

# DEFINING THE FEDERAL AND STATE REALMS OF TENDER OFFER REGULATION

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The current wave of corporate takeovers has rekindled the long-running debate over the federalization of state corporation law.<sup>1</sup> Traditionally state law has regulated the relationship between shareholders and directors within a corporation. The federal securities laws affect that relationship through required disclosure and prohibitions against fraud, but do not disturb the primacy of state control. The Supreme Court's landmark decision in *Santa Fe Industries, Inc. v. Green*<sup>2</sup> confirmed this federal/state balance when it rejected efforts to interpret fraud under the federal securities laws as encompassing shareholder complaints of management misconduct. The Court based its decision, in part, on a reluctance to federalize a substantial part of state corporation law.

Some recent judicial decisions<sup>3</sup> interpreting the Williams Act,<sup>4</sup> the federal tender offer legislation, present a different vision of the appropriate

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1. Previous debate over the federalization of state corporation law centered on proposals for federal chartering of corporations based in part on the perceived inability of states to give appropriate protection to shareholders against possible abuses by managers and others. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). During the 1960's and early 1970's, even without new legislation, federal courts gave expansive readings to federal law, particularly the ubiquitous rule 10b-5 to provide federal remedies for management overreaching of shareholders. See note 191 and accompanying text. By the late 1970's this movement had dissipated. Congress enacted no new federal legislation. In addition, the Supreme Court's 1977 decision in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), ended judicial efforts to interpret broadly existing federal securities laws to replace existing state regulation of internal corporate relationships.

Similar debates have occurred in other eras. See, e.g., Stevens, *Uniform Corporation Laws Through Interstate Compacts and Federal Legislation*, 34 MICH. L. REV. 1063 (1936); *69-A FTC Utility Corporations*, S. DOC. NO. 92, 70th Cong., 1st Sess. (1934).

2. 430 U.S. 462 (1977).

3. See *infra* notes 113-24 and accompanying text.

4. Pub. L. No. 90-4393, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(f) & 78n(d)-(f) (1982)). See *infra* Section IIA of this Article, for a discussion of the purposes of the Williams Act.

role of state and federal regulation. These courts read the Williams Act and the commerce clause of the Constitution<sup>5</sup> as mandates to protect the "market for corporate control" against state interference.<sup>6</sup> In particular, these courts found that federal law preserves for shareholders the right to use a tender offer to oust corporate management. Initially, this broad vision of the federal regulatory role did not threaten the primacy of state regulation in the realm of shareholder-director relations because the state takeover laws that courts declared unconstitutional addressed only the responsibilities of a bidder who seeks to buy the shares of target company shareholders.<sup>7</sup> However, state takeover laws passed in the wake of these decisions have been inserted into existing state corporations codes and regulate takeovers by modifying the relative rights of shareholders and directors.<sup>8</sup> Therefore, attacks on these "second generation" statutes, require courts to decide the extent to which the federal securities laws supplant state corporation law.

The Supreme Court has before it in the current term a case challenging the constitutionality of a second generation takeover statute.<sup>9</sup> The Reagan administration and Congress are also struggling to determine the proper federal role as they decide whether to impose federal regulation relating to "poison pills," "greenmail," or "golden parachutes," defensive tactics currently regulated under state law or left to the market.<sup>10</sup> This extended battleground intensifies the need to identify the principles that define the appropriate realms of federal and state law.

This Article suggests that the division of state and federal authority over tender offers can best be understood by distinguishing the regulation of economic activity that occurs across markets from the regulation of

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5. U.S. CONST. art. I, § 8, cl. 3.

6. See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 663 (1982). Professor Henry Manne developed the concept of the market for corporate control in the mid-1960's, see Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427 (1964), and it has since become a key term in economic concepts of how firms operate.

7. See *infra* notes 68-69 and accompanying text.

8. See *infra* notes 92-108 and accompanying text.

9. *Indiana v. Dynamics Corp. of America*, No. 86-97, *prob. juris. noted*, 107 S. Ct. 258 (1986).

Editor's Note:

The Supreme Court rendered a decision in this case shortly before publication of this article. Its effect is discussed in a postscript to this article, *infra*, p. 1000.

10. See generally *The Effect of Mergers on Management Practices, Cost, Availability of Credit and the Long Term Viability of American Industry*, *Hearings Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 99th Cong., 1st Sess. 609, 635 (1985) (statement of Joseph R. Wright expressing administration views on corporate takeovers).

economic activity within a firm.<sup>11</sup> State corporation law traditionally has governed activity within a firm. Each state's corporation code and its judicially applied common law of fiduciary duty determine the legal relationship between directors and shareholders. The proxy,<sup>12</sup> periodic disclosure,<sup>13</sup> and antifraud provisions<sup>14</sup> of the federal Securities Exchange Act of 1934 assist shareholders in monitoring the performance of their managers and thereby affect the shareholder-director relationship. But these federal provisions do not purport to change the substance of the relationship between shareholders and their managers that state law has created.<sup>15</sup>

States differ in the extent to which they protect shareholders against director action. For example, California tends to give more protection to shareholder interests, while Delaware's corporations act gives more freedom and flexibility to managers. In theory, leaving regulation of the shareholder-director relationship to state law permits the states to compete for corporate charters;<sup>16</sup> each acting as a laboratory within our fed-

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11. Economic theory makes a similar distinction. See Coase, *The Nature of the Firm* in *ECONOMICA*, NEW SERIES VOL. IV 386, 388 (1937). The exact nature and significance of that distinction and the reasons for the existence of firms has been much debated. See, e.g., Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972). Recent economic literature views a corporation as a nexus of contracts, posing the question as to how relationships inside a firm are different from relationships that are outside a firm. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 311 (1976).

Without attempting a precise articulation of how these relationships may differ, I argue in this Article that congressional allocation of federal and state responsibilities in the corporate and securities area reflects this difference in the means chosen by the parties to structure their economic activity. In particular, it reflects a distinction between regulation of the shareholder/manager relationship and regulation of discrete market transactions such as the purchase and sale of securities. Cf. Ribstein, *The Scope of Federal Securities Liability for Corporation Transactions*, 33 *SW. L.J.* 1129, 1164 (1980). Professor Ribstein distinguishes between market and corporate transactions in determining the reach of federal liability for nondisclosure. He suggests that because of the greater federal regulation of market participants and market transactions, federal liability connected with market transactions need not be limited to breach of disclosure duty even though federal liability in connection with corporate transaction would be more limited.

12. 15 U.S.C. § 78m(a) (1982).

13. *Id.* at § 781.

14. *Id.* at § 78j(b).

15. One federal law which does impose nondisclosure obligations on directors is section 16(b) of the 1934 Act, *id.* at § 78p(b). It requires officers, directors and shareholders owning more than 10 percent of a company's stock to turn over to the corporation any profit made on the purchase and sale of the corporation's stock within a six month period.

16. See, e.g., Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUDIES* 251 (1977). This article is discussed in more detail *infra*, text accompanying notes 164-67.

eral system to develop legal rules for corporate governance that best facilitate the raising of capital. If a state designs its corporate code to favor "home-town" management at the expense of shareholders, the market will view that state's corporations as less attractive investment vehicles and the state will lose incorporations to other states.

In discrete market transactions occurring outside the corporate form, the federal government has assumed a substantially greater role. State blue sky laws regulate the sale of securities, but these individual state laws are limited to sales occurring within each state.<sup>17</sup> The key regulator of interstate issuance of securities is federal law, the Securities Act of 1933,<sup>18</sup> passed in the first one hundred days of the New Deal, in part because of state inability to regulate national distributions involving stock sales in various states.<sup>19</sup> Similarly, federal law provides the dominant regulation of market participants, even though state law also affects these persons and entities.<sup>20</sup> In both areas, federal law imposes substantive regulation without the same deference to state law found in intracorporate relationships.

Tender offer regulation inevitably combines the two types of regulation just discussed. Tender offers involve both discrete market transactions between parties in different states and dramatic alterations in shareholder-director relations within a corporation. A federal rule would be appropriate to regulate transactions between a bidder and target company shareholders who may be located in all fifty states. However, to the extent that tender offers provide an alternative to derivative suits, proxy fights, or other voting mechanisms by which shareholders monitor their managers pursuant to state law,<sup>21</sup> state tender offer regulation is appropriate.

17. All states regulate the purchase and sale of securities by statutes that are commonly called blue sky laws. *See generally*, L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976).

A minority of states go beyond the disclosure approach and impose merit regulation. *See, e.g.*, TEX. REV. CIV. STAT. ANN. § 581-10 (Vernon 1964 & Supp. 1987) (securities commissioner authorized to deny trading if the security is not "fair, just or equitable"). The issue is often hotly debated. *See generally* Goodkind, *Blue Sky Law: Is There Merit in Merit Regulation*, 1976 WISC. L. REV. 79.

18. 15 U.S.C. § 77a *et seq.* (1982).

19. *See* L. LOSS, SECURITIES REGULATION 105-07 (2d ed. 1961).

20. *See, e.g.*, 15 U.S.C. §§ 78g, h, k, o (1982) (regulating the activities of broker-dealers).

21. *See generally* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984) (describing various means of monitoring management; disciplines generated by the market for corporate control is sufficiently limited that it can serve only as a remedy of last resort for massive managerial failure and not as the principal enforcer of corporate accountability).

The functions of state and federal regulation of tender offers are clearly interrelated. The possibility of a tender offer in the marketplace makes shareholder rights against management under state law more effective. Conversely, if shareholders have limited rights against management under state law there may be less incentive for a bidder to seek control by a tender offer. This interrelationship illustrates the complexity of tender offer regulation. It does not, however, necessarily require a different division of federal and state responsibility than that which has existed for the last half century.

This article analyzes the appropriate roles of federal and state law in regulating tender offers by first identifying the incomplete view of federal-state relations found in current case law. Subsequent sections detail the methods by which states now seek to regulate takeovers and the degree to which these state methods are consistent with federal law.

I argue that the Williams Act was intended to fill a gap in the federal regulation of change of control transactions.<sup>22</sup> Federal law regulates other kinds of changes of control (*e.g.*, proxy fights, share-for-share exchanges and mergers)—all by means of disclosure. Federal law thereby makes more effective the rights shareholders have under state law, but it does not create new substantive rights. There is little in the legislative history of the Williams Act to suggest that Congress intended to change this pattern of leaving substantive intrafirm regulation to state law. The Williams Act's extensive regulation of market transactions covered an area not subject to prior state regulation and does not of itself suggest that Congress sought to regulate the intrafirm relationship over which there had been a significant and longstanding state supervision. Similarly, Congressional recognition that overregulation of the bidder might frustrate existing state intrafirm remedies<sup>23</sup> does not imply that Congress

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22. See 113 CONG. REC. 854 (1967) ("The need for such legislation has been caused by the increased use of cash tender offers rather than the regular proxy fight to gain control of publicly owned corporations . . . [t]his legislation will close a significant gap in investor protection under the federal securities laws . . .") (remarks of Senator Williams); see also S. REP. NO. 550, 90th Cong., 1st Sess. 3 (1967) [hereinafter cited as SENATE REPORT].

23. Some supporters of the Williams Act saw federal regulation of shareholder-bidder transactions as helping management fend off corporate raiders. See, *e.g.*, 113 CONG. REC. 24665 (1967) (remarks of Senator Kuchel); 113 CONG. REC. 857 (1967) (remarks of Senator Kuchel). Yet, the legislative debates illustrate a congressional concern that too much regulation of the shareholder-bidder relationship could have an undesired effect on shareholder-manager relations. See SENATE REPORT, *supra* note 22; see also *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, Hearings on S. 510 Before Subcomm. on Securities of Banking and Currency Commit-*

intended to create new substantive intrafirm remedies for shareholders vis-a-vis management.

Congress could provide substantive intrafirm remedies if it so chose; under the Constitution Congress presumably has the power to promulgate a federal law of corporation.<sup>24</sup> In fact, there have been calls for additional federal laws regarding tender offers.<sup>25</sup> If the market for corporate control is so much more important to shareholders than voting rights, litigation rights or other means by which they can monitor their managers, or if the market for corporate control cannot effectively be regulated by "parochial" states there may be a need for federal legislation. Unless an intent to protect the market for corporate control or some similar intent is found in the legislative history of the Williams Act, it seems an unwarranted extension of current federal law to read the Williams Act as creating substantive federal rights for shareholders against their managers.

#### I. THE CONFLICTING AND INCOMPLETE VIEW OF FEDERALISM IN CURRENT CASE LAW

Hostile takeovers have produced more case law and commentary in recent years than any other corporate law topic. Yet the cases and the commentary present a confused and often inconsistent view of the appropriate role of the federal and state governments in regulating takeovers. This confusion can be seen, for example, in the report of the Securities and Exchange Commission's Advisory Committee on Tender Offers which recommended that state corporation law should continue to govern the response by a target's management to a tender offer, while at the same time proposing new federal regulations that would restrict state interference with tender offers.<sup>26</sup> This Article focuses on similar confusion

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tee, 90th Cong., 1st Sess. 57, 115, 120 (1967) (statements of Professors Hayes, Mundheim, Kaplan) [hereinafter cited as *Senate Hearings*].

24. Under the United States Constitution the federal government has only the powers delegated to it. All other powers are reserved to the states. Given the far-reaching interpretations modern courts have given to congressional powers under the commerce clause, regulation of corporate and securities matters is not an area from which the federal government is precluded from regulating. Thus, the question of federal regulation is principally one of statutory interpretation.

25. See, e.g., Fiflis, *Of Lollipops and Law—A Proposal for a National Policy Concerning Tender Offer Defenses*, 19 U.C.D. L. REV. 303 (1986).

26. For a description of the Advisory Committee's recommendations and the SEC's response, see Quinn & Martin, *The SEC Advisory Committee on Tender Offers and Its Aftermath—A New Chapter in Change-of-Control Regulation*, in *TENDER OFFERS, DEVELOPMENTS AND COMMENTARIES* (M. Steinberg ed. 1985).

evidenced in two groups of cases interpreting the Williams Act. Cases ruling on the constitutionality of state takeover laws by-and-large reflect more restrictive views about state regulation than cases deciding whether private defensive tactics violate the Act.

*A. Edgar v. MITE Corp. and Other Cases Ruling on the Constitutionality of State Takeover Statutes*

Between the passage of the Williams Act in 1968 and the Supreme Court's decision in *Edgar v. MITE Corp.*<sup>27</sup> in 1982 three-fourths of the state enacted their own tender offer statutes.<sup>28</sup> In many respects these statutes emulated the Williams Act: they were aimed at the bidder and the bidder's transactions with target company shareholders; they required disclosure, and they imposed similar substantive protections. However, many states, in an effort to help local companies fend off unwanted takeovers,<sup>29</sup> went beyond the Williams Act and provided additional "protection" to the investor, such as hearings by state officials on the fairness of the tender offer.<sup>30</sup> Because these statutes usually applied to tender offers for companies with only minimal contacts with the state, such as having assets or shareholders within a state,<sup>31</sup> a takeover bid involving shareholders across the country would likely be subject to conflicting state requirements.

In *MITE*, the Supreme Court invalidated Illinois' takeover statute as an impermissible indirect regulation of interstate commerce.<sup>32</sup> A plurality of the Court would have invalidated the statute as a direct regulation of interstate commerce<sup>33</sup> and as preempted by the Williams Act.<sup>34</sup> Since

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27. 457 U.S. 624 (1982).

28. *Id.* at 631 n.6 (1982) (listing 37 state statutes). One state statute, Virginia's, actually preceded enactment of the Williams Act by a short time.

29. See generally Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213 (1977); Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689 (1981).

30. See, e.g., *MITE*, 457 U.S. at 634-40 (describing provisions of the Illinois statute).

31. See, e.g., *id.* at 642 (describing the broad extraterritorial effects of the Illinois statute); *Great W United Corp. v. Kidwell*, 577 F.2d 1256, 1279 (5th Cir. 1978), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 443 U.S. 173 (1979) (describing the same with respect to an Idaho statute).

32. 457 U.S. at 643-46. Chief Justice Burger and Justices O'Connor, Powell and Stevens joined in this part of Justice White's opinion.

33. *Id.* at 641-43 (Chief Justice Burger and Justices O'Connor and Stevens joined in this part of Justice White's opinion.)

34. *Id.* at 634-40. (Chief Justice Burger and Justice Blackmun joined in this part of Justice White's opinion.)

*MITE*, lower courts have used all three arguments to strike down state statutes.

### 1. Preemption/Supremacy Clause Analysis

Under Article VI, clause 2 of the United States Constitution state law must yield when it conflicts with federal law. Direct conflict is not a problem because state takeover laws usually are written so that it is physically possible to comply with the provisions of both the federal and state acts. But clear precedent also holds that state law must yield to federal law if it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."<sup>35</sup> The breadth of the Williams Act's purpose obviously becomes the key determinant of the role for state law in regulating takeovers.

There seems to be general agreement in the case law that in enacting the Williams Act Congress sought to protect investors confronted by a tender offer by providing them with the information necessary to make a decision.<sup>36</sup> A state law that interfered with that disclosure clearly would be preempted. More ambiguity surrounds the extent to which the Act creates or maintains neutrality between the takeover bidder and the target management.

The legislative history of the Williams Act is helpful on this point. The bill Senator Williams originally introduced in 1965 proposed to regulate the bidder more severely than did the legislation Congress ultimately adopted.<sup>37</sup> Before hearings were held on the bill in 1967, for example, Senator Williams had dropped a provision that would have required precommencement notification to the target company.<sup>38</sup> These changes apparently reflected an awareness that too much regulation would have the undesired effect of discouraging takeovers and thereby reduce their effectiveness as a check on entrenched management.<sup>39</sup> Thus, Congress disclaimed any "intention to provide a weapon for management

35. *Id.* at 631 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

36. *See, e.g., Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 35 (1977); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975); SENATE REPORT, *supra* note 22, at 3-4 (1967).

37. *See* 111 CONG. REC. 28255 (1965) (remarks of Senator Williams describing S. 2731); *see also Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 30 (1977) (disclosure provisions originally embodied in S. 2731 "were avowedly pro-management in the target company's efforts to defeat takeover bids.")

38. *See* 113 CONG. REC. 854, 855-56 (1967) (remarks of Senator Williams).

39. *See* *Edgar v. MITE Corp.*, 457 U.S. at 633 (opinion of White, J.); SENATE REPORT, *supra* note 22, at 3.



to discourage takeover bids.”<sup>40</sup>

Nevertheless, the language of the Committee reports and the comments on the floor of Congress permit a debate as to the breadth of this “neutrality” policy. Narrowly interpreted, Congress’ position reflected a negative decision, establishing only that Congress did not want to go as far as the original bill because it would have interfered unnecessarily with the existing shareholder-management relationship. Under this view, the bill simply sought to keep federal regulation of bidder-shareholder transactions from making matters worse for the shareholders vis-a-vis their management. It expressed no judgment as to other causes (*e.g.*, state law or bylaw or charter amendments) that may interfere with the shareholder-management relationship.

Interpreted more expansively, Congress’ neutrality purpose reflected a positive decision establishing the correct balance between bidder and management and between shareholder and management that the states cannot change.<sup>41</sup> Among those who view Congress as having acted to establish such a balance, further division is possible between i) those who read the legislative declaration to prevent any conduct, state or private, that upsets the balance<sup>42</sup> and ii) those who suggest that the 1968 balance may be upset, so long as it is not by new state legislation.<sup>43</sup> This latter interpretation appears to permit private action upsetting the balance, including defensive tactics taken by directors pursuant to the broad authority in longstanding provisions of state corporation codes and traditional common law.

The three justices who made up the plurality in *MITE* seemed to interpret neutrality broadly. Writing for the plurality, Justice White stated that “[i]t is also crystal clear that a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover

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40. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975).

41. *See, e.g., Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 261 (7th Cir.) prob. juris. noted, 107 S. Ct. 258 (1986).

42. *See, e.g., Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538, 1555 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

43. *See, e.g., Fiffis, supra* note 25, at 329 (“Congress at most seems to have developed a policy of preserving the relative positions of targets and bidders under federal and state laws, that is without itself favoring either, or permitting the states to alter the balance of power. Since the target company defenses were available from the beginning and are not the result of new state legislation, the power of these defenses was always held by targets and the balance may not now be altered by federal courts.”). *See also infra* notes 151-55 and accompanying text (discussing the apparent distinction in the Second Circuit’s *Data Probe* decision between state “legislative regulation” and state law which imposes fiduciary obligations of a contractual nature).

bidder.”<sup>44</sup> He agreed with the Court of Appeals that Congress “sought to protect the investor not only by furnishing him with the necessary information but also by withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice.”<sup>45</sup> Thus, Justice White concluded that the Illinois Act was preempted insofar as it provided for a hearing that created the potential for delay and thereby “upset the balance struck by Congress by favoring management at the expense of stockholders.”<sup>46</sup> He further asserted that the Williams Act preempted the Illinois provision permitting the Secretary of State to pass on the substantive fairness of a tender offer, because it “offer[ed] investor protection at the expense of investor autonomy—an approach quite in conflict with that adopted by Congress.”<sup>47</sup>

Two justices dissented from the plurality view. Justice Stevens did not find congressional efforts to impose neutral legislation as “tantamount to a federal prohibition against state legislation designed to provide special protection for incumbent management.”<sup>48</sup> Justice Powell argued that “the Williams Act’s neutrality policy does not necessarily imply a congressional intent to prohibit state legislation designed to assure—at least in some circumstances—greater protection to interests that include but often are broader than those of incumbent management.”<sup>49</sup>

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44. 457 U.S. at 633. I have refrained from stating that the *MITE* plurality adopted either variation of the “broader” position discussed previously in the text. *MITE* involved only new state legislation and not private action taken by directors pursuant to authorization in state corporate law predating the Williams Act.

Proponents of the broader view, of course, see *MITE* as consistent with their position. See *supra* notes 42 & 43. Justice White may have fueled this disagreement by quoting Senator Williams’ statement that “[w]e have taken extreme care to avoid tipping the scales in favor of management or in favor of the person making the takeover agreement.” 457 U.S. at 633 (quoting 113 CONG. REC. 24664 (1967)). When introducing the Williams Act in 1967, Senator Williams phrased the neutrality policy a bit differently: “Every effort has been made to avoid tipping the balance of *regulatory burden* in favor of management or in favor of the offeror.” 113 CONG. REC. 854 (1967) (emphasis added). Similarly, the Senate Report states, “[t]he committee has taken extreme care to avoid tipping the balance of *regulation* either in favor of management or in favor of the person making the takeover bid.” SENATE REPORT, *supra* note 22, at 3 (emphasis supplied). Read with the emphasis supplied the Williams Act’s “neutrality” would not extend to forbidding private acts and the cases have so held. See notes 75-85 and accompanying text.

45. 457 U.S. at 634.

46. *Id.* at 639.

47. *Id.* at 640 (quoting *MITE Corp. v. Dixon*, 633 F.2d 486, 494 (7th Cir. 1980)). The plurality also would have found the Illinois act preempted because it provided for precommencement notification. See *infra* note 68.

48. *Id.* at 655 (Stevens, J., concurring in part and concurring in the judgment).

49. *Id.* at 646 (Powell, J., concurring in part).

For the most part, subsequent judicial decisions have followed the plurality.<sup>50</sup> Some courts suggest that state regulation is inconsistent with the federal policy of permitting investors to make their own decisions if the state law creates barriers that prevent a shareholder from selling into a market influenced by the presence of a bidder.<sup>51</sup> Some, however, have lingering doubts. For example, Judge Posner has written:

Most courts have agreed that the Williams Act strikes a balance between target management and tender offeror that the states may not upset. . . . Of course it is a big leap from saying that the Williams Act does not itself exhibit much hostility to tender offers to saying that it implicitly forbids states to adopt more hostile regulations, but this leap was taken by the Supreme Court plurality and us in *MITE* and by every court to consider the question since.<sup>52</sup>

## 2. Direct Regulation of Interstate Commerce

Article I, section 8, clause 3 of the United States Constitution gives Congress the power to regulate interstate commerce and limits the extent to which the states may regulate such commerce, even if Congress has not spoken.<sup>53</sup> Justice White found the Illinois statute an impermissible state regulation of interstate commerce citing both its direct and indirect effects.<sup>54</sup> Only three other justices joined in the part of the opinion find-

50. See the cases cited *infra* notes 51-52. Some courts even treat the plurality opinion as a holding of the court. See, e.g., *Esmark, Inc. v. Strode*, 639 S.W.2d 768, 771 (Ky. 1982).

51. See, e.g., *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 759 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986); *Ichan v. Blunt*, 612 F. Supp. 1400, 1420 (W.D. Mo. 1985).

52. *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 261-62 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

53. See, e.g., *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851).

54. The division between direct and indirect effect was popular earlier in the century. It has been used less frequently in more recent times, particularly since attacks on that doctrine by Chief Justice Stone. He felt the distinction provided little guidance in determining when state could permissibly regulate economic activity. See, e.g., *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945); *DiSanto v. Pennsylvania*, 273 U.S. 34 (1927) (Stone, dissenting). See generally G. GUNTHER, CONSTITUTIONAL LAW 270 (10th ed. 1980) (direct-indirect approach was in vogue for a time, co-existing with other doctrines emphasizing purpose or practical effect but the recurring theme has been a middle ground: the commerce clause by its own force, bars some but not all statute regulation). See also the repeated use of the "direct" regulation of commerce argument to strike down control share acquisition statutes in cases cited *infra* note 97. The Supreme Court continues to use the direct-indirect framework. See, e.g., *Brown-Forman Distillers Corp. v. New York State Liquour Auth.*, 106 S. Ct. 2080, 2084 (1986) ("This Court has adopted what amounts to a two-tiered approach to analyzing state economic regulation under the commerce clause." (citing *MITE*)); *Cf. Maine v. Taylor*, 106 S. Ct. 2440, 2447-48 (1986) ("This Court has distinguished between state statutes that burden interstate transactions only incidentally and those that affirmatively discriminate against such

ing an impermissible direct regulation on interstate commerce, but this part of the opinion has also been followed by several lower courts since *MITE*.<sup>55</sup> Justice White particularly criticized the fact that the Illinois Act purported to regulate commerce wholly outside the state. He feared that if other states imposed similar regulations, "interstate commerce in securities transactions generated by tender offer would be thoroughly stifled."<sup>56</sup> Courts evaluating second generation statutes might, however, be reluctant to use this "direct regulation" argument. The courts would encounter considerable difficulty in separating judicial analysis labeled direct regulation from the balancing approach applied in commerce clause cases generally. More importantly, these statutes avoid extraterritorial application and, thus, do not raise the possibility of several states regulating the same transaction.

### 3. *Indirect Regulation of Interstate Commerce*

The only part of Justice White's opinion to command a majority found the Illinois Act unconstitutional under the test of *Pike v. Bruce Church, Inc.*<sup>57</sup> *Pike* held that when a state statute "regulates interstate commerce indirectly, the burden imposed on that commerce must not be excessive in relation to the local interest served by the statute."<sup>58</sup>

Three points in the majority's opinion recur in subsequent court decisions and have important implications when *MITE*'s reasoning is applied to state corporation law. First, the Court describes as "substantial" the effect of allowing Illinois to block a nationwide tender offer. Depriving shareholders of the opportunity to sell their shares at a premium, the Court maintained, hinders the "reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition."<sup>59</sup> This unqualified praise of tender offers could apply

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transactions."). The perils of using an interstate commerce analysis for intracorporate regulation are discussed *infra* at Part IIIB.

55. See, e.g., *Terry v. Yamashita*, 643 F. Supp. 161 (D. Hawaii 1986); *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985); *Bendix Corp. v. Martin Marietta Corp.*, 547 F. Supp. 522 (D. Md. 1982); *Esmark, Inc. v. Strode*, 639 S.W.2d 768 (Ky. 1982); *Sharon Steel v. Whaland*, 466 A.2d 919 (N.H. 1983).

56. 457 U.S. at 642.

57. 397 U.S. 137 (1970).

58. *MITE*, 457 U.S. at 643.

59. *Id.* On this point the Court cited articles by Professors Easterbrook (now a judge on the Seventh Circuit) and Fischel, two of the leading proponents of applying economic principles to legal analysis and in particular, advocating a passive role by target managers in responding to a tender offer.

equally to other state corporation laws that similarly reduce “the incentive the tender offer mechanism provides incumbent management to perform well.”<sup>60</sup>

In addition, the *MITE* opinion discounted, in language broad enough to apply to many other state statutes, both of the local interests Illinois asserted to support its statute. The Court stated that “[w]hile protecting local investors is plainly a legitimate state objective, the State has no legitimate interest in protecting nonresident shareholders. Insofar as the Illinois law burdens out-of-state transactions, there is nothing to be weighed in the balance to sustain the law.”<sup>61</sup> Citing this statement, other courts have held that the states have no interest in protecting nonresident shareholders, even shareholders of a local corporation.<sup>62</sup> Under this view, if Delaware’s corporation statute were subject to a commerce clause balancing test, Delaware would have little or no interest in protecting out-of-state shareholders of Delaware corporations.

Finally, the Court gave little weight to the internal affairs doctrine as a justification for state regulation of tender offers. The Court defined the internal affairs doctrine as “a conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation’s internal affairs—matters peculiar to the relationship among or between the corporation and its current officers, directors and shareholders—because otherwise a corporation could be faced with conflicting demands.”<sup>63</sup> Tender offers, according to the Court, contemplate only a transfer of stock and “do not themselves implicate the internal affairs of the target company.”<sup>64</sup>

A subsequent lower court decision extended this reasoning to conclude that “[r]egulation of *shareholders*—and those who would become shareholders—is not the same as regulating the corporation itself.”<sup>65</sup> This ruling overlooks the fact that one of the traditional functions of state

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60. *Id.*

61. *Id.* at 644.

62. See, e.g., *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 261 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986) (Indiana has no interest in protecting residents of Connecticut from being stampeded); *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 763-64 (S.D. Ohio), *aff’d*, 796 F.2d 135 (6th Cir. 1986); *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1222 (D. Minn. 1985).

63. 457 U.S. at 645.

64. *Id.*

65. *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1223-34 (D. Minn. 1985); see also *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 763 (S.D. Ohio), *aff’d*, 796 F.2d 135 (6th Cir. 1986) (“so fundamental that it cannot be disregarded”).

corporation law has been to regulate the rights of shareholders against management within that corporation.<sup>66</sup> Indeed, almost all courts following *Edgar v. MITE* fail to acknowledge that federal law regulates tender offers in part because of their effect on the shareholder-management relationship, but in a way that complements, without supplanting, the existing state substantive regulation of that relationship. Similarly, a number of courts discussing the preemption issue have opined that the Williams Act reflects a choice of a market approach over a fiduciary approach<sup>67</sup> without recognizing the intended interaction of the Williams Act with the long-standing state and common law fiduciary duties used for regulating shareholder-management relations. In these contexts, the courts' broad statements of the federal legislative purposes and narrow recognition of state interests have the effect of federalizing a large portion of state corporation law.

In one sense, the conclusions in this section are overstated. Most of the judicial statements cited here occurred in decisions interpreting "first generation" statutes like the Illinois statute in *MITE*. Those statutes do not involve the more difficult questions as to the division of federal and state responsibility. In those statutes, the states sought to regulate market transactions between bidders and target shareholders, the very transactions that Congress regulated in the Williams Act.<sup>68</sup> Moreover, "first generation" statutes regulated an area that lacked both a history of state regulation and any indication of congressional intent to preserve the area for state regulation. In addition, the broad extraterritorial reach of these statutes and the possibility of many states regulating the same transac-

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66. The *APL* court distinguished "regulation of shareholders and those who would become shareholders" from regulating the corporation itself, suggesting that the latter is left to state law. 622 F. Supp. at 1223. If the court meant that shareholder transactions across markets can be distinguished from intrafirm relationship, the statement makes more sense. The court must still come to grips, however, with the bifurcated effect of tender offers as both market and firm transactions.

67. See, e.g., *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 567 (6th Cir. 1982); *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122, 1129 (8th Cir. 1982); *Great W. United Corp. v. Kidwell*, 577 F.2d 1256, 1279 (5th Cir. 1978), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 443 U.S. 173 (1979); *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 758-59 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986). In the early cases cited above the immediate focus of the courts were provisions giving state officials control over a tender offer. But the courts also rejected a state argument that their laws were designed to give directors an opportunity to respond on behalf of their shareholders.

68. Not only were the states regulating the transactions regulated in the Williams Act, they often also used mechanisms that Congress had rejected. See, e.g., *MITE*, 457 U.S. at 634-36 (discussing the precommencement notification provisions of the Illinois statute).

tions raised substantial commerce clause objections.<sup>69</sup> But these judicial notions, suggesting a broad purpose for the Williams Act and a broad reach for the commerce clause, gained a powerful momentum in these early cases that now has begun to affect decisions in which a more direct conflict arises between the Williams Act and traditional state regulation of corporations.

*B. Schreiber v. Burlington Northern, Inc. and Other Cases Ruling on Private Defensive Tactics*

In contrast to the *MITE* line of cases another body of case law recognizes that Congress superimposed the Williams Act over the existing state regulation of corporations in a way that left substantial room for state statutes regulating shareholder-management relations, even when state-authorized corporate structures might affect the ability of a shareholder to respond to a tender offer. Many of these cases acknowledge the influence of *Santa Fe Industries, Inc. v. Green*,<sup>70</sup> the Supreme Court's leading decision on the relationship of federal securities law to state corporation law.

In this line of cases litigation frequently originated in a challenge to defensive tactics implemented by target management to ward off an unwanted tender offer. The plaintiff, often a competing bidder, argued that the target's acts constituted manipulative acts prohibited by section 14(e) of the 1934 Act.<sup>71</sup> In *Mobil Corp. v. Marathon Oil Co.*<sup>72</sup> the Sixth Circuit held that target management's sale of its "crown jewel" asset<sup>73</sup> to one of two bidders competing for the target's shares artificially capped the market price and therefore violated section 14(e).<sup>74</sup>

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69. *Id.* at 642, 645.

70. 430 U.S. 462 (1977).

71. 15 U.S.C. § 78n(e) (1982). Section 14(e) is a broad antifraud provision that makes it "unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices . . . in connection with any tender offer." *Id.*

72. 669 F.2d 366 (6th Cir. 1981).

73. "Crown jewels" refer to a company's most valuable asset. The board of directors of a target company, facing a tender offer from an unwanted bidder, may agree to sell the crown jewels to another party to decrease the attractiveness of the target to the initial bidder. In *Mobil*, the target, Marathon, sought to deflect an unwelcome bid from Mobil by agreeing to sell its Yates Oil Field to a second bidder, U.S. Steel. Marathon also granted stock options to U.S. Steel.

74. 669 F.2d at 376 ("Mobil has shown a sufficient likelihood of ultimately establishing that the Yates Field option and the stock option had the effect of creating an artificial price ceiling in the tender offer market for Marathon common shares, and that the options therefore are 'manipulative acts or practices' in connection with a tender offer in violation of Section 14(e) of the Williams Act.")

Three other circuit courts of appeal<sup>75</sup> and the United States Supreme Court in *Schreiber v. Burlington Northern, Inc.*,<sup>76</sup> roundly rejected the Sixth Circuit's approach. The narrow holding of these cases is that "manipulation" requires misrepresentation or nondisclosure, a holding consistent with earlier Supreme Court definitions of that term as used in rule 10b-5.<sup>77</sup> The more interesting aspect of these cases for current discussion is their view of the Williams Act and the relative role of state and federal law which provided the basis for the courts' narrow definition of manipulation.

These cases emphasize that the primary focus of federal regulation in the Williams Act is disclosure. They reject the plaintiffs' efforts to bring under the Williams Act actions in which shareholders essentially claim management breached its fiduciary duty. In *Schreiber*, for example, a bidder cancelled a tender offer under circumstances suggesting that the target management might have benefited at the expense of its shareholders.<sup>78</sup> In other cases, as in *Mobil*, the target board granted an option to one of two bidders or otherwise locked up the target's assets.<sup>79</sup> The Eighth Circuit said simply that when a plaintiff claims a "breach of fiduciary duty without more, the plaintiff's remedy lies under state law."<sup>80</sup>

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75. See *Feldbaum v. Avon Prods., Inc.*, 741 F.2d 234 (8th Cir. 1984); *Schreiber v. Burlington N., Inc.*, 731 F.2d 163 (3d Cir. 1984), *aff'd*, 472 U.S. 1 (1985); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983).

76. 472 U.S. 1, 5 n.3 (1985).

77. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

78. Burlington Northern initially made a hostile tender offer for 25.1 million shares (51%) of El Paso Gas Co. at \$24 per share. El Paso management opposed the takeover, but its shareholders fully subscribed the offer. El Paso management then negotiated a friendly takeover with Burlington. Burlington rescinded its first offer without buying any shares and replaced it with a new offer for only 21 million shares from the public shareholders at the same \$24 price. For those shares not purchased in the tender offer, Burlington eventually paid \$12 cash and one-quarter share of Burlington preferred stock. The parties disagreed about whether that consideration equalled the amount paid in the tender offer. 105 S. Ct. at 2460 n.1. As a part of the second tender offer, Burlington agreed to recognize "golden parachute" contracts between El Paso and four of its senior officers, allegedly worth millions of dollars. *Schreiber v. Burlington N., Inc.*, 568 F. Supp. 197 (D. Del. 1983), *aff'd*, 731 F.2d 163 (3d Cir. 1984), *aff'd*, 472 U.S. 1 (1985).

79. See, e.g., *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984). To fight off an unwanted tender offer by Data Probe, Datatab granted another bidder, CRC, a one year irrevocable option to purchase 1,407,674 authorized but unissued Datatab shares at \$1.40 per share. Because Datatab had only 703,836 shares of common stock outstanding, the option, in practical effect, guaranteed that CRC could acquire Datatab no matter how many of the outstanding shares were tendered to Data Probe.

80. *Feldbaum v. Avon Prods., Inc.*, 741 F.2d 234, 237 (8th Cir. 1984).



In a pre-*Mobil* case, the Seventh Circuit held:

Here there is uncontroverted evidence that it was Field's recent acquisition and plans for expansion that caused the withdrawal of the CHH tender offer. The decision to make acquisitions is one governed by the state law of directors' fiduciary duty. Therefore even if such conduct were a breach of the defendant directors' fiduciary duty, the plaintiffs would be relegated to their remedy at state law. This argument therefore cannot create a federal securities law claim where the alleged "wrong" the defendant committed is barred from federal scrutiny by the rule of *Santa Fe*.<sup>81</sup>

The Third Circuit decision affirmed by the Supreme Court in *Schreiber* expressly declined to follow *Mobil* because of the Supreme Court's reluctance, as expressed in *Santa Fe*, to federalize state corporation law.<sup>82</sup>

A 1983 district court decision, *Data Probe Acquisition Corp. v. Datatab, Inc.*,<sup>83</sup> tried to reconcile *MITE* and *Santa Fe*. In ruling on whether a target board's defensive tactic violates section 14(e), Judge Sofaer wrote that Congress imposed two duties on tender offer participants:

First, to provide shareholders the required information; and second, to refrain from any conduct that unduly impedes the shareholders' exercise of the decisionmaking prerogative guaranteed to them by Congress. . . . Congress indeed meant for the federal courts to prevent tender offer participants from interfering with the informed investor choice that the Act sought to assure.<sup>84</sup>

Indeed, Judge Sofaer argued that *Edgar v. MITE*, "written by the Justice who authored *Santa Fe*, is strong evidence that the Court will recognize that the Williams Act has federally enforceable objectives beyond mere disclosure."<sup>85</sup> Yet, the district court's effort to reconcile *MITE* and *Santa Fe* did not survive appeal. The Second Circuit found the gravamen of the claim to be a breach of fiduciary duty that if entertained "would unquestionably embark us on a course leading to a federal common law of fiduciary obligations."<sup>86</sup> The court argued that under existing federal legislation it was not free to condemn a breach of fiduciary duty.

This division of regulatory responsibility between the federal law's em-

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81. *Panter v. Marshall Field & Co.*, 646 F.2d 271, 285 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (citations omitted).

82. *Schreiber v. Burlington N., Inc.*, 731 F.2d 163, 166 (3d Cir. 1984), *aff'd*, 472 U.S. 1 (1985).

83. *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

84. *Id.* at 1545.

85. *Id.* at 1555.

86. 722 F.2d at 4.

phasis on disclosure and state law's regulation of fiduciary duty tracks closely the accommodation of state and federal regulation worked out in cases applying rule 10b-5 to allegations of corporate mismanagement.<sup>87</sup> In cases alleging that directors have breached their fiduciary duty to the shareholders by causing the corporation to engage in a securities transaction favorable to the directors personally but unfavorable to the corporation, courts have had to confront the intersection of federal regulation of the purchase-and-sale transaction and state law regulation of the intra-corporate relationship between shareholders and directors. In *Santa Fe*, the Supreme Court ruled that absent express authorization from Congress, the Court would not interpret rule 10b-5 to federalize the large body of corporation law involving transactions in securities.<sup>88</sup>

Several of the *Schreiber* cases cite *Santa Fe*, in effect holding that the Williams Act does not federalize all corporate law that affects tender offers. These cases leave for state law the question of whether a board can take particular defensive action, even though the action deprives shareholders of the opportunity to accept a tender offer. This deference should influence judicial interpretations of "second generation" takeover statutes framed in the form of traditional regulation of internal corporate affairs.

## II. THE INTERSECTION OF *MITE* AND *SCHREIBER/SANTA FE*: THE SECOND GENERATION STATUTES AND CONSTITUTIONAL CHALLENGES TO PRIVATE DEFENSIVE TACTICS

### A. *The Overlap of Second Generation Statutes and Private Defensive Tactics*

Neither the *MITE* nor the *Schreiber* lines of cases discuss in any detail the conflicting approach of the other cases. Either the issue was not raised, or the court summarily disposed of the issue with conclusory statements that the constitutional prohibitions of the supremacy clause and the commerce clause apply only to state, not private actors.<sup>89</sup>

The incompleteness of the analysis in these cases has become more obvious as state legislatures have changed their method of regulating takeovers. Instead of free-standing statutes labeled as regulation of securities transactions, states are now fitting their takeover legislation

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87. See *infra* notes 190-200 and accompanying text.

88. 430 U.S. 462 (1977).

89. See *infra* text accompanying notes 140-41 & 151-55.

within their corporation codes and emphasizing the similarity of this new legislation to traditional state regulation of corporate internal affairs. In effect, these new statutes change the substantive relationship between shareholders and managers, usually making managers less vulnerable to challenges from their shareholders. Challenges to these new statutes, therefore, may also apply to the many other provisions of state corporation codes which also regulate the shareholder-management relationship.

Furthermore, as takeover statutes have become more enmeshed with state regulation of intrafirm relationships, it has become more difficult to distinguish the hindrance these takeover statutes pose to interstate commerce and to the broadly interpreted purposes of the Williams Act from similar hindrances erected by directors of target corporations pursuant to existing authorization in the corporation codes. Indeed, to some extent statutes have copied defensive tactics pioneered by target firms.<sup>90</sup> These statutes thus provide a type of standardized contract for firms incorporated in those states.<sup>91</sup>

To explore further the interrelationship of the two lines of cases consider the following methods by which states have sought to protect target managers from unwanted takeover bids:

1. *Revised First Generation Statutes.* Several states revised their first generation statutes after *MITE*, removing the extraterritoriality and the hearing or precommencement notice provisions found objectionable by the Supreme Court.<sup>92</sup> These statutes continue to require bidders to make certain disclosures to target shareholders and often provide for enforcement of violations beyond the enforcement provided by the Williams

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90. The supermajority fair price statutes described *infra* notes 104 and accompanying text, for example, parallel private defensive tactics, such as the poison pill. See *infra* note 110. Cf. 19 SEC. REG. & L. REP. (BNA) 345 (1987) (noting Ohio's effort in early 1987 to validate "poison pill" in the wake of the attempted takeover of Goodyear).

91. A supermajority statute, for example, saves a corporation not only the costs of drafting, but also the costs of getting such a provision approved by the shareholders. Under state law such changes usually require a charter amendment which requires a shareholder meeting and vote. Such a statute also permits management to avoid a negative shareholder vote. In some situations it may be easier for a target corporation to persuade the state legislature than their own shareholders. See, Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987). If this is a common explanation of state legislation, it may spur the demand for federal corporation law, but it seems difficult to separate a state preferring management in a takeover statute from other apparent managerial preferences found in corporation law generally.

92. See, e.g., HAW. REV. STAT. § 417E-1 (1985); IDAHO CODE ANN. § 30-1501 *et seq.* (Supp. 1986); IND. CODE § 23-2-3.1 (Burns 1984 & Supp. 1986); MO. ANN. STAT. §§ 409.500-409.566 (Vernon Supp. 1987); NEV. REV. STATS. 78.376 (1985); N.Y. BUS. CORP. LAW § 1600 (McKinney 1986); OKLA. STAT. ANN. tit. 71, §§ 451-62 (West Supp. 1987); TENN. CODE ANN. § 48-5-101

Act.<sup>93</sup> As limited, provisions of this sort in the Minnesota and Massachusetts statutes have been upheld by federal courts.<sup>94</sup>

2. *Control Share Acquisition Statutes.* Statutes in some states condition the right to own or vote shares obtained in a tender offer on a majority vote of all shareholders.<sup>95</sup> These statutes extend the analogy made by the Williams Act in seeking to subject all kinds of corporate changes of control to parallel federal regulation.<sup>96</sup> The control share acquisition statutes seek to subject the different kinds of changes of control to parallel state regulation. Just as mergers traditionally have required the approval of shareholders, these statutes would condition change of control through a tender offer on a vote of the shareholders. Five of these statutes have been held unconstitutional by federal courts,<sup>97</sup> perhaps because they regulate the intrafirm relationship by directly regulating the market transaction.

3. *Reduced Vote Statutes.* As a variation of the control share acquisi-

(1984 & Supp. 1986); UTAH CODE ANN. § 61-5-1 (1986); VA. CODE ANN. § 13.1-528 (1985); WIS. STAT. § 552.01 (West Supp. 1985).

See also Cane & Taussig, *Hawaii's 1985 Corporate Takeover Legislation: Is It Constitutional?*, 8 HAWAII L. REV. 391 (1986) (discussing Hawaii's revised first generation statute).

93. The Indiana, New York, Virginia and Wisconsin statutes, cited *supra* note 92, apply only to corporations chartered under that state's laws (and sometimes include an additional requirement that the corporation have assets within the state or some other connection with the state). The other states, however, continue the pattern of the first generation statutes. These statutes apply to target companies based on criteria that potentially overlap with other states. Because they do not purport to regulate the shareholder-management relationship, this second group of states thus raises issues distinct from the others discussed in this Article.

94. See *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984) (upholding several provisions of the Minnesota Corporate Takeover Act (MINN. STAT. ANN. § 80B.01 (West 1986))); *cf.* *Agency Rent-A-Car, Inc. v. Connolly*, 686 F.2d 1029 (1st Cir. 1982) (upholding against a preemption challenge MASS. ANN. LAWS ch. 110c (Mitchie/Law. Co-op 1985), which provides state remedies for failure to comply with the Williams Act disclosure requirements or parallel state disclosure obligations). The *Agency* decision predates *MITE*, but both decisions have influenced other states to adopt similar approaches.

95. See, e.g., HAW. REV. STAT. §§ 416-171 & 172 (1985); IND. CODE §§ 23-1-42-1 (Burns Supp. 1986); MINN. STAT. ANN. §§ 302A.011, 302A.449, 302A.671 (West 1985 & Supp. 1987); MO. ANN. STAT. §§ 351.015, 351.407 (Vernon Supp. 1987); OHIO REV. CODE § 1701.831 (Page 1985).

96. See *supra* note 22 and accompanying text (discussing the desire to make tender offer regulation similar to federal regulation of proxy fights and share-for-share exchanges).

97. See *Fleet Aerospace Corp. v. Holderman*, 796 F.2d 135 (6th Cir. 1986) (Ohio statute); *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, (7th Cir.), *prob. juris. noted*, 107 S. Ct. 268 (1986) (Indiana statute); *Terry v. Yamashita*, 643 F. Supp. 161 (D. Hawaii 1986) (Hawaii statute); *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, (D. Minn. 1985) (Minnesota statute); *Icahn v. Blunt*, 612 F. Supp. 1400, (W.D. Mo. 1985) (Missouri statute amended to apply to non-Missouri chartered companies with significant impact on Missouri, in this case, Trans World Airlines).

tion statute, one state limits the voting power of a shareholder who owns more than twenty percent of a corporation's voting stock to ten percent of the full voting power of those shares, unless the holders of a majority of shares vote to restore full voting power at a meeting called for that purpose.<sup>98</sup>

4. *Appraisal Statutes.* These statutes give individual shareholders a right to have their shares redeemed by the corporation under specified circumstances, such as the acquisition by another shareholder of a majority (or some smaller portion) of the target company's stock.<sup>99</sup> Almost all state corporation statutes provide appraisal rights to minority shareholders who dissent from fundamental corporate changes such as mergers.<sup>100</sup> These takeover statutes extend that right to shareholders in a tender offer. They often copy the state's general appraisal procedure although some define the "fair value" to be paid for the shares differently (and more favorably to shareholders).<sup>101</sup>

5. *Second-Step/Five-Year Delay Statutes.* Statutes in some states forbid second step mergers and other similar transactions for five years following any tender offer that does not receive the prior approval of the target company's board of directors. New York passed such legislation in late 1985,<sup>102</sup> and several other states have since followed its lead.<sup>103</sup> These statutes emphasize the role of directors in tender offers and impose a potentially severe penalty for bidders who prefer to avoid the board and take their offer directly to shareholders.

6. *Second-Step/Supermajority-Fair Price Statutes.* Several states now condition second step mergers or other similar transactions on a supermajority vote or on payment to the remaining shareholders of a

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98. WIS. STAT. § 180.25 (West Supp. 1986). Statutes cited in note 95 as control share statutes sometimes are phrased in terms of voting restriction. Indiana's statutes states that shares acquired in a control share acquisition have only such voting rights as approved by shareholders. Minnesota and Hawaii limit voting rights for one year if shares are acquired in violation of the statute. All three states provide for redemption by the corporation for share acquisitions that do not comply with the statute.

99. ME REV. STAT. ANN. tit. 13-A, §§ 603, 716 & 910 (Supp. 1986); PA. CONS. STAT. ANN. tit. 15, § 1910 (Purdon Supp. 1986). Cf. HAW. REV. STAT. § 417-19 (1985).

100. See generally F.H. O'NEAL & R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS, ch. 5 (2d ed. 1985).

101. Most states' appraisal statutes provide the minority shareholder with an award based on value that excludes any increase or decrease from the fundamental corporate change. See *id.* Takeover appraisal statutes define value to include the value brought about by the tender offer.

102. N.Y. BUS. CORP. LAW § 912 (McKinney 1986).

103. KY. REV. STAT. ANN. § 271A.391 (Baldwin 1986); IND. CODE ANN. § 23-1-43 (Burns Supp. 1986); MO. ANN. STAT. § 351.459 (Vernon Supp. 1987).

statutorily defined fair price.<sup>104</sup> Pioneered by Maryland, these statutes appear less restrictive than the New York statute because they impose no absolute time bar. But these statutes define fair price in a way so favorable to remaining shareholders that the second step merger is extremely expensive.<sup>105</sup> These statutes also encourage bidders to negotiate with the target board of directors because the pre-existing board usually can waive the onerous provision.<sup>106</sup>

7. *Fiduciary Duty Statutes.* These statutes codify a broader definition of the director fiduciary duty than the previous state common-law definition of that duty.<sup>107</sup> A statute of this type might, for example, authorize directors of a target company responding to a tender offer to consider a variety of interests beyond those of shareholders.<sup>108</sup>

8. *"Delaware Approach"* Traditional corporation statutes in states without specific takeover laws contain provisions that grant boards of directors broad, permissive powers to manage the corporation.<sup>109</sup> The similarity of this approach to those previously mentioned becomes more

104. MD. CORPS. & ASS'NS CODE ANN. § 3-601 (1985 & Supp. 1986); see also CONN. GEN. STAT. § 33-374(a) (1981); GA. CODE ANN. § 14-2-231 (Supp. 1986); ILL. ANN. STAT. ch. 32, § 7.85 (Smith-Hurd 1986); KY. REV. STAT. ANN. § 271A.397 (Baldwin 1986); LA. REV. STAT. ANN. § 12:132 (West Supp. 1987); MICH. STAT. ANN. § 21.200(775) (Callaghan Supp. 1986); PA. CONS. STAT. ANN. tit. 15, §§ 1002-06, 1408-1505, 1908-10 (Purdon Supp. 1986); WIS. STAT. ANN. § 180.725 (West Supp. 1986); VA. CODE ANN. §§ 13.1-725-728 (1985). Cf. WASH. REV. CODE ANN. § 23A.08.425 (Supp. 1987).

105. See, e.g., MD. CORPS. & ASS'NS CODE ANN. § 3-202(b) (1985). Maryland defines the fair market value of common stock to at least equal the highest value determined under three alternatives: 1) highest per share price paid by the bidder within the previous two years or in the transaction in which the bidder became the owner of more than 10 percent of the target; 2) the market value on the date the second step is announced or when the bidder became a 10 percent shareholder; 3) a price equal to market value in (2) multiplied by a fraction, the numerator of which is the highest per share price paid by the bidder in the preceding two years and the denominator of which is the market value when the bidder first began to acquire stock within the previous two years. See Hanks, *Maryland-Type Takeover Statutes: Are they "Fair Price" or Foul Ball?*, Nat'l L.J., Sept. 8, 1986, at 32, 34 (discussing how the statute will in many cases produce a price substantially higher than any price paid by the bidder to any stockholder at any time during the tender offer or subsequently).

Some states vary the definition. Michigan for example does not include the third step "multiplier" part of the definition.

106. See, e.g., MD. CORPS. & ASS'NS CODE ANN. § 3-603(c) (1985).

107. See, e.g., PA. CONS. STAT. ANN. tit. 15, § 1408.B3 (Purdon Supp. 1986); ILL. ANN. STAT. ch. 32, § 8.85 (Smith-Hurd Supp. 1986); OHIO REV. CODE § 1701.59 (Page 1985).

See MODEL BUS. CORP. ACT. § 8.30 (1984) for an example of the traditional common law duty of directors which has been codified in many states.

108. See, e.g., MO. ANN. STAT. § 351.347 (Vernon Supp. 1987); OHIO REV. CODE § 1701.59 D (Page Supp. 1987); PA. CONS. STAT. ANN. tit. 15, § 1408.B3 (Purdon Supp. 1986). See also ILL. ANN. STAT. ch. 32, § 8.85 (Smith-Hurd 1986).

109. See *infra* note 155.

obvious in states such as Delaware, where state courts have interpreted the traditional corporate law broadly to authorize boards of directors to take steps similar to the defensive tactics other states have implemented by statute.<sup>110</sup>

Even this list does not exhaust the various approaches. Some states have enacted specialized statutes applicable to specific industries or as part of other regulatory schemes.<sup>111</sup> Given the tenacity demonstrated by the state legislatures in the past decade<sup>112</sup> there is little reason to believe that we have seen the last of innovative state statutes. But this list provides enough of a glimpse of the potential for state regulation to facilitate a discussion of the appropriate role of state and federal law.

### *B. The MITE Theories as Broadly Applied*

Both the preemption and the commerce clause theories of *MITE* have been used not only to challenge "first generation" state regulation of tender offers, but also to challenge a much broader realm of state legislation, including that just described.

#### *1. Preemption and the Broad Purpose of the Williams Act*

A recurring argument made in cases challenging state takeover laws is that the Williams Act mandates a market for corporate control unfettered by state law. The legislative history of the Act contains several references to providing the investors with information so that they can

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110. See, e.g., *Moran v. Household Int'l, Inc.* 500 A.2d 1346 (Del. 1985) (approving a director-implemented poison pill that would provide shareholders with a return similar to the Appraisal Statutes or the Second Step/Supermajority/Fair Price statutes); see also *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (upholding discriminatory buyback of shares by target). Other states may not follow Delaware in the leeway given to directors. See, e.g., *Minstar Acquisition Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1258 (S.D.N.Y. 1985).

111. See, e.g., OKLA. STAT. ANN. tit. 52 § 601 (West Supp. 1987) (Special statutes regarding energy companies declared unconstitutional in *Mesa Partners II v. Unocal Corp.*, 607 F. Supp. 624 (W.D. Okla. 1985); HAW. REV. STAT. § 343D-1 (1985) (statute regulating environmental matters). Many states have special statutes purporting to regulate takeovers in industries such as insurance. See, e.g., *National City Lines, Inc. v. LLC Corp.*, 524 F. Supp. 906 (W.D. Mo. 1981), *aff'd on other grounds*, 687 F.2d 1122 (8th Cir. 1982) (invalidating provisions of Missouri Insurance Holding Companies Act). An unusual provision of New York's takeover statute prohibits "greenmail." N.Y. BUS. CORP. LAW § 513 (McKinney 1986).

112. Many states have passed multiple takeover laws as an existing state law is declared unconstitutional or as new methods appear to offer improved means of achieving state goals. Missouri has passed five different types of statutes and Oklahoma four. Wisconsin recently repealed its control share acquisition statute and passed a new statute limiting the voting power of a hostile bidder. See WIS. ANN. STAT. ANN. § 180.25 (West Supp. 1986).

make their own choice.<sup>113</sup> Both courts and commentators have viewed these references as expressing the purpose of protecting the shareholders' right freely to decide whether to sell their shares into a market influenced by tender offerors.<sup>114</sup> Management defensive tactics that remove the tender offer decision from the shareholder arguably frustrate these purposes.<sup>115</sup> It is only a short step to conclude that the Williams Act, therefore, limits defensive tactics which operate to preclude shareholder consideration of tender offers.<sup>116</sup>

A corollary frequently drawn is that Congress intended the shareholders to be the actual decision-makers and not some other group—whether a state commissioner, the target board of directors or even the shareholders collectively rather than individually.<sup>117</sup> Judge Wisdom sounded a variation of this theme in the Fifth Circuit's decision in *Great Western United Corp. v. Kidwell*<sup>118</sup> where he argued that Congress chose a "market approach" over what he labeled the "fiduciary approach" of the Idaho law, which sought to give the target board of directors an opportunity to respond to a takeover.<sup>119</sup>

113. See, e.g., SENATE REPORT, *supra* note 22, at 3; *Senate Hearings*, *supra* note 23, at 15 (statement of SEC Chairman Cohen) & 146 (statement of Senator Williams); *Takeover Bids, Hearings on S. 510 Before Subcomm. on Commerce and Finance of Committee on Interstate and Foreign Commerce*, 90th Cong., 2d Sess. 10 (1968) (statement of Chairman Cohen) [hereinafter cited as *House Hearings*].

114. See, e.g., *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742 (S.D. Ohio 1986), *aff'd*, 796 F.2d 135 (6th Cir. 1986); *Ihcan v. Blunt*, 612 F. Supp. 1400, (W.D. Mo. 1985).

115. See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 633 n.9 (1982) (quoting 113 CONG. REC. 24666 (1967) (remarks of Senator Javits), for the point that Congress did not want to deny shareholders "the opportunities which result from competitive bidding for a block of stock of a target company"). *Accord* *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1220 (D. Minn. 1985).

116. See Note, *Federal Limitations on Target Defensive Tactics: Applying Edgar v. MITE Corp. to the "Private Conduct" of Target Directors*, *infra* at p. .

117. See, e.g., *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 567 (6th Cir. 1982); *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122, 1129 (8th Cir. 1982); *Great W. United Corp. v. Kidwell*, 577 F.2d 1256, 1279 (5th Cir. 1978), *rev'd on other grounds sub nom. Leroy v. Great W. United Corp.*, 443 U.S. 173 (1979); *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 758-59 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986). Some commentators suggest such a policy may be short-sighted, at least in some situations. See Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Bechuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985); Osterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORN. L. REV. 53 (1986).

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

119. *Id.* at 1279.



These broad views of the Williams Act can be used to attack several of the state statutes described above. The control share acquisition statutes effectively put the decision about a tender offer into the hands of the shareholders as a group. For this reason several courts have struck down these statutes.<sup>120</sup> The second-step/five-year delay statutes, such as the New York statute, place the tender offer decision in the hands of the directors, unless the bidder is willing to wait five years to complete a second-step merger. The Maryland second-step/supermajority-fair price statute puts the decision in the hands of the directors, unless the bidder is willing to seek supermajority shareholder approval or pay the statutory fair price. These second-step statutes more indirectly provide the directors with decision-making power but they nevertheless raise the costs of a tender offer, thereby reducing the number of tender offers and limiting the extent to which shareholders will have the opportunity to sell their shares into a market influenced by potential tender offerors.<sup>121</sup>

The fiduciary duty statutes also can be attacked on the ground that they take the decision out of the shareholders' hands.<sup>122</sup> Even the appraisal statutes are vulnerable to similar arguments. If a nonmajority group seeks appraisal and raises the bidder's takeover cost, thus possibly deterring the offer, the statute can be read as putting the decision in the hands of this small group contrary to the shareholder-decision approach of the Williams Act.<sup>123</sup> Similarly, one court found that the Williams Act preempts state law to the extent that it permits boards of directors to grant options to purchase authorized but unissued stock without shareholder approval, if the option is used to abort an ongoing tender offer.<sup>124</sup>

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120. See, e.g., *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*, 637 F. Supp. 742 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986); *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985).

121. See Note, *Second Generation State Takeover Legislation: Maryland Takes a New Tack*, 83 MICH. L. REV. 433, 462-69 (1984); Hanks, *Maryland Type Statutes: Are They Fair Price or Foul Ball*, Nat'l L.J., Sept. 8, 1986, at 32, 38 (because the fair price provisions "effectively prevent the consummation of the freeze-out transaction in the second step, they inevitably discourage bidders from initiating a first step").

122. Junewicz, *The Supremacy Clause and the Second Generation State Takeover Statutes*, in ALI-ABA COURSE OF STUDY, NEW DIRECTIONS IN STATE TAKEOVER REGULATION, THE SECOND GENERATION STATUTES, 129, 162 (1986). Cf. Sell, *A Critical Analysis of a New Approach to State Takeover Legislation After MITE*, 23 WASHBURN L.J. 473, 486-87 (1984).

123. Cf. *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 567 (6th Cir. 1982).

124. *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538, 1555 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984) (referring to §§ 501 and 505 of New York's Business Corporation Act); see also Johnson, *Minnesota's Control Share Acquisition Statute*

## 2. Interstate Commerce

The heightened concern with state regulation of interstate commerce illustrated in the *MITE* line of cases also has potentially broad implications for state takeover legislation and state corporation laws generally. Many of the cases, including *MITE* itself, seem to equate interference with the market for corporate control to interference with interstate commerce.<sup>125</sup> Ruling on an Indiana law, Judge Posner wrote that "the efficiency with which [a corporation's tangible assets] are employed and the proportions in which the earnings they generate are divided between management and shareholders depends on the market for corporate control—an interstate, indeed international, market that the state of Indiana is not authorized to opt out of, as in effect it has done in this statute."<sup>126</sup>

If interference with the market for corporate control indeed constitutes interference with interstate commerce, a variety of laws and defensive tactics can be subjected to interstate commerce challenge. Utilizing this approach, several courts have held that the control share acquisition statutes impair the ability of the bidder to do business with the target shareholders and thus burden interstate commerce.<sup>127</sup> The New York and other second-step statutes also interfere with the bidder-shareholder relationship, even if somewhat more indirectly.<sup>128</sup> Another court has invalidated state blue sky laws to the extent that they interfere with the timing of an interstate tender offer and, thus, decrease its chances of success.<sup>129</sup> But this theory has even broader implications:

—Any state corporate statute (e.g., permitting cumulative voting, staggered terms for directors, no removal of directors without cause prior to

and the Need for New Judicial Analysis of State Takeover Legislation, 12 WM. MITCHELL L. REV. 183 (1986).

125. See *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).

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

127. See *id.* at 261; *Terry v. Yamashita*, 643 F. Supp. 161 (D. Hawaii 1986) (Hawaii statute); *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742 (S.D. Ohio), *aff'd*, 796 F.2d 135 (6th Cir. 1986) (Ohio statute); *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, (D. Minn. 1985) (Minnesota statute); *Icahn v. Blunt*, 612 F. Supp. 1400 (W.D. Mo. 1985) (Missouri statute as applied to foreign corporations).

128. See Note, *Second Generation State Takeover Legislation: Maryland Takes a New Tack*, 83 MICH. L. REV. 433 (1984); but see *Scriggins & Clarke, Takeovers and the 1983 Maryland Fair Price Legislation*, 43 MD. L. REV. 266 (1984).

129. *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982); but see *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 263-64 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986); *Icahn v. Blunt*, 612 F. Supp. 1400, 1415 (W.D. Mo. 1985).

the end of a term, authorizing issuance of "poison pill" stock) that makes it more difficult to make a tender offer similarly interferes with the market for corporate control.<sup>130</sup>

—State common law could be challenged on similar grounds. For example, judicial adoption of an "equal opportunity rule" entitling all shareholders to share in a control premium might run afoul of the prohibitions in the commerce clause.<sup>131</sup>

—Even such apparently unrelated laws such as those requiring bonds to appeal a judgment are vulnerable to this challenge. Texaco argued in its case against Getty Oil that the Texas bond requirements impermissibly interfered with the market for corporate control and were therefore invalid.<sup>132</sup> The court did not rule on that issue, but such a holding could flow logically from previous holdings.

This broad connection of interference with the market for corporate control and interference with interstate commerce addresses only the "burdens" side of the balancing equation used for indirect interferences with interstate commerce.<sup>133</sup> The *MITE* line of cases suggests that this burden will occur in many of the examples cited above and that it will be "substantial."<sup>134</sup>

On the benefits side of the equation, *MITE* and subsequent courts ascribe very little weight to state regulation of corporations chartered under its law. *MITE* characterized the internal affairs doctrine as a conflict of laws principle "of little use to the State in this context."<sup>135</sup> Other courts have found the doctrine of little use to the state in other contexts.<sup>136</sup> Thus, Delaware, with many national corporations and few resident shareholders, will have to persuade the court that the benefits to its

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130. See Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563, 625 (1983); cf. *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 261 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986) (distinguishing cumulative voting from control share acquisition statute where the effect on the interstate market is direct, intended and substantial; it is not merely the incidental effect of a general regulation of internal corporate governance). See also *Skadden Arp's Poison Pill Stance Raises Conflict of Interest Concern*, Wall St. J., July 23, 1986, at 23, col. 4) (describing a challenge to such a statute).

131. See Levmore, *supra* note 130 at 625; see also Fiflis, *supra* note 25, at 304 n.1.

132. See *Texaco Inc. v. Pennzoil Co.*, 626 F. Supp. 250, 251 (S.D.N.Y.), *aff'd*, 784 F.2d 1133 (2d Cir.), *prob. juris. notes*, 106 S. Ct. 3270 (1986).

133. See *supra* notes 57-67 and accompanying text. If the court finds the state regulation to be a direct restraint on interstate commerce, no balancing would be necessary. See *supra* notes 53-56 and accompanying text.

134. See *supra* notes 53-56 and accompanying text.

135. 457 U.S. at 645.

136. See, e.g., *Fleet Aerospace Corp. v. Holderman*, 637 F. Supp. 742, 763-64 (S.D. Ohio), *aff'd*,

state treasury and to its local citizenry from being a center of incorporations outweigh the burden it imposes on interstate commerce.

States might more successfully convince courts that benefits to *resident* shareholders outweigh these costs, at least when a state limits its takeover law to the application of locally incorporated enterprises with a great majority of shareholders who are in-state residents. Two courts have upheld such laws against commerce challenges.<sup>137</sup> On the other hand, simply limiting the reach of the law to local residents did not satisfy the Sixth Circuit. Finding the shares held by Michigan shareholders instrumental to obtaining a majority in a nationwide tender offer, the court held that a state procedure excluding the offer to Michigan residents would interfere with the national tender offer and thereby burden interstate commerce.<sup>138</sup>

Thus, as a result of both the preemption and the commerce clause analyses a substantial federalization of the law of shareholder-management relations may occur. This matter was never expressly debated by Congress in passing the Williams Act, even though federalization of state law has been vigorously debated in a variety of other areas.

### III. RECONCILING *MITE* AND *SCHREIBER*: PRINCIPLES THAT DEFINE THE APPROPRIATE REALMS OF STATE AND FEDERAL REGULATION

The broad interpretations of *MITE* detailed in the previous section and their potential impact on the federalization of state corporation law suggest a need for a clearer understanding of the principles that define the appropriate realms of state and federal regulation over tender offers. This section examines several policies that could provide a basis for reconciling *MITE* with the policies of *Santa Fe* as set forth in the *Schreiber* line of cases and thereby define those roles.

#### A. *Distinguishing State from Private Conduct*

There is little direct conflict between the *MITE* and *Schreiber* lines of cases if activities in the *Schreiber* cases can be characterized as private actions to which the constitutional prohibitions of the supremacy clause

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796 F.2d 135 (6th Cir. 1986); *APL Limited Partnership v. Van Dusen Air, Inc.*, 622 F. Supp. 1216, 1223 (D. Minn. 1985).

137. See *L.P. Acquisition Co. v. Tyson*, 772 F.2d 201, (6th Cir. 1985); *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984). Both of these cases involved revised first generation statutes.

138. *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 567 (6th Cir. 1982).

and the commerce clause do not apply.<sup>139</sup> The first courts to address the issue of whether *MITE*'s constitutional principles apply to defensive tactics in a tender offer fight have in fact used this argument. The Delaware Supreme Court in *Moran v. Household International, Inc.*,<sup>140</sup> a decision upholding a poison pill defense under Delaware law, ruled that statutory authorization of private conduct provides an insufficient nexus to the state to constitute "state action."<sup>141</sup>

That holding seems inconsistent with other cases in which preempted state law has not been so narrowly defined. In *San Diego Building Trades Council v. Garmon*, the United States Supreme Court held that state common law could not be applied in a way that frustrates federal labor policy.<sup>142</sup> Similar holdings exist for other laws.<sup>143</sup>

There is also precedent for a broader preemption when the federal securities laws and state corporate regulation overlap. In a recent Sixth Circuit case, *In re General Tire and Rubber Co. Securities Litigation*,<sup>144</sup> shareholders challenged the dismissal of a derivative suit by the corporation's directors acting pursuant to their authority under state law to manage the corporation. Under Ohio common law, it seemed likely that the business judgment rule would protect the board's decision from judicial review.<sup>145</sup> Plaintiffs claimed this application of state common law would

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139. The application of the constitutional language to state rather than private actions has been most widely noted in connection with the fourteenth amendment. *See, e.g., Virginia v. Rives*, 100 U.S. 313, 318 (1879). But similar limitations have been applied to the supremacy and interstate commerce clauses. *See infra* notes 140-41 & 151-55 and accompanying text.

140. 500 A.2d 1346 (Del. 1985).

141. *Id.* at 1353.

142. 359 U.S. 236 (1959) (tort action for damages resulting from unfair labor practices—picketing and boycotting non-union employee—preempted by §§ 7-8 of the National Labor Relations Act).

143. *See, e.g., Arkansas-La. Gas Co. v. Hall*, 453 U.S. 571 (1981) (Natural Gas Act blocked method by which state court calculated damages in a breach of contract action); *Chicago & N.W. Transp. Co. v. Kalo Brick & Tile Co.*, 450 U.S. 311 (1981) (Interstate Commerce Act precluded common law negligence action based on purported interference with contractual relations with customers brought by rail line against regulated rail carrier who sought and obtained ICC approval to abandon railroad line). *Cf. Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238 (1984) (punitive damages permitted for state common law action against operator of nuclear power plant despite claim of preemption by federal nuclear power regulation; common law action can be preempted but federal policy in this case found not to extend so far as to require preemption of this action).

144. 726 F.2d 1075 (6th Cir. 1984), *cert. denied*, 469 U.S. 858 (1984).

145. *Id.* at 1081-82. The business judgment rule is a judicial principle under which judges defer to the decision of the board of directors who are authorized by state law to act on behalf of the corporation unless there is self-dealing or some other disabling attribute that prevents the directors from acting.

frustrate federal policy underlying the proxy provisions.

The Sixth Circuit acknowledged that it would preempt application of the Ohio business judgment rule if the rule frustrated the federal proxy laws. It declined to do so in this case, however, because plaintiffs had failed to establish a causal connection between their claims and the transaction authorized by shareholders through the proxy process.<sup>146</sup> Still, the court left no doubt that in other situations the business judgment rule can frustrate federal policy and that in those situations the court would prevent the application of state law.<sup>147</sup> Using similar reasoning, the business judgment rule could not be used to protect director defensive tactics authorized by state law, if those tactics conflict with the Williams Act.

The result in *General Tire and Rubber* is consistent with the Supreme Court's decision in *Burks v. Lasker*.<sup>148</sup> *Burks* also involved a challenge to a director dismissal of a derivative suit as conflicting with federal law. The court rejected the claim, not because the directors were "private" actors, but because federal policy was not broad enough to supplant the authorization of director action found in state law. In language bearing on the Williams Act, the Court stated that "in this field congressional legislation is generally enacted against the background of existing state law; Congress has never indicated the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute."<sup>149</sup>

The cited cases provide ample precedent for preempting director conduct authorized by state law, if federal policy would thereby be frustrated. Courts, therefore, should focus on the purpose of the federal law rather than the state/private distinction. If the purposes of the Williams Act are interpreted in light of the *MITE* plurality to maintain neutrality in the broader sense of that term,<sup>150</sup> the Williams Act would preempt many director actions.

This focus on congressional purpose provides a second method by

146. *Id.* at 1081.

147. *Id.* at 1082.

148. 441 U.S. 471 (1979).

149. *Id.* at 478. See also *Abramowitz v. Posner*, 672 F.2d 1025 (2d Cir. 1982) (federal policy does not preclude dismissal of §§ 10(b) and 14(a) claims by a special litigation committee); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1980) (same); *Galef v. Alexander*, 615 F.2d 51, 64 (2d Cir. 1980) (federal policy precludes summary dismissal of a well-pleaded claim number under § 14(a) pursuant to the business judgment of defendant directors where the claim goes to the disclosures required by the federal act).

150. See *supra* notes 41-43 and accompanying text.

which one court has avoided the constitutional issue regarding private defensive tactics. The Second Circuit in *Data Probe* suggested that the Williams Act was more concerned about some state laws (special takeover statutes) than other state laws (corporation statutes or common law authorizing director conduct). In *Data Probe*, the district court had maintained that “[t]he notion that the reasoning in *Edgar v. MITE Corp.* can be distinguished as inapplicable to private suits seems unsound.”<sup>151</sup> The Second Circuit disagreed and found the Williams Act inapplicable to the challenged director action. Without discussion, the court also held the commerce clause inapplicable to a challenge to director conduct.<sup>152</sup> It disposed of the supremacy clause objection by interpreting the Williams Act to bar only “legislative regulation of the tender offer process, including administrative review of the fairness or unfairness of the offer.”<sup>153</sup> In a footnote, Judge Winter noted that *MITE* did not involve “the application of fiduciary obligations of a contractual nature imposed by state law,”<sup>154</sup> suggesting that this second type of state regulation, the kind involved in *Data Probe*, would not be preempted.

Under this view, the *MITE* and *Schreiber* lines of cases can be reconciled if the Williams Act reflects a policy choice to override positive state regulation of tender offers but not state regulation achieved by imposing fiduciary obligations of a contractual nature or by common law applications of the business judgment rule enabling directors of target companies to implement defensive tactics. This focus on the form of state regulation, however, produces an awkward policy result: interference with the market for corporate control would be banned if written into a specific state takeover law but permitted if accomplished by directors under a more general state law. In effect, this would authorize private parties to do what the state cannot. State legislatures and judiciaries would be permitted to foster and encourage defensive tactics that interfere with the market for corporate control.<sup>155</sup> Yet other states would be

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151. *Data Probe Acquisition Corp. v. Datatab Inc.*, 568 F. Supp. 1538, 1555 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

152. 722 F.2d at 5 (“In *Edgar v. MITE Corp.*, . . . a majority of the Court held that the Illinois Takeover Act imposed an impermissible burden on interstate commerce, a rationale inapplicable to the present dispute which involves private acts.”).

153. *Id.*

154. *Id.* at 5 n.3.

155. The extent to which the judiciary, legislature, and bar in the relatively small state of Delaware have combined to develop and preserve a favorable legal environment for corporations has been the topic of substantial writing. *See, e.g.*, Cary, *supra* note 1; Comment, *Law for Sale: A Study of the*

seen as intruding into the realm of the federal regulation or interfering with interstate commerce when they seek to assist their corporations by providing a standardized takeover barrier.

Interference with the market for corporate control cannot be so easily separated. Indeed, the SEC's Advisory Committee on Tender Offers lumped together harm to the economy from defensive tactics provided by takeover statutes and from actions instituted by private parties acting pursuant to state law.<sup>156</sup> The elusive nature of such a distinction becomes apparent upon considering the various ways state governments have structured their corporation laws to help directors.

First, it is not self-evident that Delaware's approach to shareholder-management relations should be treated differently from Ohio's declaration of shareholder-management relations found in its control share acquisitions statute. Delaware's broad grant of authority to directors may well be a more effective means of aiding managers against shareholders. As a practical matter, it removes the need for a separate takeover statute to protect its corporations.<sup>157</sup> Moreover, it is difficult to distinguish the fiduciary duty, appraisal, and second-step statutes from the Delaware or Ohio approaches. Each appears to interfere with the market for corporate control to some extent. Each also appears to reflect a conscious state policy about the relative positions of shareholders and managers within a corporation. Thus, these new approaches suggest that division based on state versus private conduct, or positive state legislation versus state law imposing fiduciary obligations, will not produce a consistent theory to differentiate the role for state and federal law in regulating takeovers.

### *B. Protectionism and Interstate Commerce Jurisprudence*

Questions about the meaning of the commerce clause have occupied a significant place in the deliberations of the Supreme Court since its earliest days, spawning a variety of theories and constant litigation. A recurring theme through much of this history is a basic hostility to protectionist state legislation that blatantly discriminates against out-of-

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*Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969). *But see* Arshat, *Reply to Professor Cary*, 31 BUS. LAW. 1113 (1976).

156. ADVISORY COMMITTEE ON TENDER OFFERS, REPORT OF RECOMMENDATIONS, Recommendation No. 34 (1983).

157. Delaware had a "first generation" takeover statute, but has taken no legislative action since *Edgar v. MITE* to regulate takeovers.



state economic interests.<sup>158</sup> Certainly judges in the *MITE* line of cases have ascribed this type of motive to state statutes that appear designed to prevent the takeover of local firms.<sup>159</sup>

In a corporate setting courts may be tempted to apply this principle too readily. The in-state/out-of-state division, which provides a necessary factual foundation for a finding of state protectionism, substantially overlaps in corporate cases with the management/shareholder division. Typically, the managers of many large American corporations reside in the state of incorporation or that state identifies with management, while the great majority of shareholders reside in other states. Any state law regulating internal corporate affairs that favors the interests of management over those of the shareholders would adversely affect interstate commerce by transferring the cost of the regulation (including the lost benefit of an advantageous takeover) to out-of-state shareholders. In this situation, a court will have a difficult time separating provisions that discriminate against out-of-state interests from many other provisions in the corporations code.

A court's effort to determine if an entire state corporations code impermissibly regulates interstate commerce is eased by the constitutional principle that Congress may redefine the extent to which states may regulate interstate commerce.<sup>160</sup> In the corporate area, Congress clearly has left a broad area of shareholder-management relations to state law.<sup>161</sup> Using its authority over corporations, a state may prefer managers over shareholders in a way that unduly harms out-of-state interests. That tendency will, however, be checked to some extent by the competition between states for corporate charters,<sup>162</sup> which may operate to insure that states cannot externalize the costs of such changes in the long run.

Against this background, courts should reserve invalidation for commerce clause reasons for those cases in which the state statute blatantly

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158. See, e.g., *Mesa Petroleum Co. v. Cities Serv. Co.*, 715 F.2d 1425, 1429 (10th Cir. 1983); *Mesa Partners II v. Unocal Corp.*, 607 F. Supp. 624, 629 (D. Okla. 1985).

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

160. See *South-Central Timber Dev., Inc.*, 467 U.S. 82, 87 (1984); *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946). This redefinition need not be stated expressly. See *L.P. Acquisition Co. v. Tyson*, 772 F.2d 201, 205 (6th Cir. 1985) (no "talismanic" significance to expressly stated).

161. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). *But see* *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 263 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986) (no indication that Williams Act was intended to insulate a state takeover statute from complaints that it unduly burdens interstate commerce).

162. See *infra* notes 164-66 and accompanying text.

discriminates against out-of-state interests. When the alleged discrimination cannot be distinguished easily from shareholder-management conflicts, courts should not use the commerce clause to stifle state policy debates or the debate over federalization of corporation law.<sup>163</sup>

C. *Distinguishing Regulation of the Market for Corporate Control from Regulation of Capital Markets*

Judge Winter, the author of the Second Circuit's *Data Probe* decision, previously had suggested an alternative theory that would define the appropriate realms of state and federal regulation of takeovers. In an article he wrote while on the Yale Law School faculty, Winter expressed a general preference for state regulation of corporations. He argued that the competition between states for charters would facilitate the development of legal rules most appropriate for the capital market.<sup>164</sup> A state corporations code that reduces the yield to shareholders will spawn corporations that are less attractive investment opportunities than comparable corporations chartered in other states or bonds, savings accounts, land and other investments.<sup>165</sup> Only managers wanting a "one shot take the money and run raid" would seek out such a code. Winter, however, exempted regulation of the market for corporate control from this system of preferred state regulation. He was concerned that competition among the states would provide inadequate protection for the market for corporate control. An ineffective market for corporate control would prevent the effective functioning of product market competition, the competition for capital, and management's self-interest in seeking to increase its own return, all of which otherwise operate to "channel the chartering decision toward those legal arrangements which optimize the management-shareholder relationship."<sup>166</sup>

If state regulation of the market for corporate control is less effective than state regulation of other aspects of intrafirm relationships, the proper scope for federal and state law can be defined based on that principle. Yet a significant part of Winter's argument turns on the extraterri-

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163. "The inherent conflicts between managerial autonomy . . . and . . . investor protection . . . ought to be worked out at the policy level and not diverted into the unpredictable byways of commerce clause jurisprudence." Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 845 (1984).

164. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUDIES 251 (1977).

165. *Id.* at 257.

166. *Id.* at 287-88.

toriality of early takeover laws. This characteristic permitted the statute to operate outside of the competition between state legal systems for corporate charters.<sup>167</sup> Now that state laws regulating takeovers apply only to locally incorporated corporations,<sup>168</sup> competition for charters may be more effective.<sup>169</sup>

Even if there is a need for a federal law to prevail over state law in regulating the market for corporate control, it is not at all clear that Congress intended this displacement in passing the Williams Act. The tender offer is not the only means by which the market for corporate control operates, although it may be the most effective.<sup>170</sup> Other mechanisms, such as a proxy fight, perform a similar function and federal law already regulated these mechanisms when Congress enacted the Williams Act. The legislative history of the Act discloses that Congress sought to fill the gap in the federal regulatory scheme by covering this newly popular method of acquiring control.<sup>171</sup> There is no evidence that Congress intended to regulate the shareholder-director relationship differently from previous federal regulation.

#### *D. Federal Recognition of State Regulation of Economic Activity Within the Firm*

The theories discussed thus far do not reconcile the federal interven-

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167. See *id.* at 289 (“The extraterritorial features of takeover statutes in effect restrain competition between state legal systems for corporate charters.”).

168. All second generation statutes described *supra* at notes 95-108 and accompanying text apply only to corporation’s chartered under that particular state’s law. Often the statutes also require some other connection to the state such as a specified portion of assets or shareholders. Some revised first generation statutes continue to base their coverage on connections other than incorporation within the state, see *supra* note 93, and should be distinguished from the remaining statutes for purposes of this Article.

169. Second generation statutes, such as control share acquisition statutes, still have extraterritorial effect in that they can regulate a transaction between a purchaser and a seller, neither of whom is a resident of the state in which the corporation is incorporated. However, this type of extraterritorial effect does not let a state externalize the cost of regulation in the same way as the first generation statutes. If the state’s laws favor management and offer an inferior return as compared to corporations chartered in other states, the state will be adversely affected by the market for competition in charters.

170. See generally *Coffee*, *supra* note 21; see also *Winter*, *supra* note 164, at 258 (recognizing that “one ought not to overstate the case [that competition between the states for charters may provide inadequate protection in the case of takeover statutes], however, since competition in the product and capital markets exerts pressure in other directions”).

171. SENATE REPORT, *supra* note 22, at 4 (“The bill would correct the current gap in our securities laws . . . to provide for full disclosure”); *Senate Hearings*, *supra* note 23, at 42 (statement of Senator Kuchel).

tion in tender offers permitted in the *MITE* cases with the respect for state law found in the *Schreiber/Santa Fe* cases, nor do they adequately explain the division of responsibility between federal and state government in regulating takeovers. The best explanation for such a division views state law as providing the primary regulation of the rights among participants within the corporation and federal law as facilitating the exercise of these state-provided rights but not creating additional substantive rights. Accordingly, the Williams Act's regulation of the market transactions between a bidder and a target company shareholder aids shareholders in monitoring management. But the Act should not be read to alter existing substantive rights of shareholders against their managers.

This is not to say that federal law is not concerned with regulating economic activity within a firm. A variety of provisions in the Securities Exchange Act of 1934 are intended to affect the intrafirm relationship. Proxy rules aim to "prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure."<sup>172</sup> Periodic disclosures required by section 13 of the 1934 Act similarly aid shareholders in evaluating the performance of their managers and making decisions concerning the exercise of their rights against managers.<sup>173</sup> Antifraud provisions back up the specific disclosure obligations in accomplishing the desired protection for shareholders.<sup>174</sup>

Both the periodic disclosure and antifraud provisions perform a dual role. Apart from assisting shareholder monitoring of management performance, both provisions protect investors in the specific transactions in which they buy and sell securities.<sup>175</sup> The Williams Act has two similarly interrelated effects, first on the market transaction between the bidder and the target shareholder and second on the intrafirm relationship.

Other parts of the federal securities laws specifically regulate changes in corporate control. All are nonsubstantive in nature and look to state law for the underlying substantive rights. For example, in friendly acquisitions such as mergers, federal law mandates disclosure if proxies are solicited from shareholders in order to obtain the necessary approval re-

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172. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

173. 15 U.S.C. § 78m (1982).

174. *Id.* § 78j(b).

175. *See* L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 537 (1983).

quired by state law.<sup>176</sup> Federal law also requires disclosure if the acquisition takes the form of a sale of assets, but only if state law requires a shareholder vote.<sup>177</sup> If the particular state permits directors to take action without shareholder approval (e.g., short form mergers in most states),<sup>178</sup> the shareholders will not receive the benefit of the federal disclosures. In hostile takeovers which take the form of a proxy fight for the election of directors, federal law mandates disclosure while state law provides the election rules.<sup>179</sup> Tender offers continually were compared to these transactions during consideration of the Williams Act. Insofar as the new Act was designed to fill a gap in existing regulation and regulate this new technique in a way parallel to existing regulation,<sup>180</sup> the federal role in regulating takeovers, as in these pre-existing areas of federal regulation, should not extend to substantive rights of shareholders vis-a-vis managers.

Tender offers are not the first area in which a dispute over federal regulation of intrafirm relationships has arisen. Indeed, this previous debate should provide guidance in interpreting the Williams Act. In the proxy regulation area, the most instructive case is *SEC v. Transamerica Corp.*,<sup>181</sup> a 1947 decision by the Third Circuit ruling on whether a corporation's proxy solicitation must include shareholder proposals. An SEC rule required management's proxy statement to include any shareholder proposal concerning subjects about which state corporation law permitted shareholders to act. Transamerica's management asserted that a by-law (implemented pursuant to the corporation's charter and the provisions of Delaware's corporation code) authorized them to act "as a block or strainer to prevent any proposal to amend the by-laws, which it may deem unsuitable, from reaching a vote at an annual meeting of stockholders."<sup>182</sup>

The court ruled that the corporation's position was "overnice and un-

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176. 15 U.S.C. § 78n (1982); rule 14a-3, 17 C.F.R. § 240.14a-3 (1986); schedule 14A, Item 14, 17 C.F.R. § 240.14d-100, Item 14 (1986).

177. 15 U.S.C. § 78n (1982).

178. See, e.g., DEL. CODE ANN. tit. 8, § 253 (1983); N.Y. BUS. CORP. LAW § 905 (McKinney 1986); REV. MODEL BUS. CORP. ACT § 11.04 (1984).

179. 15 U.S.C. § 78(n) (1982); 17 C.F.R. § 240.14a-3 (1986).

180. See SENATE REPORT, *supra* note 22, at 3. See also *Memorandum of the SEC to the Committee on Banking and Currency, U.S. Senate on S. 2731, 89th Congress, reprinted in 112 CONG. REC. 19003, 19005 (1966).*

181. 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 322 U.S. 847 (1948).

182. *Id.* at 516.

tenable," apparently as a matter of Delaware law.<sup>183</sup> But then, perhaps as Professor Loss has noted, "because the court realized that it did not have the last word in interpreting the state law,"<sup>184</sup> the court added an alternative holding:

[A]ssuming arguendo that this was not so, we think that we have demonstrated that Gilbert's proposals are within the reach of security-holder action were it not for the insulation afforded management by the notice provision of By-law 47. If this minor provision may be employed as Transamerica seeks to employ it, *it will serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14(a).* We entertain no doubt that Proxy Rule X-14A-7 represents a proper exercise of the authority conferred by Congress on the Commission under Section 14(a). This seems to us to end the matter. The power conferred upon the Commission by Congress cannot be frustrated by a corporate by-law.<sup>185</sup>

The court's finding of a congressional intent to require fair opportunity for corporate suffrage parallels findings by more recent courts requiring the relatively unfettered operation of the market for corporate control.<sup>186</sup> But that may be reading congressional intent too broadly. In the proxy area, the SEC in 1954 amended its shareholder proposal rule (now rule 14a-8) to require inclusion of shareholder proposals that are "a proper subject for action for security holders" under "the laws of the issuer's domicile."<sup>187</sup> As Professor Loss has observed:

[T]he Commission probably has little choice under the statute. When the state law is clear that a particular matter is for the directors alone, that would seem to be decisive. If Congress had intended to give the Commission power to reallocate functions between the two corporate organs, so revolutionary a federal intervention would presumably have been more clearly expressed.<sup>188</sup>

He added in a footnote that "[t]his would approach federal incorporation in all but name."<sup>189</sup>

183. *Id.* at 518.

184. See L. Loss, *supra* note 175, at 537.

185. 163 F.2d at 518 (footnote omitted) (emphasis added).

186. See, e.g., *Data Probe Acquisition Corp. v. Datatab Inc.*, 568 F. Supp. 1538, 1555 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

187. 17 C.F.R. § 240.14a-8(c)(1) (1986).

188. L. Loss, *supra* note 175, at 530.

189. *Id.* at 530 n.65.

A similar debate concerning possible federal substantive regulation of intrafirm relationships arose in connection with rule 10b-5,<sup>190</sup> the broad antifraud provision promulgated by the SEC pursuant to the statutory authority of section 10(b) of the 1934 Act, to prohibit fraudulent or deceptive devices in connection with the purchase or sale of securities.<sup>191</sup> During the 1960's and 70's, some federal courts gave this rule an expansive reach, reading rule 10b-5 to cover not only misrepresentations, but also fraud in the broader sense of unfair conduct by corporate fiduciaries.<sup>192</sup> In *Santa Fe Industries, Inc. v. Green*,<sup>193</sup> a 1977 decision written by Justice White, the author of the *MITE* decision, the Supreme Court squashed such an expansive reading. The Court held that a plaintiff must show a deceptive or manipulative act (not just unfairness) in order to invoke section 10(b).<sup>194</sup>

In what is perhaps its clearest indication to date of the interrelationship of federal securities law and state corporate law, the Court said:

absent a clear indication of Congressional intent we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities. . . . "Corporations are creatures of state law and investors commit their funds to corporate directors on the understanding that except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders state law will govern the internal affairs of the corporation."<sup>195</sup>

Since *Santa Fe* several federal courts of appeals have interpreted "deception" to give a federal remedy to shareholders who were mistreated by their managers.<sup>196</sup> These courts narrowly interpret *Santa Fe* to exclude from rule 10b-5 only those cases having both deficiencies present in *Santa Fe*—that is, they deal with corporate mismanagement and lack any deception. If corporate mismanagement is accomplished by deception, a

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190. 17 C.F.R. § 240.10b-5 (1986). See generally Ribstein, *supra* note 11.

191. 15 U.S.C. § 78j (1982).

192. See, e.g., *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277 (2d Cir.), cert. granted, judgment vacated and case remanded to determine mootness, 429 U.S. 881 (1976); *Green v. Santa Fe Indus. Inc.*, 533 F.2d 1283, 1287 (2d Cir. 1976), rev'd, 430 U.S. 462 (1977); *Bryan v. Brock & Blevins Co.*, 343 F. Supp. 1062 (N.D. Ga. 1972), aff'd on state law grounds, 490 F.2d 563 (5th Cir. 1974).

193. 430 U.S. 462 (1977).

194. *Id.* at 479.

195. *Id.* at 479 (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

196. See, e.g., *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980); *Alabama Farm Bureau Mut. Cas. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), cert. denied, 449 U.S. 820 (1980); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

federal remedy accrues. If the challenged transaction involves an act by a corporation,—e.g., the managers cause the corporation to sell corporate stock to themselves or their friends for too low a price—the necessary deception is that of the corporation. Courts have found material deception of the corporation when those who caused the corporation to act had a conflict of interest and did not disclose the true facts to shareholders (even if shareholders were not required to act for the corporation), so long as the disclosure would have enabled minority shareholders to protect themselves by seeking an injunction to prevent the corporate action or by taking other protective action such as filing for an appraisal after a fundamental corporate change.<sup>197</sup>

These cases have been criticized vigorously by some judges and commentators as inconsistent with the Supreme Court's decision in *Santa Fe*.<sup>198</sup> These cases effectively provide a federal remedy to a shareholder harmed by a faithless fiduciary. But even as so extended, the federal rule 10b-5 cause of action depends on the shareholder-manager relationship created by state law. If state law provides no substantive right against the directors, no federal disclosure obligation arises. A federal remedy exists only if a state remedy also exists.<sup>199</sup> In effect, these courts interpret the disclosure provisions of the federal securities laws to supplement and safeguard shareholder rights against directors provided by state law.<sup>200</sup>

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197. See *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *but see* *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979).

198. See, e.g., *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980) (Aldisert, J., dissenting); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977) (Meskil, J., dissenting), *cert. denied*, 434 U.S. 1069 (1978); *Alabama Farm Bureau Mut. Cas. Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979) (Skelton, J., dissenting), *cert. denied*, 449 U.S. 820 (1980). See also R. JENNINGS & H. MARSH, *SECURITIES REGULATIONS, CASES AND MATERIALS*, 951-52 (5th ed. 1982) (criticizing decisions such as those cited *supra* note 196 for standing *Santa Fe* on its head); Gorman, *At the Intersection of Supreme Avenue and Circuit Street, The Focus of Section 10(b) and Santa Fe's Footnote 14*, 7 J. CORP. L. 199 (1982).

199. See *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1292 (9th Cir. 1979) ("Indeed under the *Goldberg* rationale, it is precisely because there are state law remedies for the shareholders that deception can be found.").

200. *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980) ("That the harm to plaintiff from the omission was deprivation of a state remedy in no sense diminishes the federal interest in preventing the omission and thereby ensuring full disclosure of all material information in securities transactions."). *But see* *Dixon v. Ladish Co.*, 597 F. Supp. 20, 28 (E.D. Wis. 1984), *aff'd sub nom. Kademian v. Ladish*, 792 F.2d 614 (7th Cir. 1986) ("failure to disclose facts which would alert investors to nothing other than a breach of fiduciary duty is insufficient to invoke the federal remedy"); see generally Lashbrooke, *The Alternative Action Requirement: The Derailment of Santa Fe*, 1981 DUKE L.J. 963; Roitre, *Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws*, 50 FORDHAM L. REV. 781, 807-09 (1982).



The tender offer cases go further by establishing substantive rights for shareholders against their managers. For example, Judge Sofaer in the district court decision in *Data Probe*, held that Congress had imposed two duties on tender offer participants: first, disclosure, and second, "to refrain from any conduct that unduly impedes the shareholders' exercise of the decision-making prerogative guaranteed to them by Congress."<sup>201</sup> In finding prerogatives granted by Congress instead of state law, the judge seems to have found a substantive federal right. His reasoning parallels that used in the *Transamerica* case—why would Congress require disclosure if it did not intend for shareholders to be able to use that disclosure effectively? Yet in both the proxy and rule 10b-5 areas, Congress and the courts have recognized that these federal rights facilitate the effective exercise of shareholder rights against managers derived from state law, but do not displace the relationship determined by state law.<sup>202</sup>

A third area in which federal law affects shareholder rights against management, albeit to a lesser extent than the two areas previously mentioned, is derivative suits. Such litigation occurs when a shareholder sues on behalf of the corporation after the board has refused to sue. Often the defendants in such suits are insiders who would be unlikely to cause the corporation to sue themselves. Derivative suits, like proxy fights, tender offers and other market mechanisms, permit shareholders to monitor their managers.<sup>203</sup> The effectiveness of derivative suits in this regard has been controversial. There have been recurring proposals for change by those who feel the cost of this form of monitoring exceeds the benefits received.<sup>204</sup>

Federal regulation of derivative suits has been limited to procedural rules governing the conduct of such suits in federal court.<sup>205</sup> The federal courts apply state substantive laws regarding the relative rights within the corporation of shareholders and directors. If state law permits directors to terminate derivative suits, federal courts will not interfere with that balancing of the shareholder-director relationship, unless that dis-

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201. *Data Probe Acquisition Corp. v. Datatab Inc.*, 568 F. Supp. 1538, 1545 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

202. See Statement of Joseph R. Wright, ADMINISTRATION VIEWS ON CORPORATE TAKE-OVERS, at 25 ("the task of identifying and controlling potentially abusive conduct by target management has traditionally and properly been the subject of state, not federal law.").

203. See Coffee, *supra* note 21.

204. See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949) (discussing securities-for-expenses statutes).

205. See FED. R. CIV. P. 23.1.

missal would violate a federal policy.<sup>206</sup> This lack of substantive rules regarding derivative suits is thus consistent with other areas in which federal law regulates intrafirm relationships.

These examples of federal restraint might be less relevant if Congress viewed tender offers as having an effect that called for a more intrusive federal approach. Judge Sofaer put the argument this way:

A different form of protection is necessary under the Williams Act than under the 1934 Act because tender offer battles, even in a context of full disclosure, create extreme pressures and may involve tactics which distort or even abort the investment decision. Furthermore, whereas available state court remedies might be sufficient to warrant refusing to recognize a federal claim for "unfairness" under Section 10(b), a federal, injunctive remedy is a necessary adjunct to the Williams Act goal of preventing abuses of the tender offer procedure *before* they damage shareholders undermining or aborting the tender offer process.<sup>207</sup>

Yet, it is hard to find evidence in the legislative history of such a dramatic change in the relationship of federal law to state regulation of intrafirm relationships. The congressional decision to include substantive regulation of the market transaction between the target shareholder and the bidder (by including requirements as to pro rata acceptance of tenders and withdrawal rights for shareholders who tender) does not necessarily imply a congressional intention to provide new substantive rights for shareholders against their managers when that approach is contrary to almost all previous federal regulation of intrafirm activity. The House and Senate hearings focused on filling a gap in the federal regulation not changing the face of federal regulation. Senator Williams' initial bill, introduced in 1965, had been written as an amendment to section 10(b) of the 1934 Act. It was later moved to section 14 after an SEC memorandum suggested the proxy section would be a more appropriate place for the tender offer rules.<sup>208</sup> As further evidence of the more limited reach intended for the Williams Act, the legislative history contains several references to various defensive tactics that management might take.<sup>209</sup>

206. *Burks v. Lasker*, 441 U.S. 471 (1979); *Galef v. Alexander*, 615 F.2d 51, 64 (2d Cir. 1980).

207. *Data Probe Acquisition Corp. v. Datatab Inc.*, 568 F. Supp. 1538, 1544 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984). Judge Winter, in his previous academic writing suggested a similar point, that federal law was needed for regulation of market of corporate control in a way that it was not needed for other intrafirm relationships. See Winter, *supra* note 164.

208. See *Memorandum of the SEC to the Committee on Banking and Currency, U.S. Senate on S. 2731, 89th Congress*, reprinted in 112 CONG. REC. 19003 (1966).

209. See *Senate Hearings, supra* note 23, at 57, 115, 125, 145 (statements of Professors Hays,

Thus, while Congress clearly decided not to impose a new federal law that delayed the tender offer process to the benefit of management, it did not forbid directors from using their authority under state law to undertake those activities, (except in those situations in which management initiated a tender offer for its own shares).<sup>210</sup>

#### IV. CONCLUSION

Broader federal regulation may be necessary or appropriate to deal with the possible harm to shareholders arising from defensive tactics that interfere with the market for corporate control and from the inability of states to deal with that interference. But the vulnerability of shareholders to improper dealings by their managers has been the traditional concern of state law. Federal law has been involved in this area for at least fifty years but has always taken care not to supplant state regulation of intrafirm relationships.

In light of this prior history, any change in the role of federal law should not be lightly inferred. Congress, not the courts, should declare any such extension. The substantive regulation of market transactions between a bidder and target company shareholders in the Williams Act

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Mundheim & Kaplan) and Appendix II (article listing defensive tactics); *House Hearings, supra* note 113, at 20 (statement of SEC Chairman Cohen); H.R. REP. NO. 1373, 94th Cong., 2d Sess. 12 (1976) (in connection with the Hart-Scott-Rodino Antitrust Improvement Act of 1976 listing defensive tactics that may be taken and referring to congressional intent to prevent longer delay from being used to engage in such tactics, but no suggestion of prohibition of tactics themselves); 122 CONG. REC. 30877 (1976) (statement by Rep. Rodino, to the same effect listing as possible tactics "abolishing cumulative voting, arranging a speedy defensive merger quickly, incorporating in a state with an anti-takeover statute, or negotiating costly lifetime employment contracts for incumbent management.").

210. See 15 U.S.C. § 78m(e) (1982); SENATE REPORT, *supra* note 22, at 5; cf. *Senate Hearings, supra* note 23, at 19 (statement of SEC Chairman Cohen listing forms of efforts management may use to discourage shareholders from tendering and proposed regulation on corporate repurchase and disclosure of management's views). See also 17 C.F.R. §§ 240.13e-4 & 240.14d-10 (1986) (which prohibit discriminatory tender offers by management, such as the one implemented by Unocal to fight off a hostile tender offer from Boone Pickens, described in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)). A federal court earlier had refused to invalidate such action under the Williams Act finding that Congress did not intend to substantively regulate tender offers. See *Unocal Corp. v. Pickens*, 608 F. Supp. 1081 (C.D. Cal. 1985). The SEC's authority to implement such a rule has been questioned. See, e.g., Fiftis, *supra* note 25, at 323. The SEC responded to arguments that the rule would preempt state corporate law by stating that those persons "fail to recognize that Congress made that decision when it enacted Section 13(e)." SEC Release No. 33-6653, at 16 (Sept. 4, 1986), reprinted in [1986-87] FED. SEC. L. REP. (CCH) ¶ 84,016, at 88,190. While such a rule clearly affects shareholder-management relations, its focus on a market transaction between the two distinguishes this federal regulation from more general federal regulation of shareholder-management relations.

does not necessarily imply that Congress also intended to adopt a policy giving shareholders substantive federal protection against their managers beyond rights available under state law. This issue of the federalization of corporation law deserves rigorous debate, but it is an issue that judicial decisions applying the Williams Act as yet have ignored.

#### POSTSCRIPT

Since this article was submitted for publication, the Supreme Court agreed to hear *CTS Corp. v. Dynamics Corporation of America*, and rendered its decision. The Court's decision upholding the Indiana control share acquisitions statute against both preemption and commerce clause challenges clearly limits the reach of the reasoning set out in the majority and plurality opinions in *Edgar v. MITE Corp.* and affirms a broader realm for the operation of state corporation law. The Court's rejection of a broad view of the purpose of the Williams Act that would preempt "a variety of state corporate laws of hereto unquestioned validity", likely will resolve the conflict discussed in part IIIB of this Article in favor of all the state laws discussed at that point. This includes the other second generation statutes enacted by the various states and the additional statutes that undoubtedly will be enacted in the wake of this decision.

What the Court did not do, however, is to present a coherent account of the overall division of responsibility between the federal and state realms. This article does present such an account, arguing that Congress has left intrafirm relationships to be regulated by state law, while it has retained for the national government the primary role in the regulation of economic activity occurring across markets. The holding and reasoning of the *CTS* case are entirely consistent with this article's analysis. The Court's decision shifts the focus of debate to Congress, which should expressly consider the federalism aspects of future tender offer legislation.