *Id.* at 949.

"Greenmail" represents the premium the target pays in repurchasing the shares held by an insurgent or potential bidder.

37. *Id.* at 951.

proposed second step transaction, dooming Mesa's bid and preventing any further takeover attempts.³⁸ The court nevertheless found Unocal's actions as reasonable in relation to the threat Mesa posed.³⁹

In *Moran v. Household International, Inc.*,⁴⁰ the court upheld an extraordinarily potent "poison pill" defense.⁴¹ Household's board authorized a plan under which the announcement of a tender offer for thirty percent, or acquisition of twenty percent, of its outstanding stock triggered the issuance of rights to purchase a new class of stock.⁴² If unexercised when the acquiring company completed a second step transaction, the right entitled its holder to purchase the acquiror's common stock at a fifty percent reduction.⁴³ By design and effect, this "flip-over" provision precluded two-tiered offers involving substantial second step transactions.⁴⁴ Appearing *amicus curiae* the SEC argued that the plan deterred virtually all hostile takeover attempts.⁴⁵ The court, however, found the

38. Unocal valued the debt it offered at \$72 per share. *Id.* Because Mesa proposed to exchange debt valued at \$54 per share for a similar number of shares, Unocal's offer effectively increased the cost of Mesa's proposed second tier by \$18 per share, or 33%. Mesa dropped its takeover bid for Unocal. But Unocal's actions had a more permanent effect with respect to other possible attempts. Goldman Sachs & Co. estimated that the "minimum liquidation value" of Unocal stock at \$60 per share. *Id.* at 950. Assuming this represents a rough estimate of the company's market value, no bidder would be willing to pay more than an average of \$60 per share. Thus, unless Unocal accepted offers below \$42 per share for the 51% of its still outstanding stock, no further bidding would occur.

39. The court identified two sources empowering the board to deal selectively with corporate shareholders: (1) the statutory powers conferred in DEL. CODE ANN. tit. 8, §§ 141(a) (placing corporate business and affairs under the board's direction) & 160(a) (permitting a corporation to deal in its own stock); and (2) the board's "fundamental duty and obligation to protect the corporate enterprise . . . from harm reasonably perceived, irrespective of its source." 493 A.2d at 953-54.

40. 500 A.2d 1346 (Del. 1985).

41. The "poison pill" defense contemplates issuing preferred stock to holders of common stock as a special dividend. When an outsider acquires a certain percentage ("control") of the company's outstanding stock, the share entitles its holder to redeem it for cash equal to the highest price paid for common shares necessary to obtain "control." See Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1964-65 (1984).

42. 500 A.2d at 1348-49. The rights became immediately exercisable to purchase 1/100 share of preferred stock for \$100, but Household retained the option to redeem for \$0.50 per right, the rights triggered by a tender offer announcement.

43. *Id.* at 1349.

44. See *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch. 1985).

45. See Brief of the Securities and Exchange Commission, *Amicus Curiae, Moran v. Household Int'l, Inc.*, at 12 [hereinafter cited as SEC *Amicus Brief*]. The SEC first noted that most bidders ultimately seek full control of targets. *Id.* at 18. Even in any-and-all tender offers, bidders must employ second step transactions to achieve that control, because such offers only rarely result in acquisition of more than 80%. *Id.* at 20. But Household's plan precluded such transactions. Thus, the SEC concluded, the plan completely entrenched Household management contrary to shareholders' best interests. *Id.* at 18.

plan "reasonable in relation to the threat posed."⁴⁶

*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁴⁷ finally confirmed the existence of limits on the use of target defensive tactics under Delaware law. To defeat an obstreperous bidder and to quiet disgruntled debtholders,⁴⁸ Revlon arranged a leveraged buy-out with Forstmann, Little & Co. In return, Forstmann demanded a lock-up option⁴⁹ and an agreement preventing Revlon from considering any further bids. The court enjoined this arrangement, holding that management may not use a lock-up to end an active bidding contest,⁵⁰ at least when a desire to protect themselves from litigation partially motivates the directors.⁵¹

Notwithstanding the apparent limits *Revlon* imposes on target defensive tactics, the business judgment rule analysis developed in *Unocal* preserves a central role for incumbent management in hostile takeover

46. 500 A.2d at 1357 & n.14. The court first found that the plan did not foreclose all possibility of hostile takeovers. According to the court, bidders' options "rang[ed] from tendering with a condition that the Board redeems the Rights, tendering with a high minimum condition of shares and Rights, and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing Household to self-tender for the Rights." *Id.* at 1354. The SEC disagreed, questioning the "untested and highly uncertain" nature of these suggestions. SEC Amicus Brief, *supra* note 45, at 21, 21-29.

The court then found statutory authorization for Household's plan in § 157 of Delaware's corporation law, which authorizes a corporation to issue rights "to purchase from the corporation any shares of its capital stock." DEL. CODE ANN. tit. 8, § 157 (1983). The court rejected plaintiffs' arguments, *inter alia*, that § 157 did not comprehend rights used as a takeover defense, 500 A.2d at 1351, or authorize rights to purchase stock in the acquiring corporation, *id.* at 1352.

47. 506 A.2d 173 (Del. 1986).

48. In response to various overtures and tender offers by Pantry Pride, Inc., Revlon initiated several defensive moves. First, it adopted a rights plan pursuant to which Revlon shareholders would receive a right entitling them to exchange their shares for notes. *Id.* at 177. Acquisition by anyone of 20% of Revlon's outstanding stock triggered the rights, unless the offeror consummated an offer at or above a certain price. *Id.* Second, Revlon consummated an exclusionary self-exchange offer. *Id.* Finally, it arranged a leveraged buy-out ("LBO") with Forstmann, Little & Co. *Id.* at 178. To effect the LBO Revlon waived restrictive covenants contained in the notes it offered in the exchange offer. This caused a drop in the market price of the notes, prompting "irate noteholders" to threaten litigation. *Id.* The second LBO arrangement with Forstmann included an agreement by Forstmann to boost the market value of the exchange offer debt. *Id.* at 178-79. The court upheld each of Revlon's first three moves. *Id.* at 180-81.

49. A "lock-up" option represents an option to purchase assets or stock at a bargain price. It usually is contingent upon failure of the option holder to complete a takeover of the target. Bidders demand these options to compensate them for the risk and expense of undertaking a takeover. In this case, Revlon gave Forstmann an option to purchase two Revlon divisions when any other person acquired 40% of Revlon's shares. *Id.* at 178.

50. To enhance its legal position in this case, Pantry Pride announced another bid topping by \$0.75 per share the price negotiated between Revlon and Forstmann, and also offered to support the deflated notes. *Id.* at 179.

51. *Id.* at 184.

attempts. The *Unocal* analysis affords management considerable latitude to determine which bids are "in the best interests of the corporation," and expands the "interests" relevant to that decision.⁵² Moreover, it provides management with highly effective tools to enforce that determination.⁵³

III. MORAN'S "STATE ACTION" OBJECTION

In *Edgar v. MITE Corp.*,⁵⁴ the United States Supreme Court restricted the ability of the states to regulate takeover bids. When the plaintiffs in *Moran* sought to apply the same restrictions to the actions of target management, the Delaware Supreme Court curtly rejected the argument. Statutory authorization of corporate directors, the court maintained, "provides an insufficient nexus to the state" to constitute "state action which may violate the Commerce Clause"⁵⁵

Most "state action" challenges arise in the context of the fourteenth amendment.⁵⁶ The dormant commerce clause, however, contains an analogous limitation. It prohibits state regulation that burdens interstate commerce,⁵⁷ but does not apply to burdens imposed by private actors.⁵⁸ In *Moran*, the activities alleged to impermissibly burden interstate commerce can be characterized as those of the target management.

In several fourteenth amendment-"state action" cases, the United States Supreme Court has recognized that the state may so involve itself in private conduct that the constitutional limitations on state conduct

52. See *supra* text accompanying notes 32-33 & 35.

53. See *supra* notes 36-51 and accompanying text.

54. 457 U.S. 624 (1982).

55. 500 A.2d at 1353, citing *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir.), *rev'g* 568 F. Supp. 1538 (S.D.N.Y. 1983). In *Data Probe*, the Second Circuit reversed the lower court's holding that *MITE* limited state statutory authorization of target defensive tactics. The court simply found that Congress did not intend this result. Thompson, *supra* note 4, at 1073-74, rejects this rationale.

56. U.S. CONST. amend. XIV, § 1, provides that "No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States . . ." Because the amendment prohibits only state malfeasances, it does not reach individual invasions of the same rights. See *The Civil Rights Cases*, 109 U.S. 3 (1883).

57. See *supra* note 16.

58. *Cf. Reeves, Inc. v. Stake*, 447 U.S. 429 (1980) (5-4) (distinguishing for dormant commerce clause purposes between states acting as "market participants" and states acting as "market regulators," the Court held that when South Dakota opened a cement plant, it was acting as a private business, and, therefore, was not subject to dormant commerce clause restrictions).

should apply to the private activity.⁵⁹ The Court recently restated the state action inquiry as a two-part analysis.

First, the deprivation must be caused by the exercise of some right or privilege created by the State or by a rule of conduct imposed by the State or by a person for whom the State is responsible. . . . Second, the party charged with the deprivation must be a person who may fairly be said to be a state actor.⁶⁰

Target defensive tactics obviously meet the first step of the state action inquiry. The state imposes fiduciary duties upon corporate directors to act in the best interests of the corporation's shareholders. Pursuant to this duty, directors employ target defensive tactics.⁶¹

Under the second part of the state action inquiry, statutory authorization of private conduct, "without something more," does not establish state action.⁶² Rather, the nexus between the state and the challenged action must be such that the state may be said to be "responsible" for the specific conduct.⁶³ When the state compels or encourages the conduct, or when an extensive, mutually beneficial "symbiotic relationship" exists between the state and the private actors, state action exists.⁶⁴ Extensive regulation or mere approval or acquiescence is not sufficient.

The decisions in *Moran* and *Unocal* suggest that the Delaware Supreme Court has actively enhanced the ability of target directors to fight off hostile takeovers. Whether labeled significant encouragement or a mutually beneficial relationship, this judicial activism should constitute "state action" so as to trigger the dormant commerce clause restrictions.

This judicial activism of the Delaware Supreme Court has taken two forms. First, the court appears to have broadened the business judgment rule standard as applied to target defensive tactics. In its restatement of the business judgment rule in *Unocal*, the court subtly stifled the rule's focus. Traditionally, the business judgment rule applies only to "disinterested" business decisions.⁶⁵ Because target directors face an inherent

59. See, e.g., *Reitman v. Mulkey*, 387 U.S. 369 (1967); *Burton v. Wilmington Parking Auth.*, 365 U.S. 715 (1961).

60. *Lugar v. Edmondson Oil Co.*, 457 U.S. 922 (1982).

61. See *supra* text accompanying note 33.

62. See *Lugar*, 457 U.S. at 939; see also *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345 (1974).

63. *Rendell-Baker v. Kohn*, 457 U.S. 830, 839 (1982).

64. See *Blum v. Yaretsky*, 457 U.S. 991, 1004 (1982); *Rendell-Baker*, 457 U.S. at 840; see also *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345 (1974); *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972); *Burton v. Wilmington Parking Auth.*, 365 U.S. 715 (1961).

65. See *supra* text accompanying note 28.

conflict of interest when confronted with an unwanted takeover bid, in applying the business judgment rule the courts have focused on the motives of the target directors in blocking a takeover attempt.⁶⁶ The *Unocal* analysis purports to recognize the potential conflict of interest, but inquires only into the directors' investigation of the offer.⁶⁷ The shift in focus de-emphasizes the threat that management self-interest poses to shareholders. Moreover, the court's expansion of the interests target directors can consider in deciding to block a takeover bid permits them to weigh interests traditionally the concern of state governments rather than of corporate management.

The decisions in *Unocal* and *Moran* also reveal the Delaware Supreme Court's willingness to stretch statutory authorization to approve highly effective defensive tactics.⁶⁸ In *Unocal*, the court interpreted the statutory provision permitting a corporation to deal in its own stocks to authorize the corporation to deal *selectively* with corporate shareholders.⁶⁹ In *Moran*, the court interpreted the statutory authority to issue rights "to purchase from the corporation any shares of *its* capital stock"⁷⁰ to authorize the corporation to issue rights to purchase shares in the *acquiring* corporation.

Delaware's approval of highly effective defensive tactics by way of broad interpretations of existing statutory authority and judicial review of target directors' actions under a lenient business judgment analysis is "something more" than acquiescence or mere approval of target defensive tactics. Indeed, by imposing a fiduciary obligation upon target directors to resist certain takeover attempts, Delaware arguably compels the director's conduct. In any case, the Delaware court unabashedly sides with incumbent management. Because the interests of Delaware and the directors of its corporations tend to coalesce, the judicial activism of the

66. See, e.g., *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964) (management may not act "solely or primarily out of a desire to perpetuate themselves in office"); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir. 1981) (plaintiff must show that "impermissible motives predominated" the directors' decision).

67. See *supra* note 32 and accompanying text.

68. In some respects, expanding the interests management can consider in takeover fights extends the directors' authority. Some second-generation takeover statutes in fact amended the state's statutory fiduciary duty provisions to protect similar interests. See, e.g., PA. STAT. ANN. tit. 15, § 1408 (Purdon Supp. 1985). Delaware's judiciary, however, has developed that state's fiduciary duty law.

69. See *supra* note 39.

70. DEL. CODE ANN. tit. 8, § 157 (1983) (emphasis added).

Delaware court should satisfy the "state action" requirement under the dormant commerce clause.

Through its courts Delaware has accomplished many of the regulatory goals of anti-takeover statutes. Like second generation takeover statutes, the target defensive tactics approved by the Delaware courts enhance the power of target management in hostile takeover bids. This enables incumbent management to protect the interests of "local" corporations and thus the state. Substituting judicial activism for legislative action has permitted Delaware to accomplish these goals outside the constraints imposed by the Supreme Court's dormant commerce clause analysis in *MITE*. This result, however, seemingly contradicts the policies underlying *San Diego Building Trades Council v. Garmon*,⁷¹ in which the United States Supreme Court held that the supremacy clause deprived the states not only of their power to regulate but also of their equitable and common law jurisdiction. As the Court stated:

Our concern is with delimiting the areas of conduct which must be free from state regulation if national policy is to be left unhampered. . . . Even the States' salutary effort to redress private wrongs or grant compensation for past harm cannot be exerted to regulate activities that are potentially subject to the exclusive federal regulatory scheme.⁷²

IV. DORMANT COMMERCE CLAUSE ANALYSIS OF TARGET DEFENSIVE TACTICS

The commerce clause prohibits state regulation imposing burdens on interstate commerce excessive in relation to the local interests the state seeks to further.⁷³ In effect, the commerce clause establishes an "exclusive federal regulatory scheme" over interstate commerce. In *Edgar v. MITE Corp.*,⁷⁴ the Supreme Court held that state legislation authorizing state officials to block nationwide tender offers impermissibly interfered with this scheme. The principles the Court utilized in reaching this result apply equally to target defensive tactics which permit incumbent management to block such tender offers.

71. 359 U.S. 236 (1959). In *Garmon*, non-union employers obtained an award of damages in the California state courts for injuries resulting from the peaceful union activities of the defendants. The National Labor Relations Board had previously refused to exercise its jurisdiction under the National Labor Relations Act to redress those activities. Nevertheless, the Court, finding that the Act encompassed the union activities involved in the suit, overturned the California damage award.

72. *Id.* at 246-47.

73. See *supra* note 16.

74. 457 U.S. 624, 646 (1982).

A. *Burdens on Interstate Commerce*

The defensive tactics sanctioned in *Unocal* and *Moran* undeniably impede nationwide takeover attempts. Although considerable debate about the propriety of target defensive tactics persists,⁷⁵ *MITE* clearly reveals that the effects of inhibiting nationwide tender offers can outweigh the state's interests in regulating takeovers.⁷⁶ Judicial interpretations that sanction target defensive tactics can inhibit interstate tender offers and burden interstate commerce just as the statutory provisions invalidated in *MITE* did.⁷⁷

In addition, the Delaware Supreme Court's decisions in *Unocal* and *Moran* apparently authorize target management to block any two-tiered offer.⁷⁸ Bidders frequently utilize two-tiered takeovers to acquire larger targets.⁷⁹ Permitting management to deter any two-tiered takeover attempt would shield large national corporations from takeover attempts but leave smaller in-state corporations unaffected.⁸⁰ Thus, *Unocal* and *Moran* might actually burden interstate commerce more than a statute authorizing management to obstruct all forms of takeovers.

B. *State Benefits*

In *MITE* the Supreme Court considered two state interests as possible justifications for state takeover regulation: protecting resident investors and regulating the internal affairs of corporations organized under the state's laws.⁸¹ Although the business judgment rule protects corporate

75. See, e.g., Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 102 (1979).

76. 457 U.S. at 643. According to the Court, blocking tender offers denies shareholders an opportunity to sell their shares at a premium, hinders the efficient allocation of resources and reduces market incentives for efficient management performance. *Id.* (citing, *inter alia*, Easterbrook & Fischel, *supra* note 29).

77. Indeed, in *MITE* the Court cited an article dealing only with target defensive tactics as evidence of the adverse effects of inhibiting tender offers. See *supra* note 77 and accompanying text.

78. See *supra* text accompanying notes 36-46.

79. See Office of the Chief Economist of the SEC, *The Economics of Partial and Two-Tiered Tender Offers*, 49 Fed. Reg. 26,755, reprinted in [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,637, at 86,920-921 (June 29, 1984) [hereinafter cited as *SEC Tender Offer Study*].

80. *Cf. id.* at 86,927 (creating "regulatory disincentives" for two-tier offers "may have more important effects for larger takeover targets than smaller targets").

81. 457 U.S. at 644.

directors from liability to shareholders,⁸² it ultimately furthers shareholders' interests. Shareholders relinquish management of the corporation's day-to-day affairs to the directors in order to maximize their investment.⁸³ The business judgment rule affords directors the discretion necessary to carry out their managerial duties and encourages competent persons to become directors⁸⁴ by protecting them from mistakes of judgment.⁸⁵ Moreover, the rule avoids judicial second-guessing of complex business decisions.⁸⁶ Thus, insofar as the Delaware court's interpretation of the rule protects shareholders' interests in effective corporate management, it implicates a legitimate state interest.

In *MITE* the Supreme Court noted that the state's interest in investor protection did not extend to nonresident investors.⁸⁷ The Court also questioned whether the internal affairs doctrine could justify legislatively imposed tender offer regulation.⁸⁸ Judicial sanctioning of target defensive tactics under the business judgment rule avoids both concerns. The business judgment rule is an integral aspect of Delaware's corporate governance system.⁸⁹ Federal law reserves the primary responsibility for the regulation of corporate governance to the state of incorporation.⁹⁰ This congressional policy favoring state regulation imparts legitimacy, under the commerce clause analysis, to any state regulation of corporation governance.⁹¹ The business judgment rule thus reflects Delaware's legiti-

82. See *supra* text accompanying note 28.

83. See generally Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978).

84. See Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 650-51 (1983).

85. See *supra* note 28 and accompanying text.

86. See Note, *supra* note 84, at 650-51.

87. 457 U.S. at 644.

88. *Id.* at 645-46. The Court first belittled the internal affairs doctrine as only a conflict of laws principle. But the Court proceeded to state that the doctrine could not justify state tender offer regulation. Tender offers involve transfers of stock to third parties. Thus, the Court maintained, tender offers do not involve corporate internal affairs. The Court also noted that the Illinois statute applied to corporations not incorporated in Illinois.

89. See *supra* text accompanying notes 27-28.

90. See *Burks v. Lasker*, 441 U.S. 471 (1978); *Thompson*, *supra* note 4, at 1059.

91. *Cf. Raymond Motor Transp., Inc. v. Rice*, 434 U.S. 429 (1978) (state highway regulations carry a presumption of validity because of the "peculiarly local nature of this subject of safety"); *Huron Portland Cement Co. v. City of Detroit*, 362 U.S. 440 (1960) (upholding a burdensome city pollution ordinance partially relying on a congressional policy of leaving pollution regulation to state and local government); *cf. Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (existence of state remedies for the challenged conduct bears directly on the issue of whether Congress intended a federal cause of action under securities laws).

mate interest in regulating the internal affairs of its corporations, even though the rule affects the interests of nonresident investors.

The applications of the business judgment rule in *Unocal* and *Moran* nevertheless raise serious questions as to whether the business judgment rule actually benefits shareholders, and therefore *advances* legitimate local interests.⁹² The rule presumes that investors have alternatives to derivative suits, including hostile takeover attempts, for resolving policy disputes with management.⁹³ Judicial authorization of target defensive tactics which all but destroy those alternatives runs contrary to the policies reflected by the rule and to shareholder interests. Moreover, when management tactics cause obvious and immediate harm to target shareholders,⁹⁴ judicial reluctance to second-guess those actions seems unjustified.

In both *Unocal* and *Moran*, target management evinced more concern about the use of allegedly unfair tender offer tactics, namely two-tiered tender offers and greenmail, than for shareholder interests.⁹⁵ Admittedly, the directors argued that these tactics were unfair to *shareholders*, but close scrutiny of these allegations demonstrates that sheltering shareholders from these tactics offers at best uncertain protection of share-

92. In *APL Limited Partnership v. Van Dusen*, 622 F. Supp. 1216, 1221 (D. Minn. 1985), the court pointed out that the commerce clause balances burdens and *benefits*. Thus, the court stated, the state must show not only that the statute seeks to further legitimate state interests, but in fact furthers those interests. *Id.*, citing *Edgar v. MITE Corp.*, 457 U.S. at 644 (questioning whether the Illinois Business Takeover Act "substantially enhances the shareholders' position").

93. Because the rule protects business decisions whether "good" or "bad," provided the directors meet the appropriate standard of care in reaching their decisions, *see supra* note 29 and accompanying text, it must presume shareholders remain free to redress policy disputes with ineffective management or replace it.

94. For instance, *Unocal's* assertion that it protected its shareholders is simply untenable. First, the *Unocal* offer increased *Unocal's* leverage beyond that implied in *Mesa's* proposed second step transaction. Although the increased premium might have compensated *Unocal* noteholders for the increased risk of failure, the remaining shareholders received no additional compensation. Indeed, the decline in *Unocal's* stock price further increased the costs to the remaining shareholders. The combined effect of becoming a *Unocal* debtholder and remaining a shareholder as a result of proration undoubtedly reduced the additional premium acquired in the exchange offer. Second, the directors knew the offer would involve "placing restrictive covenants upon certain corporate activities until the obligations were paid." 493 A.2d at 951. Third, "[t]he directors were told that the primary effect of this obligation [the exchange offer debt] would be to reduce exploratory drilling, but that the company would nonetheless remain a viable entity." *Id.* at 950. Creating more financial risk while severely restricting the corporation's ability to maintain a high level of cash flow in the long term, undoubtedly harmed the corporation.

95. *See supra* text accompanying notes 36 & 44; *see also* Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 319 (1985) (target management attempts to justify some defensive tactics *solely* on the ground of the unfairness of two-tiered offers).

holders' interests. Although two-tiered tender offers result in greater shareholder coercion than single-step offers,⁹⁶ an SEC study suggests that two-tiered offers do not *unfairly* coerce target shareholders.⁹⁷ In addition, greenmail, although harmful to target shareholders,⁹⁸ is a *defensive* tactic. Target shareholders suffer only if target management actually pays greenmail to defeat a takeover.⁹⁹ Justifying defensive tactics on the basis of a threat that target management poses to its own shareholders' best interests stands the law on its head.

C. *Balancing Burdens and Benefits*

Delaware's business judgment rule reflects a strong state interest in regulating the internal affairs of corporations organized under its laws. The rule also implicates the state's interest in protecting investors. Upholding the target defensive tactics involved in *Unocal* and *Moran*, however, over-extends the business judgment rule without conferring significant benefits on target shareholders. These concerns undermine the alleged state interest in sanctioning such tactics under the business judgment rule.¹⁰⁰ On the other hand, *MITE* recognizes the significant burden that target defensive tactics place on interstate commerce. These

96. See Note, *supra* note 41, at 1966.

97. See *SEC Tender Offer Study*, *supra* note 79; see also Dennis, *supra* note 95 (two-tiered tender offers do not unfairly coerce shareholders and are in shareholders' best interests). The SEC study examined the relative frequency, and comparative premiums, of two-tiered, any-and-all, and partial tender offers. The evidence showed that bidders employed two-tiered offers relatively infrequently and mainly to acquire large targets. *SEC Tender Offer Study*, *supra* note 79, at 86,921. Moreover, the study found that although premiums in any-and-all offers exceeded two-tiered premiums, the difference between the two was small, especially in comparison with premiums in partial offers. *Id.* Thus, while any-and-all offers might moderately increase shareholder wealth, deterring two-tiered offers might completely forestall takeover attempts of larger firms. The study concluded that target shareholders' losses from deterring takeovers, even though relatively few, can outweigh gains from the increased premium realized. *Id.* at 86,927.

98. See Office of the Chief Economist of the SEC, *The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices*, [1984-85 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,713, at 87,174 (Sept. 11, 1984) [hereinafter cited as *SEC Greenmail Study*]; see also Dennis, *supra* note 95, at 335-37 (noting other studies reporting similar findings). The SEC study examined stock prices from the date the bidder made its initial purchases until the target company repurchased the bidder's shares at a premium. The study found an overall negative, although small impact on stock prices and shareholder wealth, particularly in struggles for control, and concluded that greenmail payments were not in shareholders' best interests. This study has some notable flaws. In particular, measuring prices to the date of announcement of the repurchase may not permit the market enough time to fully incorporate the new information. Moreover, the repurchase may indicate more strongly management's intention to ward off perhaps all offers. See Dennis, *supra* note 95, at 336-37.

99. See *SEC Greenmail Study*, *supra* note 98, at 87,174.

100. Cf. *Edgar v. MITE Corp.*, 457 U.S. at 644-47 (after questioning whether state legislation

burdens may outweigh Delaware's uncertain interest in continuing to sanction these tactics.

V. CONCLUSION

Edgar v. MITE Corp. restricts the ability of states to regulate corporate takeovers. Yet sanctioned under Delaware's business judgment rule, target defensive tactics provide equally effective takeover regulation. The fact that target directors *initiate* the "regulatory" conduct should not insulate target defensive tactics from *MITE*'s constitutional restrictions. For in the context of hostile takeovers, the state, through its judiciary, actively sides with incumbent management. Consistent with the constitutional principles enunciated in *MITE* the courts should prohibit target defensive tactics which effectively preclude shareholder consideration of hostile tender offers.

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substantially furthered the state's interest, the Court concluded that the burdens of inhibiting interstate tender offers outweighed legitimate state interests).

