FEDERALISM AND THE MARKET FOR CORPORATE CONTROL

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The controversy over how, if at all, to regulate corporate takeovers has been raging for more than twenty years. And as often as not the question has been who will do the regulating. Such confusion, is, of course, inherent in the federal system. But it is compounded in connection with corporation law not only because federal law expressly preserves the right of the states to regulate,[1] but also because the several stock exchanges have broad regulatory powers.[2] As one would expect, all who have the power to regulate takeovers and takeover defenses have attempted to use it.

Until 1987 the growing consensus was that the market for corporate control was distinctly interstate in character, and that only Congress and the Securities and Exchange Commission (SEC or Commission) had the authority to regulate it in any comprehensive way.[3] All that quickly changed. In *CTS Corp. v. Dynamics Corp. of America*,[4] the Supreme Court upheld the right of states to restrict takeovers of resident companies, and in *Business Roundtable v. SEC*,[5] the D.C. Circuit Court of Appeals struck down the SEC's rule 19c-4, the Commission's most significant effort to curtail a wide range of takeover defenses by potential target companies, on the grounds that these defenses have the effect of reducing shareholder democracy.

It might seem, to some observers at least, that the forces of darkness have prevailed in the war over takeover regulation. Most academic commentators hailed takeovers as a way of keeping management on its toes.[6] On the other hand, potential target managers and their advocates saw

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1. Securities Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (1988). Interestingly, however, federal law only preserves the right of the states to regulate securities. It says nothing expressly about corporation law. Ironically, it is widely argued that state securities law is redundant and could well be repealed. *See genrally* Sargent, *State Disclosure Regulation and Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027 (1987).

2. Securities Exchange Act of 1934 § 6, 15 U.S.C. § 78f (1988).

3. *See* Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988).

4. 481 U.S. 69 (1987).

5. 905 F.2d 406 (D.C. Cir. 1990).

6. *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

takeovers as destructive, short-term strategies that amounted, at best, to the mere rearrangement of ownership interests and distracted business from its real objectives.[7] To be sure, between the rise of state takeover statutes and the fall of rule 19c-4 corporate management is much more secure than it was. But that does not necessarily mean that the reason things turned out as they did is that the establishment usually wins. It may well be that both of these key decisions turn out to be eminently wise—both in terms of setting jurisdictional lines and in terms of substantive regulation.

I. A SHORT AND CRITICAL HISTORY OF TAKEOVER REGULATION

The story of takeover regulation begins in 1968 when Congress passed the Williams Act,[8] thereby extending the Securities Exchange Act of 1934 into the realm of tender offers. Though commentators have often said that the fundamental purpose of the Williams Act is to assure a level playing field on which bidder and target management can fight out the contest for control,[9] the truth is that the Williams Act was intended to discourage tender offers.[10]

The Williams Act addresses tender offers in two distinct ways. First, largely consistent with the traditional role of federal securities law, the Williams Act requires a bidder to make various disclosures in connection with a bid.[11] The theory is that something similar to a registration statement ought to be required when someone seeks to buy securities wholesale from the public. After all, in the typical share-for-share merger the surviving company is required to register the stock that is offered in exchange for the target's stock. Why should the rule differ in connection with a cash offer merely because cash is not a security that requires registration under federal law? The question is supposed to be rhetorical.

Second, the Williams Act sets forth certain ground rules under which

7. *See, e.g.*, Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987).

8. Securities Exchange Act of 1934 §§ 13(d)-(e), 14(d)-(f), 15 U.S.C. § 78m (d)-(e), 78n (d)-(f) (1988).

9. *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985); Piper v. Chris-Craft Indus., 430 U.S. 1, 26-37 (1977); R. FERRARA, M. BROWN & J. HALL, TAKEOVERS: ATTACK AND SURVIVAL 5-10 (1987).

10. *See* R. FERRARA, M. BROWN & J. HALL, *supra* note 9, at 8.

11. Securities Exchange Act of 1934 §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78m(d) (1988). Securities Exchange Act Rules 14d-6, 14d-100, 14d-101, 17 C.F.R §§ 240.14d-6, 240.14d-100, 240.14d-101 (1990).

every tender offer must proceed. Anyone who becomes an owner of more than five percent of the shares of a company must notify that company within ten days.[12] If a tender offer is made, tendering shareholders have the right to withdraw their shares for the first seven days of the offer, and after sixty days if the shares have not been purchased.[13] If the offer is over-subscribed, the offeror must purchase a pro rata portion of the stock of shareholders who tender during the first seven days of the offer.[14] If the buyer raises the offered price during the pendency of the offer, the higher price must be paid to all tendering shareholders.[15]

The Williams Act does not work particularly well. Tender offers depend on the bidder finding hidden value in a company. Thus, the idea that the bidder would disclose its true intentions is absurd. Most bidders simply state that they are buying shares for investment or in order to gain control of the target company.[16] Few ever really explain why. Moreover, the idea that shareholders care why someone is offering a premium for their shares is equally absurd, though they may well care whether the offeror, or someone else, would offer more. Indeed, even if shareholders did pay much attention to the reasons behind tender offers, disclosure would likely backfire. If a shareholder thought that the offeror had misguided plans for the company, she would probably tender her shares in order to avoid remaining a shareholder in a poorly managed company. If she thought that the bidder's plans were brilliant, she might well be more inclined to hold out for an increase.[17]

The bidding rules, too, leave much to be desired. The ten day period implied in the Williams Act is really quite short. The idea was to discourage the Saturday Night Special, that is, a bid with a very short duration that forces shareholders to make up their minds quickly or else face the loss of the offered premium.[18] But most bids last longer anyway.[19]

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12. Securities Exchange Act of 1934 § 13d, 15 U.S.C. § 78m(d) (1988). *See also* Securities Exchange Act Rules 13d-1 - 13d-5, 17 C.F.R §§ 240.13d-1 - 240.13d-5 & Schedule 13D, 17 C.F.R. § 240.13d-101 (1990).

13. Securities Exchange Act of 1934 § 14(d)(5), 15 U.S.C. § 78n(d)(5) (1988).

14. *Id.* § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1988).

15. *Id.* § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1988).

16. *See* Tobin & Maiwurm, *Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419, 434-36 (1983).

17. *See* Booth, *The Problem with Federal Tender Offer Law*, 77 CALIF. L. REV. 707, 711 n.12 (1989); Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y.L. SCH. L. REV. 553, 561, 589-90 (1978).

18. *See* R. FERRARA, M. BROWN & J. HALL, *supra* note 9, at 5-6.

19. Virtually all bids now remain open for at least 30 calendar days even though the 20 business

Proration also was a nightmare for all concerned. When the terms of a bid are altered during its course, as they frequently are, the effect is to set up a new proration pool for each installment of the bid. Thus, an early tenderer might suffer proration whereas a later tenderer might actually have all of her shares purchased.

Finally, the five percent notification rule is easily avoided because of the ten day delay. Thus, a bidder may cross the five percent threshold and continue to purchase for ten days without identifying himself. This ten day window of opportunity also renders the highest price rule rather hollow. The market usually notices increased activity in a stock long before any disclosure is required. As the price rises, sophisticated traders buy and sell knowing fully well that it is likely that a tender offer or other bid is in the offing. The net result is that a large percentage of shares will already have been concentrated in the hands of market professionals by the time the offer is announced. In short, the highest price rule will not protect those shareholders who sold out earlier, if indeed, the rule offers protection at all.[20]

In a remarkably uncontroversial move, the SEC took steps to patch up many of these defects. With hardly a hint of authority from Congress, the Commission extended to twenty days the time period during which an offer must remain open.[21] The Commission further required, by rule, that proration extend throughout an offer,[22] though here, in a nod towards Congress, the rule was styled as an *exemption* from the statutory proration requirement.

Aside from the defects inherent in the Williams Act, bidders and market professionals devised all sorts of ways around the Act and the SEC's rules. Thus the SEC sometimes reacted to these moves with still other rules that also often extended well beyond anything Congress had actually authorized. The most notable example arose when Boone Pickens made an offer for Unocal, and Unocal countered with its own tender offer. Pickens responded that he would tender his shares to Unocal and use the money to finance another offer. Unocal then modified its offer, directing it only to shareholders other than Pickens. The Delaware

day requirement under SEC rules would allow for bids to remain open for as few as 26 calendar days. Most bids end up being extended still further.

20. *See* Booth, *supra* note 17, at 720-24.

21. Securities Exchange Act Rule 14e-1, 17 C.F.R § 240.14e-1 (1990).

22. Securities Exchange Act Rule 14d-8, 17 C.F.R § 240.14d-8 (1990). *See* Note, *The Impact of* Schreiber *on the SEC Tender Offer Timing Rules*, 57 GEO. WASH. L. REV. 77, 99 (1988).

Supreme Court found no breach of fiduciary duty inherent in this tactic and let the offer proceed.[23] The SEC then responded with a rule that forever after would require a tender offer to extend to all shareholders.[24] This time the Commission did not escape significant criticism.[25]

Meanwhile, back in state capitals all over the country, legislators rushed to enact takeover legislation at the state level. The first generation of state takeover laws followed the lead of Congress and focused primarily on disclosure. The states, of course, have concurrent jurisdiction over securities. Both the Securities Act of 1933 and the Securities Exchange Act of 1934 stipulate that the Acts shall not be construed to deprive the states of their authority to regulate securities.[26] The states, after all, had regulated securities transactions since 1911 when Kansas passed the first blue sky law.[27] Many commercially important states continue to regulate the quality of securities sold within their borders.[28] Thus, it should not have been surprising that the states also assumed that they were entitled to regulate the merits of tender offers. Accordingly, many states' takeover statutes conferred upon the state securities commissioner the right to review the fairness of a tender offer, either at his own instance or upon application by target management.[29]

First generation state takeover statutes were an undeniable disaster. They applied on the basis of the target shareholders' residency. Because any self-respecting company would have shareholders in every state, it was theoretically possible for the securities commissioners of every state to review the merits of a particular tender offer. In reality, it was not uncommon for several states to get involved.[30]

The potential for conflicting outcomes is readily apparent. Nevertheless, the securities commissioner of any given state could probably only block an offer to target shareholders within that state. Thus, if nature had taken its course, it seems likely that a tender offer would seldom be stopped in any important state. The target shareholders would simply

23. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

24. Securities Exchange Act Rule 14d-10, 17 C.F.R § 240.14d-10 (1990).

25. *See, e.g.*, R. FERRARA, M. BROWN & J. HALL, *supra* note 9, at 81-83.

26. *See supra* note 1.

27. *See* T. HAZEN, THE LAW OF SECURITIES REGULATION 219-22 (1985).

28. *See generally Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).

29. *See, e.g.*, Edgar v. MITE Corp., 457 U.S. 624 (1982) (holding unconstitutional Illinois statute that provided for review of tender offers by state securities commissioner).

30. *See, e.g.*, Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978).

not stand for it, particularly if target shareholders in other states were free to tender their shares for a quick gain. For example, Pennsylvania recently enacted the most restrictive state takeover statute yet, but many companies chose to opt out of it because of concern that the law would prompt big investors to sell their shares and would thus have more of an adverse effect on the price of the company's stock than any protection from takeover might be worth.[31] After all, if restrictive takeover rules sufficiently depress a company's stock, the company may become a more attractive target than it would have been without such protection.

But nature was not allowed to take its course. The Supreme Court stepped in and invalidated most first generation statutes when it overturned Illinois' statute in *Edgar v. MITE Corp.*.[32] In a plurality opinion, the Court held that the Illinois statute violated the dormant commerce clause. That is, it constituted an undue burden on interstate commerce. Substantial sentiment on the Court favored the position that federal law preempted the Illinois statute. Four Justices, led by Justice White, believed that the Illinois law conflicted with the Williams Act. For example, the delay that could result from a target company seeking a state hearing exceeded the period of time that Congress had specified that an offer must remain open.[33]

Notwithstanding the decision in *MITE*, it is not at all clear whether a first generation statute, limited to a review of whether an offer should proceed in a given state, would ultimately constitute much of a burden on interstate commerce. Nevertheless, the Supreme Court took an entirely defensible position given that the invalidated Illinois act purported to apply nationwide. If the act had applied only to Illinois corporations or only to offers made to Illinois shareholders, the result might have been quite different.[34] The *MITE* decision caused a mad scramble among the states to devise new takeover statutes that would not offend the Constitution. Although the states concocted at least five varieties of second generation statutes, the statutes all had one thing in common: application of each was limited to companies incorporated in the enacting state and having a significant presence there.

Second generation takeover statutes operate in widely varying ways.

31. *See* Wayne, *Many Companies in Pennsylvania Reject State's Takeover Protection*, N.Y. Times, July 20, 1990, at A1, col. 1. *See generally* Booth, *supra* note 3, at 1693-96.

32. 457 U.S. 624 (1982).

33. *Id.* at 634-43.

34. *Id.* at 641-43.

First, the modified first generation statutes focus primarily on disclosure. Second, the fair price statutes seek to assure that second-step mergers are carried out at the same price as first-step tender offers. Third, the control share statutes sterilize the shares of any bidder acquiring more than a given percentage of target company shares and give the remaining target shareholders the right to vote on whether or not to re-enfranchise the bidder. Fourth, the ill-named business combination statutes prohibit any merger or sale of assets within a period of three to five years after a bidder acquires a triggering percentage of shares.[35] Finally, appraisal statutes give shareholders the right to demand cash for their shares when a bidder gains a controlling block.[36]

Other generations of state takeover statutes have been spawned in the meantime, in part by the worry that the federal courts would strike down the second generation statutes. Some statutes seek to regulate greenmail.[37] Others modify long-standing notions of fiduciary duty so as to allow management to consider the interests of constituencies other than stockholders in responding to the threat of a takeover.[38] Still other statutes legitimize the poison pill.[39] The Federal Reserve Board even got into the act with a rule interpretation that restrict the use of junk bonds in raising money to finance the purchase of stock.[40] Further, the Internal Revenue Code, was amended both to discourage the use of junk bonds and to penalize greenmail.[41]

With few exceptions, commentators viewed second generation state takeover statutes as not only unwise, but also unconstitutional.[42] The party line among scholars of corporation law was that *MITE* had established the proposition that the states could not impede the interstate market for corporate control. Thus, ironically, the Williams Act, which was

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35. Business combination statutes are oddly named because they also prohibit the sale or disposition of any significant asset. Indeed, they are aimed primarily at so-called "bust-up" takeovers.

36. *See* Booth, *supra* note 3, at 1670-81.

37. N.Y. BUS. CORP. LAW § 513(e) (McKinney 1986); 1990 PA. S.B. 1310 (to be codified at 15 PA. CONS. STAT. ANN. §§ 2571-76).

38. OHIO REV. CODE ANN. § 1701.59(E) (Anderson 1985).

39. Smith-Hurd § 6.05, ILL. ANN. STAT. ch. 32 para 6.05 (Supp. 1990); 15 PA. CONS. STAT. § 2513 (1989).

40. 12 C.F.R. § 207.112 (1990).

41. I.R.C. §§ 279, 5881 (Jan. 3, 1986). It bears noting too that the accounting profession got into the act with a rule that required any greenmail premium to be charged against earnings. *See* 18 Sec. Reg. & L. Rep. (BNA) No. 1, at 19 (Jan. 3, 1986).

42. For a long, but partial, list of articles critical of state takeover statutes, see Booth, *supra* note 3, at 1638 n.10.

originally viewed as unduly restrictive, became a rallying point for those who opposed state takeover laws. Perhaps it was seen as the lesser of two evils, or perhaps most commentators simply forgot that they had railed against it a few years earlier.

The SEC mounted a vigorous campaign to oppose state takeover statutes.[43] The reason is unclear. One explanation is that the Commission was trying to protect its turf, namely, the ability to regulate tender offers. Another explanation is that the SEC was under the influence of academics and fellow travelers who overwhelmingly subscribed to law and economics, in general, and the Chicago school, in particular. Either way it seems clear that the Commission saw, as part of its job, the tasks of ridding the world of state takeover laws and company-adopted defenses that interfered, in its view, with a free market in corporate control. Nevertheless, the spectacle of the SEC as a supplicant before the Supreme Court of Delaware ought to suggest that something was awry.[44]

Virtually no one expected the Supreme Court to uphold the Indiana control share statute when it came before the Court in 1987 in *CTS Corp. v. Dynamics Corp. of America*.[45] Indeed, some courts went so far as to hold that Congress had occupied the field with the Williams Act and that any effort by the states to regulate the tender offer process must fall on supremacy grounds.[46] Though the *CTS* decision came as a surprise, it contains little that is really contoversial. The Court merely held that the states have traditionally had the authority to regulate the internal affairs of corporations, including the allocation of voting rights, and that the Indiana statute did just that.[47] Interestingly enough, the other varieties of state takeover statutes were not similarly limited. For the most part, the other second generation statutes, that is, fair price statutes and business combination statutes, and indeed, appraisal statutes, sought to dictate the outcome of takeover contests by regulating the price at which mergers could be effected or by totally banning them when the board of directors was not consulted in advance.

The Supreme Court decision in *CTS*, like the decision in *MITE*, has

43. *See* 20 Sec. Reg. L. Rep. (BNA), No. 29 at 1171.

44. For example, the SEC submitted an amicus brief in Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). The Delaware Supreme Court was not impressed and upheld the poison pill challenged there as a reasonable response to a perceived threat to the potential target company.

45. 481 U.S. 69 (1987).

46. *See, e.g.*, Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), *rev'd in part*, 481 U.S. 69 (1987).

47. *CTS*, 481 U.S. 87-94.

since been interpreted as a broad endorsement of state takeover statutes. Acting on this interpretation, Wisconsin enacted an astonishingly restrictive business combination statute.[48] It prohibited all business combinations for a period of five years after a change of control when the board of directors of the target company had not approved the transaction before the acquirer had garnered a triggering percentage of shares. Unlike the Delaware statute,[49] which had come to serve as a model for most states, no provision in the Wisconsin statute exempted bidders who acquired eighty-five percent or more of the target company shares. Moreover, and more extreme, no provision in the statute allowed any Wisconsin corporation to opt out of its coverage.

The Wisconsin statute was challenged in court and ultimately the Seventh Circuit, completing its tour of three generations of takeover statutes, one from each of its three contstituent states, held in *Amanda Acquisition Corp. v. Universal Foods Corp.* that the Wisconsin statute was constitutional.[50] In an opinion that has become the leading case since the last statement by the Supreme Court in *CTS*, Judge Easterbrook read *CTS* as a blanket endorsement of state takeover statutes and held in essence that because the statute in question was a state takeover statute it must therefore be constitutional.

While all of this was going on at the state level, and Congress was wringing its hands at the federal level, the SEC was presented with a unique opportunity to outlaw a wide array of takeover defenses through use of its authority over stock exchange rules. The New York Stock Exchange (NYSE or Exchange) has long had a rule against listing companies with multiple-class capitalization, popularly known as the "one-share one-vote" rule. In recent years, however, several companies listed on the exchange became fearful of increasing their exposure to takeover and began to issue low-voting or nonvoting stock to acquire other companies. The most notable examples were General Motors' purchases of EDS and Hughes Aircraft in connection with which GM issued the celebrated Class E and Class H common stock with one-half vote per share.[51] Other companies sought to use nonvoting stock more aggressively by proposing plans of recapitalization in which scattered public shareholders would be offered nonvoting stock with enhanced financial

48. WIS. STAT. ANN. § 180.726 (West Supp. 1991).
49. DEL. CODE ANN. tit. 8, § 203 (Supp. 1991).
50. 877 F.2d 496 (7th Cir. 1989).
51. *See* Karmel, *Is One Share, One Vote Archaic?*, N.Y.L.J., Feb. 26, 1985, at 1, col. 1.

rights in exchange for their voting stock.[52]

The NYSE thus became worried about losing business to other exchanges that were more hospitable to takeover defenses, and suspended the one-share one-vote rule rather than revoke the listing of the offenders. Further, the Exchange sought either to abolish the rule or to induce, or force, other exchanges to adopt similar rules, with the help of the SEC's authority over such things.[53] To make a long story short, the SEC proposed and adopted what amounted to a new uniform listing rule, rule 19c-4, applying to all exchanges as well as to most over-the-counter stocks.[54] The rule would have prohibited the listing of any company that undertakes a transaction that "would have the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class . . . of common stock" registered under the Exchange Act.[55] The rule focused in particular on recapitalizations, that is, modifications of the rights of existing shareholders, but it allowed listed companies to issue new stock with lesser voting rights, the practice which, ironically, led to the controversy in the first place.

In June 1990, the D.C. Circuit Court of Appeals struck down rule 19c-4 in *Business Roundtable v. SEC*[56] on the theory that the rule exceeded the authority granted to the Commission under the Exchange Act. The court, speaking through Judge Williams, reasoned that the primary purpose of the Exchange Act was disclosure and that rule 19c-4 did not serve that purpose, despite the Commission's claims to the contrary.[57] As the court noted, the Exchange Act is premised in part on the notion that shareholder voting works.[58] Thus, to prohibit the shareholders from voluntarily entering into a transaction by which they agree to have their voting power reduced—presumably in exchange for some other benefit—is more inconsistent with the spirit of the Exchange Act than it is in furtherance of it. Coincidentally, the Supreme Court's decision in *CTS*

52. *See* Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987).

53. *See* Voting Rights Listing Standards—Proposed Disenfranchisement Rule, Exchange Act Release No. 24623, 1987 Fed. Sec. L. Rep. (CCH) ¶ 84,143 (June 24, 1987) [hereinafter Proposing Release].

54. *See* Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release No. 25891, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247 (July 7, 1988) [hereinafter Adopting Release].

55. *Id.*

56. 905 F.2d 406 (D.C. Cir. 1990).

57. *Id.* at 410-12.

58. *Id.* at 411.

provides direct support for this argument.[59]

Both *CTS* and *Business Roundtable* are widely viewed as losses for those who sing the praises of the free market in corporate control. In fact, both may have been important victories.

II. State Takeover Statutes Reconsidered

The idea that because the Supreme Court struck down the Illinois statute in *MITE* all state takeover statutes are unconstitutional is more than a bit simplistic. Thus, several commentators argued that state takeover statutes were protectionist legislation in the sense that they were designed to favor companies incorporated in the enacting state at the expense of companies incorporated elsewhere.[60] In other words, the argument was that state takeover statutes were designed to create a safe haven for domestic corporations. The theory was that the states were simply trying to keep domestic corporations in the family, and that state takeover statutes would prevent the free flow of control of assets from state to state and, therefore, would ultimately make resource allocation nationwide far less efficient than it otherwise would be.

Of course state takeover legislation is protectionist, but not in the sense that it is primarily motivated by a desire to favor in-state companies at the expense of out-of-state companies. The simple explanation for state takeover legislation is that it was prompted by threats to constituent companies that then sought help from their government.[61] Sophisticated arguments about how a state was in reality trying to have its cake and eat it too by protecting resident companies from takeover, while allowing takeover artists to ply their trade as long as foreign companies were the targets, simply prove too much.

On the other hand, it is not immediately obvious why takeover legislation arose at the state level and at the federal level. One would have thought that the same political forces that led the states to adopt legislation designed to inhibit the takeover process would have operated at the

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59. *CTS*, 481 U.S. at 87-94.

60. *See*, Romano, *The Political Economy of State Takeover Statutes*, 73 VA. L. REV. 111 (1987).

61. *See id.* at 123, 136. While legislators may justify their actions on the grounds that they protect the local economy, that does not make the claim true. Most legislators probably understand that protectionist legislation, at least domestically, is likely to be struck down as unconstitutional and is, in any event, probably unwise because it amounts to subisidizing local business and discouraging commerce with the rest of the nation.

federal level as well. Why were state legislatures susceptible to these forces when Congress was not? One answer is that Congress is much more deliberate. That is, Congress is much less likely to act quickly or on the basis of less than a full hearing of the issues. Another answer is that Congress is much more susceptible to lobbying by takeover artists. Still another answer is that state legislators are all the opposite things: likely to act hastily, and much more susceptible to lobbying by potential targets.[62]

In any event, politics has made some strange bedfellows when it comes to takeover legislation. Virtually no one other than shareholders, who are woefully scattered and generally lacking in political clout, was in favor of takeovers. On the other hand, and mindful of the fact that such generalizations are dangerous, both conservatives and liberals had some pretty good reasons for wanting to clamp down on takeover activity. Conservatives, because of traditional connections to corporate management, often opposed takeovers because they represented a direct threat and because, they argued, takeovers made it difficult to manage with a view towards long term results. Many believed, quite sincerely, that short-sighted, quick profit strategies motivated many takeovers. Many others were concerned about bust-up takeovers—that is, takeovers that contemplated dismembering the conglomerates formed in the merger waves of the 1950s and 1960s—and saw such deals as unwise, destructive, and maybe even sinful.[63]

Liberals held the view that nothing could be worth the displacement that takeovers entailed, though it was never clear that, overall, jobs were lost or lives were ruined on any broad basis as a result of takeover activity.[64] In addition, widespread nervousness arose both about the insider trading that takeovers seemed to foster and the massive amounts of corporate debt that were being built up in the sinister-sounding junk bond market.[65] In any event, liberals were generally swayed by the folly of takeovers. In fact, takeovers probably represented a significant opening up of corporate America to potential entrepreneurs that previously had

62. *See id.* at 123-26.

63. *See* Lipton, *supra* note 7.

64. *See Amanda*, 877 F.2d at 500 n.5. Ivan Boesky, Michael Milken, and various other convicts might well disagree.

65. In a forthcoming article, I argue that one justification for the campaign against insider trading is the possibility that many deals are proposed as a way of creating opportunities to trade on inside information and not because of their own merit. Booth, *The Paradoxes of Insider Trading*, 39-41 (1991) (unpublished manuscript).

been relegated to climbing the corporate ladder within a behemoth structure.[66] Moreover, takeovers produced massive gains for pensioners and other not so incredibly wealthy investors. These gains were, of course, at the expense of companies being publicly held, since much takeover activity came in the form of going private deals that effectively closed off relatively large corporations from public view.

Whatever the true motivation, no one lost, politically speaking, at the statehouse where a tough antitakeover statute was enacted. In all likelihood a bit of truth underlies each of the political explanations for why state takeover statutes were enacted. But it does not necessarily follow that state takeover laws are inherently suspect. A law proposed for self-serving reasons does not necessarily render it a bad law. Indeed, who would bother to propose a law that did not somehow improve someone's situation? In short, the fact that lobbying efforts of potential target companies prompted the passage of state takeover statutes should be irrelevant to any discussion of their merits. But, quite to the contrary, it became central. Indeed, in one article, the authors went so far as to say that any discussion of the merits of state takeover statutes was beside the point, because the real reason such statutes were proposed was to protect companies incorporated in the enacting state from takeover by outsiders.[67]

Looking back, it seems curious that so many commentators would lean to the results-oriented conclusion that the Supreme Court's decision in *MITE* should be read as a blanket condemnation of state takeover statutes. Nevertheless, in *Amanda* Judge Easterbrook read *CTS* as a blanket endorsement of state takeover statutes and held, in essence, that since the statute in question was a state takeover statute it must therefore be constitutional. The *Amanda* opinion is remarkable for many reasons. Foremost among them is its self-conscious result orientation that has been viewed by some as tongue in cheek. Some have theorized that Judge Easterbrook might have been inviting Congress, or conceivably the Supreme Court, to act.[68] In other words, Judge Easterbrook perhaps was

66. The perception that the pieces of conglomerates are worth more than the whole motivates many, probably most, takeovers. Thus, the usual plan is to "bust up" such organizations into smaller parts. *See* Lipton, *supra* note 7. The not so incidental benefit is a multiplication of smaller independent companies and keener competition.

67. Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989).

68. *See* Honabach & Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI. KENT L. REV. — (1989) (forthcoming).

trying to write a reversible and, indeed, likely to be reversed, opinion.

What is truly baffling about the *CTS* decision and its reception, however, is that few seem to have noticed that the Supreme Court did not overrule *MITE* in *CTS*. No one suggests that the Illinois statute struck down in *MITE* would now be constitutional just because the Indiana statute was upheld in *CTS*. Indeed, if the two decisions are read as narrowly as possible, it is easy to see daylight between them. In the *MITE* case, the Supreme Court struck down a state statute that created the potential for state-by-state review of a transaction that was interstate in character.[69] The statute posed the obvious danger that any one state could stand in the way of a transaction found desirable by any other state. The situation is analogous to one state's attempt under its blue sky laws to prohibit a corporation from selling its securities not only in that state but also in any other state. And the blue sky laws had never worked that way—at least not officially.[70]

Reading *CTS* at its narrowest, the Supreme Court said nothing more than that voting rights are traditionally a matter of state law, and that the Indiana act was a reasonable response to a perceived problem that arises as a result of majority rule and the diaspora of shareholders.[71] That is, the Indiana control share statute was designed to alleviate the problem of coercive tender offers that may arise when a bidder gains control and then seeks to freeze out the remaining shareholders at a less attractive price.

On the other hand, such a reading of *MITE* and *CTS* ultimately results in a form of rational basis review for state economic legislation. In other words, it is a form of the unspeakable: substantive due process. The statute in *CTS* was upheld, notwithstanding the burden on interstate commerce, at least in part, because it furthered a legitimate end.[72] It is, of course, one thing to identify the purpose of a statute and quite another

69. 457 U.S. 624 (1982).

70. *See MITE*, 457 U.S. at 641-43. Admittedly, an issue of stock that cannot be qualified in one of the larger merit regulation states such as California or Texas, has little hope of being sold out since so many investors reside in those states. The phenomenon is similar to the influence that Texas is sometime said to have over what school books get published.

71. *CTS*, 481 U.S. at 81-84.

72. Ironically, the end that it furthered, or rather, the evil that it addressed, was one that many academic commentators had concluded was not worrisome. Although many state takeover statutes, as well as poison pill defenses adopted company by company, had sought to undo the coercion that attended the front-end loaded two-tiered tender offer, such offers had largely fallen into desuetude, and commentators questioned whether they had ever really been coercive in the first place. *See*

to overturn it on the grounds that it does not serve that purpose or any legitimate purpose. Nevertheless, *CTS* does provide support for the proposition that a court may look to the purposes of a state takeover statute when balancing a state's legitimate interests in the regulation of corporations and deciding whether it should be upheld. As long as the Court continues to follow a balancing approach to dormant commerce clause questions, it would seem that whenever a burden on commerce is found the statute must at least have a proper purpose, and must not be any more burdensome than necessary.[73]

Moreover, one may argue that purpose analysis is much more appropriate in an area in which there is concurrent jurisdiction. As long as federal securities law preserves the right of the states to regulate corporations and securities, it will be unusual for a preemption argument ever to carry the day. Thus, when a state undertakes to enact or interpret laws so as to extend its jurisdiction in this area, it would seem that the courts should be quicker to take a hard look at the state's purpose and methods.[74]

Finally, one must question whether it makes any sense even to talk in terms of burdens on commerce in this area. It seems quite clear that a change in a state's corporation law will always have a significant impact on interstate commerce. Thus, any decision that a change in state corporation law does or does not constitute an undue burden on interstate commerce necessarily is tied up with the wisdom of the law.[75]

Grundfest, *Two-Tier Bids Are Now a Defensive Technique*, Nat'l L. J., Nov. 9, 1987, at 26, col. 1. *But see* Booth, *State Takeover Statutes Revisited*, 88 MICH. L. REV. 120 (1989).

Curiously, one of the arguments made against dual class recapitalizations was that shareholders might be stampeded into accepting the offer of nonvoting stock with enhanced financial rights by fear of the consequences of holding out, that is, being left behind in a tiny minority with voting stock but without the financial incentives that were presumably offered to those who traded in their shares. The argument relies on the same coercion theory that was supposedly discredited as a justification for state takeover statutes.

73. *See* Sroufe & Gelband, *Business Combination Statutes: A "Meaningful Opportunity" for Success?*, 45 BUS. LAW 891 (1990).

74. Indeed, preemption arguably works both ways in this area. The concept of federal law as preemptive of state law is familiar, if difficult. What is less well understood is that state law can effectively preempt federal law since one of the factors to be considered in determining whether there is a cause of action under federal law is whether the matter in question is one that is addressed by state law. *See* Cort v. Ash, 422 U.S. 66 (1975).

75. As the Supreme Court noted in *CTS*, an important fiction is at work in connection with commerce clause analysis as it touches on corporation law, namely, that a corporation exists only where it is incorporated. *CTS*, 481 U.S. at 89-93. That is, even though corporate governance is clearly a matter of interstate commerce, we treat a corporation as if all of its affairs are handled intrastate. It bears noting that jurisdictional rules are parallel. For example, for purposes of diver-

While on the surface it would appear that Judge Easterbrook in *Amanda* was hewing to a narrow view of his duties as interpreters of the law, there may be another side to the story. Those who seem most concerned about avoiding the appearance that they are making law may in fact be the more disrespectful of the democratic process. It could be that enforcing a law to the letter in a situation in which it turns out to have absurd consequences is really a way of rubbing the nose of the legislature in its work. At the very least, it remains open to question whether government would work better with a judiciary that interpreted away obvious mistakes in legislative enactments or one that simply enforced laws no matter how unwise or unlikely to have been intended.[76]

The central question in *Amanda* should have been what, if anything, the *CTS* decision had to say about other varieties of second generation takeover statutes. In particular, what does it have to say about business combination statutes, which because of the adoption of such a statute in Delaware had even by then become the standard for most other states.

Arguably, Judge Easterbrook took a stab at distinguishing the case presented in *Amanda* from that in *CTS* by inquiring, at least in passing, into the possibility that the contract clause of the Constitution might prohibit a state from altering the right of a shareholder to all the benefits associated with the shares when they were acquired.[77] In fact, this was one of the weaker arguments that might have been made for striking down the Wisconsin statute. The problem with the contract theory is that it has long since been held that shareholders have no vested claim in any particular set of rights that they might have by virtue of owning shares.[78] In other words, it is perfectly legal and constitutional for the shareholders acting as a group to amend the articles of incorporation so as to change the rights that they as shareholders enjoy.[79] Moreover, it is

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sity jurisdiction, a corporation is a resident of the state of incorporation and the state in which it has its headquarters. 28 U.S.C. § 1331 (1988).

76. *See Amanda*, 877 F.2d at 503. *See also* Pilon, *Rethinking Judicial Restraint*, Wall St. J., Feb. 1, 1991, at A1, col. 4. *Cf.* United States v. Marshall, 908 F.2d 1312 (7th Cir. 1990), *cert. granted sub nom.* Chapman v. United States, 59 U.S.L.W. 3420 (U.S. Dec. 10, 1990) (No. 90-5744).

77. *Amanda*, 877 F.2d at 505. *See* Butler & Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988); Butler & Ribstein, *The Contract Clause and the Corporation*, 55 BKYLN. L. REV. 767 (1989). *See also* Cuddy, *Some Observations on the Contract Clause and the Corporation by Henry N. Butler and Larry E. Ribstein*, 55 BROOKLYN L. REV. 847 (1989).

78. *See, e.g.*, Bove v. Community Hotel Corp., 105 R.I. 36, 249 A.2d 89 (1969); REVISED MODEL BUSINESS CORP. ACT § 10.01, 10.04 (1984).

79. *See Amanda*, 877 F.2d at 505-06. Although the concept of the corporation as an elaborate

clear that the state can do the same.[80]

Other approaches could have been much more fruitful. One of the differences between the two kinds of statutes is that the business combination statute does not seek to assure effective shareholder choice. Thus, to the extent that the central justification for the *CTS* decision is that the statute deals with the perceived problem of shareholder coercion, that rationale is not available for a statute that simply prohibits a business combination that is not approved in advance by the board of directors.

On the other hand, business combination statutes have a good deal in common with traditional forms of state regulation over corporations. The states have traditionally defined the scope of authority of the board of directors. Under a statute like Delaware's, which allows a business combination to go forward if the acquirer acquires at least eighty-five percent of the target company's shares, it can be said that the statute is little more than a reversion to earlier days when a two-thirds shareholder

standard form contract is an invaluable interpretive tool, it has its limitations. That is, the analogy is not perfect. For one thing, both the state and a specified majority of shareholders may vary the terms of this "contract." This is no minor detail. Debt holders, who quite clearly do have a contractual relationship with the corporation, may not vote under many corporation statutes and under section 316 of the Trust Indenture Act, 15 U.S.C. § 77 (1988), may not vote to modify any significant terms of the contract ("indenture") that governs the obligation that the corporation owes to them. Moreover, while a shareholder may sue derivatively for a wrong done to the corporation as long as she was a shareholder at the time of the wrong, a bondholder may not sue derivatively at all, at least not in most jurisdictions. On the other hand, no limitation exists on the contractual rights of a bondholder who acquires bonds at a discount after some wrong to the corporation. *See generally* ABA Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

80. *See* Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819). It is not, however, completely clear that a state can alter the contract that shareholders have with their corporation for any purpose that the legislature may fancy, including the desire to protect resident corporations from takeover. It could be that changes in state corporation law should be presumed valid only when they further the function of corporate law as a standard form deal between shareholders, management, the corporation, and the state. In other words, the ultimate question is whether a state is utterly free to amend its corporation law as it sees fit or whether the purpose of the amendment must somehow be tied to traditional notions of what corporation law is about. Practically speaking, any analysis of whether there is a legitimate state purpose for a given change assumes that the change has to do with the function performed by the law before the change. So in that sense, the answer must be that a state is not utterly free for any unrelated purpose to amend a law in a way that burdens interstate commerce and *a fortiori* cannot amend away property rights. All this assumes, of course, that the purpose of a statute is relevant for commerce clause purposes which may not be the case. *See* Cities Service Gas Co. v. Peerless Oil & Gas Co., 340 U.S. 179, 188 (1950); Sroufe & Gilband, *supra* note 73, at 902-05. Assuming that it is, however, the further question arises as to who must formulate the purpose. *Compare Amanda*, 877 F.2d at 503 (noting that there is a big difference between what Congress enacts and what it supposes will ensue) *with Marshall*, 908 F.2d 1322-24 (court may uphold federal statute if it serves any proper purpose court may conceive).

vote was typically required to approve any merger. If the states could reduce the required percentage from two- thirds to a bare majority, why should they not now be able to increase the required majority back up to eighty-five percent under limited circumstances?[81]

Moreover, there is a sense in which a control share statute is less defensible in the face of federal tender offer legislation than is a business combination statute. Federal law thoroughly regulates disclosure in connection with the exercise of corporate voting rights.[82] And to some extent federal law regulates the substance of voting rights insofar as shareholders must now be given the opportunity to vote separately on whatever issues are likely to arise at a meeting of the shareholders. While it might be argued that the line-item proxy, and indeed the right to compel management to cast a vote contrary to its own position, are nothing more than matters of disclosure, such a characterization is twisted at best.[83] On the other hand, until recently at least, the Commission has never attempted to enforce particular kinds of voting rights.[84] Thus, in a situation in which a shareholder would have no vote anyway, or in which a shareholder's vote could not possibly count—because an outright majority is controlled by a single individual or group—neither Congress nor the Commission has ever gone farther than to require disclosure of information as would be required if proxies were being solicited.[85] That is, until recently there has never been any attempt to force a corporation to have or keep any particular set of voting rights. Nevertheless, the fact remains that federal legislation has invaded the area of voting rights more deeply than it has any other substantive area of corporation law. Thus, it could be argued that business combination statutes occupy an

81. Indeed, mergers once required the unanimous vote of the shareholders. Appraisal rights were the *quid pro quo* for dropping that requirement. *See* Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981). But there is no reason to think that even that arrangement could not be undone. *See Amanda*, 877 F.2d at 505-09.

It might also be argued that the board has traditionally had plenary power over decisions to sell or liquidate the company in that under most corporation statutes such transactions may be undertaken upon board recommendation. *See generally* Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315 (1987). On the other hand, the ability of the shareholders in effect to override the decision of the board not to sell the company is rather like a derivative suit, that is, a last-ditch check on the ability of the board to run the company in a way that the shareholders find offensive. *See generally* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE, *Introduction to Part VI, Reporter's Note*, Tent. Draft No. 8 (1988).

82. *See Business Roundtable*, 905 F.2d at 411-14.

83. *See id.*

84. The recent example is rule 19c-4 itself.

85. *See* Securities Exchange Act of 1934 § 14c, 15 U.S.C. § 78o(c) (1990).

area that is more protected from federal intervention than the control share statutes upheld in *CTS*.

Ultimately, the distinction between the control share statute and the business combination statute, however, is that the control share statute is designed to further shareholder choice, whereas the business combination statute is designed to avoid it. Moreover, business combination statutes passed on a state-by-state basis are arguably motivated by a desire to prevent control of the corporation from being transferred outside the state. As such, business combination statutes raise at least the question whether they constitute an excessive burden on interstate commerce. If it is possible for a state to cure an identifiable evil with a less drastic piece of legislation, then it would seem that the burden created by a more drastic piece of legislation, at least if it is placed on interstate commerce, is undue.[86] The problem thus becomes identifying the evil to be remedied. Control share statutes focus on shareholder's coercion and protecting the right of shareholders to decide the ultimate disposition of their company. Business combination statutes focus instead on the ability of directors to remain in control long enough to follow through with their programs. The problem with the business combination statute, however, is that while it accomplishes its goal, it also permanently protects incumbent management. Arguably then the business combination statute effectively insulates the corporation from challenge by any party, whether within the state or without the state.[87]

Finally, in thinking about whether state takeover laws are wise or constitutional, it may be useful to think of analogous questions. For example, would it be constitutional for a state to declare that some sort of good or asset that had been freely tradeable could no longer be sold or transferred, either within the state or to outsiders? Or could a state declare that primogeniture would henceforth be the only means by which to transfer land?[88] More to the point, could a state enact a law prohibit-

86. *Cf.* Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1977) (corporate action disfavoring minority shareholder in close corporation must be supported by business purpose and must not be any more harmful to minority interests than necessary); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969) (same in context of publicly held corporation).

87. *See generally* Sroufe & Gilband, *supra* note 73.

88. It bears noting that the rule against perpetuities may well be founded on the idea that things of value ought to be capable of being bought and sold at least eventually. *See* Dunbar v. Radfield, 7 Cal. 2d 515, 61 P.2d 744 (1936) (rule against perpetuities does not apply to business trust since rights therein vest immediately and may be freely alienated).

ing any company incorporated there from re-incorporating in another state?[89] Clearly such statutes would not discriminate against non-residents since they would equally affect residents. On the other hand, the flow of assets in interstate commerce would clearly be substantially affected. Admittedly, the analogy is not perfect since under a business combination statute assets may continue to be sold when the sale is approved by the board of directors. But given that the board of directors has no ownership interest in the asset and that shares represent the entire ownership interest, the analogy is not far wrong. Moreover, to confer the right to decide when a thing of value may be sold and to dictate the specifics of the decision are two different things. In other words, state action is one thing, while corporate action is quite another. Thus, it is clearly relevant that the Wisconsin statute in *Amanda* did not allow for a target company to opt out—though a company could always re-incorporate elsewhere—but is it enough to overturn it?

At the very least, it seems clear that the ability to transfer an asset is part of its value over and above its inherent value. Thus, impairing the right to transfer the asset arguably constitutes a taking by the state.[90] The view has often been expressed that shares cannot legally be made nontransferable and that only reasonable restrictions on tranfer will be tolerated.[91] Though such assertions have usually been aimed at corporations seeking to freeze their shares in the hands that held them, perhaps the idea that a share must be transferable, unless good reasons exist for it not to be, is more fundamental.

Finally, what difference does it make, if any, that federal law is seen in some respects as a gap filler? A sort of reverse preemption doctrine applies when deciding whether to imply a federal cause of action under an ambiguous statute. The courts have quite clearly held that one important factor in deciding whether there is a federal cause of action is whether the matter is one traditionally relegated to state law.[92] More-

89. *See* Allenberg Cotton Co. v. Pittman, 419 U.S. 20 (1974); *Amanda*, 877 F.2d at 505.

90. *See Amanda*, 877 F.2d at 505. Indeed, the modern trend toward recognizing a distinction between closely held and publicly held corporations is based on the fact that minority shareholders in a close corporation are exposed to significantly greater risk because they cannot easily sell their shares. *See* Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

91. *See, e.g.*, W. CARY & M. EISENBERG, CORPORATIONS 421 (6th ed. 1988).

92. Cort v. Ash, 422 U.S. 66 (1976). On the other hand, congressional silence is not necessarily dispositive. Congress ought to be able to decide affirmatively to do nothing and not to have the states interfere, particularly where, as here, the decision may be to rely on a vigorous interstate market as a substitute for regulation.

over, this doctrine has been applied more often in connection with federal securities law than it has in perhaps any other context.[93] While there are no firm answers to these questions, they suggest that something is wrong with business combination statutes.

III. Takeover Regulation by the Exchanges

Although the *Business Roundtable* case will no doubt come to be cited for the proposition that rule 19c-4 infringed on an area of law that is left to the states, the case does not exactly say that. Indeed, it would be more remarkable if the case did say that since, in effect, such a rationale would amount to preemption of federal law by state law. What the court did say was that the Exchange Act focuses on disclosure, and that although one might argue that one reason for encouraging disclosure in connection with shareholder voting is to ensure shareholder democracy, such an explanation is, as Judge Williams pointed out, overbroad.[94] Admittedly, the court further reasoned that if the Commission had the authority to regulate the use of nonvoting stock by virtue of its authority over listing standards, it would have authority over all aspects of corporate governance.[95] In order to uphold the rule, there must be, as the court called it, a "firebreak" somewhere that delineates the areas left to state regulation.[96] The burden, however, was on the Commission to show where the firebreak was. The alleged unique historical background of the one-share one-vote rule was not enough.[97] Although the court here comes closer to saying that the reason why rule 19c-4 must fall is that voting rights are the province of the states, again it does not quite do so. It only says that assuming the SEC is not entitled to take over all of corporate governance, the SEC must point to the limits of its jurisdiction.[98]

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93. *See, e.g.*, Transamerica Mort. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

94. *Business Roundtable*, 905 F.2d at 411-14.

95. *Id.* at 412.

96. *Id.* at 413.

97. *Id.*

98. Of course, a surface tension exists between resort to purposes in connection with rule 19c-4 and the methods employed in connection with statutes at both the federal and state level. To put it simply, any consideration of purposes in connection with a statute is questionable because it suggests that the court is substituting its judgment for that of the legislature. Needless to say, one difference between the cases is that an agency, such as the SEC, is an agency and a legislature is a legislature. A legislature, whether Congress or at the state level, does not need to justify its actions except minimally. Thus, the courts will bend over backwards to find a legitimate purpose for a legislative act even if the legislature has failed to specify one. *See* United States v. Marshall, 908 F.2d 1312, 1325 (7th Cir.), *cert. granted sub nom.* Chapman v. United States 59 U.S.L.W. 3420 (U.S. Dec. 10,

All of the foregoing notwithstanding, the decision provides two other rationales that are much murkier and possibly much more important. One stems from the curiosity that the Exchange Act appears to command in section 6(b)(5) that an exchange, as a self-regulatory organization (SRO) adopt only rules that further the purposes of the Exchange Act.[99] As Judge Williams points out, read literally this section seems to imply that if an exchange rule is proper for the exchange to have then it is also necessarily proper for the SEC to tinker with it, because it must by definition be a rule that furthers the purposes of the Exchange Act.[100] Judge Williams responded quite properly to this argument, which appears to have been raised *sua sponte*, with the observation that some exchange rules have the status of substitutes for law, and other rules are simply rules.[101] In other words, the fact that the exchanges and the National Association of Securties Dealers have been deputized as SROs

1990) (No. 90-5744). An administrative agency, on the other hand, can have no more authority than is delegated to it assuming, of course, that it is even legal for the legislature to delegate its authority. On the other hand, a statute has little if any meaning in isolation from its purpose and application. As Wittgenstein put it, no rule can apply itself. Thus, what a statute means and how it will apply necessarily is left to the administrative agencies and the courts who have little guidance in interpreting a statute other than the effect it is intended to have. But if that is the job of a judge, there can be little doubt that when the straightforward language of a statute runs counter to its avowed or apparent purpose, the judge should favor an application that makes sense over one that does not, at least where the confusion is understandable.

99. Securities Exchange Act of 1934 § 6(b)(5), 15 U.S.C. § 78f(b)(5) (1990). It should thus be noted that rule 19c-4 was a meta rule, that is, a rule about what sort of rules an exchange must have. In form, this is an admirably restrained approach to the matter: the SEC did not specify a particular rule, but rather, in effect, ordered the exchanges to come up with listing rules consistent with the goals set forth in the SEC rule.

It is, in a way, curious that rule 19c-4 only applied to changes in voting rights. Although a rule that purported to prohibit nonvoting stock would have been a much more obvious incursion into the traditional realm of state law, the SEC, in theory, could have justified such a rule on the same grounds that supported the rule that was proposed, namely the mandate to protect shareholder democracy. Nevertheless, by proposing a rule that froze voting rights where they stood, the SEC revealed a tendency simply to oppose change. The campaign against state takeover statutes was disturbingly similar. In essence, the SEC sought to freeze state law where it stood at a time when federal lawmakers were stymied in their efforts to enact new takeover legislation. It is, of course, unfair to attribute naked fear of change or a petty, misery-loves-company attitude to the Commission. Its campaign in connection with takeovers was no doubt prompted by a sincere belief that takeovers were good and that they should be encouraged with whatever tools were at hand. But whatever the real reason for the SEC's approach to takeover regulation, the whole story suggests that the states remain the appropriate regulators. The incredible array of rules that has emerged from the states, together with the sorry Williams Act and the near paralysis that has plagued Congress, indicate that here at least the idea of the states as legislative laboratories is at work and that Congress suffers from some sort of public choice malaise.

100. *Business Roundtable*, 905 F.2d at 414.

101. *Id.* at 414-15.

does not necessarily mean that every rule or decision must be viewed as a substitute for law. Thus, the section must be read as referring only to those rules that occupy a place in the system as a substitute for legal rules that otherwise might be imposed from without. Or as Judge Williams put it, some rules have the effect of preempting state law, and others do not.[102] Of course, in order to determine which is which we must refer to the purposes of the Exchange Act, which brings us back to disclosure.

Judge Williams' explanation is absolutely correct, but it demonstrates the sorry state of the Exchange Act, in particular, and statutory law, in general. Clearly, nothing in the text of the Exchange Act says that the rules referred to in section 6(b)(5) are only certain kinds of rules. The issue of the status of SRO rules is not a new one. Indeed, it has come up often, particularly in cases in which disgruntled investors seek to maintain suit in federal court on a cause of action that may not rise to the level of fraud. One common tactic in such situations is to assert that the defendant, who is typically a broker-dealer, has violated some SRO rule intended to benefit investors.[103]

The obvious question is whether this brouhaha is just a bunch of lawyers arguing over jurisdictional niceties that ultimately make little difference in the real world. It is not. To see why, it is necessary to take a hard look at the third and last reason given for the *Business Roundtable* decision. It involves the meaning of the 1975 amendments to the Exchange Act, which broadly mandated that the SEC take steps to "facilitate the establishment of a national market system for securities."[104] One of the avowed purposes of these amendments was to assure fair competition among broker-dealers and among exchanges.[105] The Commission thus argued that the 1975 amendments, which also gave it authority to mandate many kinds of trading rules, gave it authority to prevent the exchanges from engaging in what Judge Williams aptly described as a "race to the bottom" in listing regulations.[106]

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102. *See id.* at 415.

103. *See, e.g.*, Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); Lange v. H. Hentz & Co., 418 F. Supp. 1376 (N.D. Tex. 1976). *But see* Carpenter v. United States, 484 U.S. 19 (1987). *See also* Gordon v. New York Stock Exch., 422 U.S. 659 (1975); Silver v. New York Stock Exch., 373 U.S. 341 (1963).

104. Securities Exchange Act of 1934 § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (1990).

105. *See Business Roundtable*, 905 F.2d at 415.

106. *Id.* The reference, of course, is to the landmark law review article by the late William Cary in which he criticized the idea of state corporation law because of the competition that tends to arise to attract corporations from other states by offering ever more lenient laws. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). *See also* Fischel, *The Race to*

As Judge Williams points out, the Commission adopted a curious reading of the 1975 amendments.[107] If the amendments were meant to increase competition, how is it that they authorize the Commission to stop competition by promulgating a rule that mandates uniformity? To some this argument may sound petty. It depends on whether one tends, naturally or politically, to have confidence in markets. In all fairness, the Commission may have had a point. If we are going to depend on SROs to keep their own houses in order and to save the government the worry and expense of hands-on regulation and enforcement, we should at least monitor the performance of the SROs to see that the situation does not turn into one of foxes guarding the chicken coop. Moreover, if a particular practice clearly becomes undesirable, why not go ahead and impose a rule against it? Why take the risk that "destructive competition" might crop up and leave us worse off? In short, if a law represents a marginal improvement in welfare, why not enact it?

The simple answer is that law cannot do everything. Clearly, law is much better at prohibition than at command and control.[108] More to the point, situations may arise in which the cost of a rigid and uniform rule exceeds the benefit. Some matters, even if they are capable of being regulated, are better left to the free market. Indeed, the burden should be on the proponent of a law to prove that it will amount to a net improvement over no law at all.

Much can be said for stock exchange regulation of takeovers. Indeed, in some countries, such as Great Britain, the exchanges are the primary regulators of such matters.[109] The former New York Stock Exchange rule against multiple classes of common stock with different voting rights is, or was, a prime example of the unique place of the exchanges in the regulatory scheme. Neither federal nor state law limits the number of classes of stock or differences in voting rights. The idea behind federal law is that as long as the differences are disclosed, investors can decide for themselves whether to buy or sell.[110] The idea behind state law, on

the Bottom Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U.L. REV. 913 (1982).

107. *Business Roundtable*, 905 F.2d at 416.

108. *See* Booth, *Self-Regulation in a Democratic Society*, 50 J. AIR L. & COM. 491, 509-12 (1985).

109. *See generally* DeMott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. REV. 945 (1983).

110. *See* Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985); *Business Roundtable*, 905 F.2d at 411-14.

the other hand, is that the corporation should be a flexible vehicle, and that agreements among shareholders to divide up the right to control ordinarily should be enforced.[111] There is nothing mistaken about either policy. Nevertheless, an exchange has good reasons to prohibit limited voting rights stock. If such stock is permitted, investors must inform themselves about what rights they acquire in buying a stock. By eliminating potential differences in the bundle of rights represented by a share of stock, an exchange can make equity capital available at the lowest possible cost. In short, by standardizing shares somewhat, exchange rules can bring buyers and sellers of equity together more efficiently.

In the absence of a central reputational agency like an exchange, standardization and its economies might not arise.[112] Even if companies seeking the cheapest possible capital were to forgo differential voting

111. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 31, 203 N.E.2d 577, 586-87 (1964).

112. *See* Booth, *supra* note 17, at 752-61; Macey & Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1023-24 (1990). *See also* Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987). The idea of an exchange as a reputational intermediary was not entirely lost in connection with the SEC's consideration of rule 19c-4. It was suggested that if a particular voting rule turned out to be desirable, then it would attract issuers to the exchange that offered it, and that marketplace competition would lead the exchanges to adopt the appropriate rules. *See* Proposing Release, *supra* note 52, at 88,779 n.86. The Commission dismissed the argument with the reply that managers do not always do what is best for their companies, while at the same time asserting that any rule adopted should leave room for competition among the exchanges, but only in the areas of price and service and not in the provision of safe havens from takeover. *Id.* Disagreement also arose as to whether listing on an exchange, or on a particular exchange, affects stock prices. *See* Proposing Release, *supra* note 52, 88,773 & n.50 (summarizing studies indicating that listing and delisting do not result in gains and losses in share prices). *Compare* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 268-69 (2d Cir. 1984) (delisting constitutes irreparable harm for purposes of granting injunction) *with* Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 725-26 (5th Cir. 1984) (contra). None of this is dispositive of the idea that listing categories *could* generate real gains, however, since, as the SEC itself noted, evolution in the trading market has proceeded at such a rapid pace over the past twenty years that most studies are outdated. *See* Proposing Release, *supra* note 52, at 88,773-74 n.50. Moreover, recent studies indicate that stocks which are included in the Standard & Poors 500 enjoy an immediate and permanent gain presumably as a result of being associated with the other 499 stocks. *See* Schleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986). *See also* Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CALIF. L. REV. __ (1991) (forthcoming); Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 898-99 (1988); Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990). While this gain no doubt arises at least in part because investors and traders depend on the Standard & Poors 500 to formulate portfolios thus generating more demand for the included stocks, that is precisely the point. There is no reason to believe that the same would not hold true for stock exchange listing categories if they reliably represented the unique characteristics of the included companies. Since the exchanges have more or less abdicated this function in recent years, if they ever really performed it, there is no reason to expect

rights, it would still be necessary for investors to check. Thus, a modicum of standardization allows capital to be raised at lower cost than in a less regulated market. This is not necessarily to say that the former NYSE rules were the best possible rules, but rather that only an exchange is in a position to adopt such rules because of the conflicting missions of federal and state law. In other words, exchange listing, including the package of rules that go with it, is a product. Indeed, companies pay considerable sums for it. Why else would the exchanges ever have bothered to impose their own quite detailed and typically more onerous corporate governance rules on listed companies? And why would listed companies have willingly complied?[113] It is, in short, only natural that different exchanges have different rules.

Moreover, the exchanges are probably in the best position to regulate tender offers. Arguably, tender offers are more like a form of trading than the proxy contests on which their regulation under the Williams Act is based.[114] The implicit object of a tender offer is to determine at what price control of the target company may be bought. In other words, a tender offer is not simply an all-or-nothing contest to determine who should manage the target.[115] Indeed, much, if not all, of the controversy surrounding coercive offers and entrenching defenses—which is to say virtually all of the controversy surrounding tender offers—reduces to questions about whether the market is allowed to function freely and without distortion to establish a fair price for control.[116]

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existing studies to show a significant price effect associated with listing on an exchange or on a particular exchange.

113. *See* Macey & Kanda, *supra* note 108, at 1009.

114. *See* Cohen, *Address on Proposed Legislation to Regulate Tender Offers before the American Society of Corporate Secretaries, Inc.*, Colorado Springs, Colo., June 28, 1966, in V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 850, 850-52 (3d ed. 1987).

115. *See* Booth, *Management Buyouts, Shareholder Welfare and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985).

116. The prevailing view among academics is that because the stock market is efficient, shareholders in a freely functioning market for corporate control would tender their shares for a very small premium over market price. In other words, any premium is enough. Needless to say, if that is true, then there is less reason to think that the stock exchanges ought to regulate contests over control. But the efficient market does not necessarily imply that any premium is enough. It is entirely possible that shareholders hold differing opinions about the value of a given share of stock, even if ordinarily they would not act on those opinions by betting inordinate amounts of their investment funds on any one stock in the absence of an unusual circumstance, such as a tender offer, that calls upon them to make an investment decision on the basis of company-specific valuation rather than portfolio-oriented valuation. In other words, there is every reason to believe, at least in the context of a tender offer, that demand curves for stock, like demand curves for most other commodities, slope downward. If so, the idea that a tender offer ought to be seen as an auction is appealing.

In addition, exchange rules presumably are less formal than statutes, or SEC rules, or indeed case law, and presumably may be applied more flexibly, at least in theory.[117] Since there is reason to think that certain kinds of takeover defenses are appropriate for certain kinds of companies, it may well be vital to permit a regulatory system that allows different kinds of companies to choose different packages of takeover rules. Professor Gilson has suggested that the kind of takeover defenses that are appropriate for a company may depend on the company's stage of development.[118] A mature company with little need for further access to the equity market likely will have higher agency costs than a growing company that needs additional, higher-risk capital. Management in a growing company will have every incentive to please its shareholders whether or not the shareholders have a vote. Thus, a recapitalization that offers most public shareholders a financially attractive package of nonvoting securities is not likely to be abusive, and the price of the company's stock is not likely to fall when such a recapitalization is proposed. Conversely, a company that has no need for additional equity capital and thus has fewer incentives, other than the threat of takeover, to induce management to keep the price of its stock high, disserves its shareholders by such a recapitalization and will likely see the price of its stock drop as a result of the proposal or will find that the value of the securities that must be offered to induce sufficient participation will be prohibitively high. Such a company thus would be better advised to undertake a management buyout in which the shareholders escape more or less completely from the agency costs associated with a mature firm. As Professor Gilson points out, the fact that both strategies can be mutually beneficial, depending on the characteristics of the company in question, indicates that both should be legal. The danger, of course, is that if both

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Downward sloping demand implies that there is no single fair price for a share of stock. Rather, stock is valued along a continuum: the shareholder demand curve. Since there is no single fair price, there is no sense in focusing regulations on a substantive quest for it or on an effort to provide investors with quantitative protections. A sensible regulatory scheme instead will seek to insure that the market for control works as smoothly as possible. With that goal in mind, the stock exchanges would seem to be the most likely regulators of takeover contests, since no institution other than the stock exchanges is concerned primarily with the smooth and efficient functioning of the trading process itself. *See generally* Booth, *supra* note 17; Booth, *supra* note 108.

117. *See* Adopting Release, *supra* note 53, *passim*; Proposing Release, *supra* note 52, at 88,777, 88,782-83. *See also* Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987). *Cf. Business Roundtable*, 905 F.2d at 414-16.

118. Gilson, *supra* note 52, at 841.

options remain legal, mature companies will take advantage of a strategy appropriate for growing companies as a simpler and cheaper way of insulating management from the threat of takeover.[119]

Viewed in this light, it is easy to see why the NYSE might have had a rule different from other exchanges. If most of the companies whose stock is traded there are mature companies—as indeed they are—then a rule that precludes them from entering into inappropriate, albeit perfectly legal, transactions makes a good deal of sense. It is somewhat tougher to see that abolishing the rule and setting up uniform rules for all exchanges might well have represented a loss for shareholders—in the form of needlessly increased risk—as well as for capital-consuming companies, and ultimately for the exchanges, which would see less investment in mature companies than there otherwise might have been.

Aside from the fact that agency costs may differ among companies of various sizes and maturities, coercive tender offers are far more threatening to smaller, growing companies, which are less actively traded and which, because of their smaller size, are more susceptible to being operated as a captive subsidiary. Shareholders in such companies are not only likely to differ more in their opinions of what constitutes an adequate offer—since the market for their stock is presumably somewhat less efficient—but they also justifiably fear the consequences of a partial bid and are thus more likely to tender early for what they perceive as a less attractive offer than a shareholder in a large company. In short, rule 19c-4 likely would disserve smaller companies and eradicate whatever positive attraction alternative exchanges may have had.

So why would the NYSE seek to have the SEC impose a uniform rule on all exchanges that might be appropriate only for the NYSE? The fairly obvious answer is that the SEC's governmental authority was a way for the NYSE to protect itself from competition and, incidentally, to

119. Gilson thus concludes that an optimal rule would allow companies to start out with multi-class capitalization but would preclude companies which are already publicly held from recapitalizing. *Id.*; Adopting Release, *supra* note 54, at 89,215- 19; Proposing Release, *supra* note 53, at 88,777-80. In all fairness, the SEC recognized the possibility of legitimate business purposes for multi-class capitalization. Adopting Release, *supra* note 54, at 89,215-19; Proposing Release, *supra* note 53, at 88,780. Thus, the rule adopted was essentially what Professor Gilson recommended. The problem, of course, is that it can be difficult to predict the most desirable structure at the organizational or initial public offering stage. Most companies would therefore opt for dual class structure even though they might be better off with a single class, if for no other reason than lack of an option to undo the latter. Similarly, management would likely be reluctant ever to propose a recapitalization to eliminate a dual class structure. The net effect of the rule then would likely have been to increase the risk of single class capitalization to the point that no one would ever opt for it.

put competing exchanges at a disadvantage. Rule 19c-4 was, in short, the result of what has been called "rent-seeking" by the NYSE.[120] That is, rather than face up to the need to make a decision that might or might not give it a competitive edge, the Exchange sought to have the SEC prohibit competition with respect to the voting rights component of listing standards.

Assuming for the moment that the exchanges were doing their job, what might a scheme of exchange-administered takeover regulation look like? One possible mode of variable regulation entails determining the percentage of stock ownership required to control any given company. Companies with a control percentage above some cut-off figure would be subject to anticoercion rules, while those below would not. Such a scheme poses the obvious problem that any cut-off is somewhat arbitrary. Moreover, determining each company's control percentage is likely to be quite speculative. And the scheme would no doubt generate a multitude of strategies designed to take advantage of it. Given these difficulties, the most likely way to set up a dual system of regulation based on control percentages would seem to be through the stock exchanges.

Of course, a more flexible listing category system arguably would leave investors in largely the same position as currently, since it would merely substitute exchange-level decisions as to, say, appropriate defensive measures, for decisions now made by boards of directors. That argument misses the point, however. If the exchanges are regarded as trustworthy regulators of defensive tactics, investors need never bear the expense of determining precisely which defenses a company has adopted. In short, it is at least possible to have the benefits of standardization without suffering its confinement if some reputational intermediary can be installed.

Specifically, the exchanges could determine, through the quasi-administrative, self-regulatory process, which companies to subject to a particular tender offer scheme. Each exchange could effect the proposed system by establishing two classes of listings. Indeed, there is no reason why more than two categories could not be established, each offering a different package of tender offer rules. More restrictive tender offer rules would apply to smaller, riskier companies, and less stringent rules would apply to larger, more established companies. In many ways, a scheme of multitiered exchange regulation, if wholly voluntary, would differ little from present law. As things stand, companies are largely free to adopt a

120. *See* Romano, *supra* note 60.

wide variety of advance defenses that have the effect of eliminating the threat of partial and two-tier bids. Nevertheless, stock exchange regulation would likely provide an improvement. The reason, again, is standardization. The current absence of rules forces investors to do considerable research to determine what kinds of defenses are appropriate for a particular company, as well as what kinds of defenses a company has in place. Once the latter determination is made, the investor has no assurance that the company will not adopt additional or different defenses. In the end, then, investors probably treat most companies as if they have the full complement of defenses. The company that declines to adopt them all thus enjoys no advantage in the market. It must pay as much for capital as the most heavily defended company, even though its management willingly exposes itself to greater discipline.

Additional stock exchange regulation—even an essentially voluntary, self-categorizing scheme—could change all this. Aside from reducing information costs for shareholders, exchange regulations would act as a coordinating agent or catalyst for management. While under the current regulatory scheme, management gains little by failing to install shark repellents, if a stock exchange reserved a listing category for fully-exposed companies, it would be far less costly for any one company to forgo advance defenses. By associating itself with other similar companies in the competition for public capital, the fully-exposed company presumably would enjoy the most attractive terms. Of course, some sort of restriction on a company's switching quickly from one category to another would be necessary. For example, the switch might be allowed only after a shareholder vote, and the exchange might even require the subject company to include a requirement for such a vote in its articles of incorporation. Without some such assurance, the categories would be no better than the current system since investors would assume that a company threatened with a takeover would switch.

Undoubtedly, some danger exists that companies without any real need for it will choose a more protective scheme of regulation. The danger may not be all that significant, however. Practically speaking, a company might be compelled to join a particular category. If investors care about takeover premiums, they will care about a company's listing category. A mature company that chooses the more restrictive scheme designed for growth companies might find the price of its stock depressed, and its cost of capital elevated. Moreover, at least in theory, causing the company to pay more than necessary for capital could constitute waste, rendering management personally liable.[121]

In summary, the idea behind a scheme of exchange regulation of tender offers is not so much to enforce more rigorous or even different rules, but rather to provide clear standardized choices that will act as focal points for both management and investors. The contemplated stock exchange rules would serve simply as a catalyst: something around which listed companies could congregate. A system of stock exchange categories would do little directly to increase or decrease the array of possible defenses a company could adopt. Rather, it would simply allow for grouping defenses into identifiable packages with recognizable costs and benefits. It would also give the company that chooses exposure some assurance that it would not be alone, that its exposure would not go unrecognized, and that the potential benefits of its choice would be realized.

It seems clear that regulating the tender offer process through the medium of stock exchange rules makes a good deal of sense. But what will prompt the exchanges to adopt appropriate and *differing* tender offer regulations? The question is particularly pertinent given the events that led to the adoption of rule 19c-4. The NYSE was understandably concerned that by retaining its one-share one-vote rule it might drive away current and potential listings.[122] After all, an exchange is a business as well as a self-regulatory organization. Competition for listings is fierce. Moreover, other exchanges had declined to adopt rules similar to the NYSE rule.[123]

The NYSE's fear of losing business, however, may have been overblown. The old one-share, one-vote rule arguably reduced information costs and risk and increased liquidity in connection with the least risky stocks. The fact that the rule might compel some issuers to forgo listing is not necessarily dispositive: repeal of the rule may have driven other issuers away. If, in fact, the rule reduces information costs and risk and increases liquidity, issuers who do not highly value the flexibility of unlisted status will probably seek another trading medium that offers the

121. *See, e.g.*., Joy v. North, 692 F.2d 880, 896 (2d Cir. 1982) (bank directors may be held liable for making loan at inadequate interest rate given risk of project being financed), *cert. denied*, 460 U.S. 1051 (1983). *See also* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *But see* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

122. *See* Adopting Release, *supra* note 54, at 89,217; Proposing Release, *supra* note 53, at 88,770, 88,775.

123. *See* Adopting Release, *supra* note 54, at 89,209-10, 89,217; Proposing Release, *supra* note 53, at 88,770, 88,775. It should be noted that the NYSE had attempted to persuade other exchanges to adopt a uniform rule. *Id.* at 88,771.

benefits of such a risk-reducing rule. Or indeed, the least risky companies might not offer their shares publicly at all if forced to bear a cost of capital increased by the takeover fears of risky companies seeking stock exchange protection. This is not to say that every exchange or other trading medium should necessarily adopt similar rules. Indeed, from the viewpoint of the NYSE, if such rules were universally imposed, it would no longer be the exchange of choice for the least risky issuers. The optimal solution, at least from the point of view of the market as a whole, may be different exchanges for companies with different characteristics, which, of course, is what has traditionally been the case. Though again it bears noting, however, that the Exchange need not have risked losing much, if any, business if it had adopted a voluntary two-tier listing system.

The objection of exchanges, which for one reason or another appear to have lost sight of their self interest, may simply preclude the SEC from imposing such a scheme. It may not be possible legally to force one exchange to adopt a rule without forcing all to do so if indeed the latter is even legal. This limitation argues in favor of self-regulation with greater flexibility and less ties to notions of due process and equal protection. That is, if a sufficiently flexible legal rule is not capable of being devised, then maybe the problem is that the subject is not appropriate for legal regulation. The real question now is when *does* the SEC have the authority to review, much less mandate, exchange rules? The *Business Roundtable* case clearly says that the Commission has limited authority over stock exchange listing standards and, indeed, all stock exchange rules. Practically speaking, the effect of this uncertainty may be limited since the exchanges may well continue to come to the Commission routinely for approval of rule changes.[124]

Whatever else it might also be in the eyes of the law— private club, public utility, or natural monopoly—a stock exchange is a business. By giving the exchanges the authority to establish listing standards, we give them something like a property right that can be bought and sold. That right engenders competition, or at least allows it to arise. It might be

124. The case also calls into question the Commission's authority in connection with control over the products that are allowed to be traded on an exchange. *See, e.g.*, Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989). It should be noted that the American Stock Exchange has now adopted (subject to SEC approval) a new listing rule consistent with its earlier rule that will allow many forms of multi-class capitalization that are currently prohibited on the NYSE and on NASDAQ's National Market System. *See* Norris, *AMEX Rule of Supervoting*, N.Y. Times, Apr. 12, 1991, at D8, col. 3.

argued that when the law, through the imposition of significant regulation, has impressed a trust of sorts on certain business activities, it amounts to the waste of a public good to give up jurisdiction. Compelling as that argument may be however in connection with, say, national parks, establishing property rights, whether in free or previously regulated goods is a perfectly legitimate function of the law and indeed perhaps one of its higher functions.[125]

CONCLUSION

Did all this destroy takeovers? Probably not. But taken in combination with the campaign against insider trading, the razing of Drexel Burnham, and the lynching of Michael Milken, it was certainly a factor. Nevertheless, the campaign to federalize corporation law, which seemed like such a good idea fifteen years ago, now looks like utter folly. Congress has proven itself unable to cope with issues of corporate control. And to say the least, the SEC has not fared well in recent years in its role as champion of the takeover. Meanwhile, the states, particularly Delaware, and the courts have demonstrated remarkable resilience and, indeed, creativity in dealing with contests for corporate control. It seems, in short, as if federalism works.

125. The reason is the same one that explains why whales are scarce and chickens are not, even though chickens are consumed at a far greater rate. Ironically, the 1975 amendments to the Exchange Act strongly suggest that Congress believed the stock exchanges to be a sort of public trust. For example, section 11 prohibits any member of an exchange from using a seat to trade primarily for his or her own account.