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January 4, 1988

BY HAND

Susan C. Del Pesco, Esquire
Prickett, Jones, Elliott, Kristol
& Schnee
1310 King Street
P.O. Box 1328
Wilmington, Delaware 19899

Re: Proposed Section 203

Dear Susan:

Enclosed are the following materials for utilization in connection with the Executive Committee's consideration tomorrow of proposed Section 203 which today was passed by the Corporation Law Section by a vote of 101 to 24:

1. A copy of the final version of the statute.

2. A memorandum prepared by Ed McNally (Vice Chairman of the Section) and Stephen Jenkins discussing the legislation.

3. My letter to various members of the Section dated December 29, 1987.

4. My memorandum to the Section referring to the Wall Street Journal editorial published on New Year's Eve.

At your request, I am also forwarding copies of the enclosed materials to all members of the Executive Committee.

Very truly yours,

A. Gilchrist Sparks, III

/lrg
Enclosures

cc: Arthur G. Connolly, Jr., Esquire (w/enc.) (By Hand)
Michael J. Rich, Esquire (w/enc.)
Rodman Ward, Jr., Esquire (w/enc.) (By Hand)
William L. Witham, Jr., Esquire (w/enc.)
William E. Wright, Esquire (w/enc.)
Jeremy J. Abelson, Esquire (w/enc.) (By Hand)
Richard A. Levine, Esquire (w/enc.) (By Hand)
Richard R. Cooch, Esquire (w/enc.) (By Hand)
Israel J. Floyd, Esquire (w/enc.) (By Hand)
Douglas B. Catts, Esquire (w/enc.)
Paulette S. Moore, Esquire (w/enc.) (By Hand)
John F. Schmutz, Esquire (w/enc.) (By Hand)
The Honorable Jay Paul James (w/enc.) (By Hand)
Christine K. Demsey, Esquire (w/enc.) (By Hand)
Joseph M. Kwiatkowski, Esquire (w/enc.) (By Hand)

948L - 12/23/87

Add a new Section 203 to read as follows:

§ 203 Business Combinations With Interested Stockholders

(a) Notwithstanding any other provision of this chapter, a corporation shall not engage in any business combination with any interested stockholder for a period of 3 years following the date that such stockholder became an interested stockholder, unless (1) prior to such date the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder, or (2) upon consummation of the transaction which resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the number of shares outstanding those shares owned (i) by persons who are directors and also officers and (ii) employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer, or (3) on or subsequent to such date the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least 66-2/3% of the outstanding voting stock which is not owned by the interested stockholder.

(b) The restrictions contained in this section shall not apply if:

(1) the corporation's original certificate of incorporation contains a provision expressly electing not to be governed by this section;

(2) the corporation, by action of its board of directors, adopts an amendment to its bylaws within 90 days of the effective date of this section expressly electing not to be governed by this section, which amendment shall not be further amended by the board of directors;

(3) the corporation, by action of its stockholders, adopts an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by this section, provided that, in addition to any other vote required by law, such amendment to the certificate of incorporation or bylaws must be approved by the affirmative vote of a majority of the shares entitled to vote. An amendment adopted pursuant to this paragraph shall not be effective until 12 months after the adoption of such amendment and shall not apply to any business combination between such corporation and any person who became an interested stockholder of such corporation on or prior to such adoption. A bylaw amendment adopted pursuant to this paragraph shall not be further amended by the board of directors;

(4) the corporation does not have a class of voting stock that is (i) listed on a national securities

exchange, (ii) authorized for quotation on an inter dealer quotation system of a registered national securities association or (iii) held of record by more than 2,000 stockholders, unless any of the foregoing results from action taken, directly or indirectly, by an interested stockholder or from a transaction in which a person becomes an interested stockholder;

(5) a stockholder becomes an interested stockholder inadvertently and (i) as soon as practicable divests sufficient shares so that the stockholder ceases to be an interested stockholder and (ii) would not, at any time within the 3-year period immediately prior to a business combination between the corporation and such stockholder, have been an interested stockholder but for the inadvertent acquisition; or

(6) the business combination is proposed prior to the consummation or abandonment of and subsequent to the earlier of the public announcement or the notice required hereunder of a proposed transaction which (i) constitutes one of the transactions described in the second sentence of this paragraph; (ii) is with or by a person who either was not an interested stockholder during the previous 3 years or who became an interested stockholder with the approval of the corporation's board of directors; and (iii) is approved or not opposed by a majority of the members of the board of directors then in office (but not less than 1) who were directors prior to any person becoming an interested stockholder during the previous 3 years or were recommended for election or elected to succeed such

directors by a majority of such directors. The proposed transactions referred to in the preceding sentence are limited to (x) a merger or consolidation of the corporation (except for a merger in respect of which, pursuant to section 251(f) of this chapter, no vote of the stockholders of the corporation is required); (y) a sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions), whether as part of a dissolution or otherwise, of assets of the corporation or of any direct or indirect majority-owned subsidiary of the corporation (other than to any direct or indirect wholly-owned subsidiary or to the corporation) having an aggregate market value equal to 50% or more of either the aggregate market value of all of the assets of the corporation determined on a consolidated basis or the aggregate market value of all the outstanding stock of the corporation; or (z) a proposed tender or exchange offer for 50% or more of the outstanding voting stock of the corporation. The corporation shall give not less than 20 days notice to all interested stockholders prior to the consummation of any of the transactions described in clauses (x) or (y) of the second sentence of this paragraph.

Notwithstanding paragraphs (1), (2), (3) and (4) of this subsection, a corporation may elect by a provision of its original certificate of incorporation or any amendment thereto to be governed by this section, provided that any such amendment to the certificate of incorporation shall not apply to restrict a business combination between the corporation and an interested stockholder of the corporation if the interested stockholder became such prior to the effective date of the amendment.

(c) As used in this section only, the term:

(1) "affiliate" means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, another person.

(2) "associate," when used to indicate a relationship with any person, means (i) any corporation or organization of which such person is a director, officer or partner or is, directly or indirectly, the owner of 20% or more of any class of voting stock, (ii) any trust or other estate in which such person has at least a 20% beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity, and (iii) any relative or spouse of such person, or any relative of such spouse, who has the same residence as such person.

(3) "business combination," when used in reference to any corporation and any interested stockholder of such corporation, means:

(i) any merger or consolidation of the corporation or any direct or indirect majority-owned subsidiary of the corporation with (A) the interested stockholder, or (B) with any other corporation if the merger or consolidation is caused by the interested stockholder and as a result of such merger or consolidation subsection (a) of this section is not applicable to the surviving corporation;

(ii) any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions), except proportionately as a stockholder of such corporation, to or with the interested stockholder, whether as part of a dissolution or otherwise, of assets of the corporation or of any direct or indirect majority-owned subsidiary of the corporation which assets have an aggregate market value equal to 10% or more of either the aggregate market value of all the assets of the corporation determined on a consolidated basis or the aggregate market value of all the outstanding stock of the corporation;

(iii) any transaction which results in the issuance or transfer by the corporation or by any direct or indirect majority-owned subsidiary of the corporation of any stock of the corporation or of such subsidiary to the interested stockholder, except (A) pursuant to the exercise, exchange or conversion of securities exercisable for, exchangeable for or convertible into stock of such corporation or any such subsidiary which securities were outstanding prior to the time that the interested stockholder became such, (B) pursuant to a dividend or distribution paid or made, or the exercise, exchange or conversion of securities exercisable for, exchangeable for or convertible into stock of such corporation or any such subsidiary which security is distributed, pro rata to all holders of a class or series of stock of such corporation subsequent to the time the interested stockholder became such, (C) pursuant to an exchange offer by the corporation to purchase stock made on the same terms to all holders of said stock, or (D) any issuance or transfer of stock by the corporation, provided however, that in no case under (B) - (D) above shall there be an increase in the interested stockholder's proportionate share of the stock of any class or series of the corporation or of the voting stock of the corporation;

(iv) any transaction involving the corporation or any direct or indirect majority-owned subsidiary of the corporation which has the effect, directly or indirectly, of increasing the proportionate share of the stock of any class or series, or securities convertible into the stock of any class or series, of the corporation or of any such subsidiary which is owned by the interested stockholder, except as a result of immaterial changes due to fractional share adjustments or as a result of any purchase or redemption of any shares of stock not caused, directly or indirectly, by the interested stockholder; or

(v) any receipt by the interested stockholder of the benefit, directly or indirectly (except proportionately as a stockholder of such corporation) of any loans, advances, guarantees, pledges, or other financial benefits (other than those expressly permitted in subparagraphs (i)-(iv) above) provided by or through the corporation or any direct or indirect majority owned subsidiary.

(4) "control," including the term "controlling," "controlled by" and "under common control with," means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract, or otherwise. A person who is the owner of 20% or more of a corporation's outstanding voting stock shall be presumed to have control of such corporation, in the absence of proof by a preponderance of the evidence to the contrary. Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith and not for the purpose of circumventing this section, as an agent, bank, broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of such corporation.

(5) "interested stockholder" means any person (other than the corporation and any direct or indirect majority-owned subsidiary of the corporation) that (i) is the owner of 15% or more of the outstanding voting stock of the corporation, or (ii) is an affiliate or associate of the corporation and was the owner of 15% or more of the outstanding voting stock of the corporation at any time within the 3-year period immediately prior to the date on which it is sought to be determined whether such person is an interested stockholder; and the affiliates and associates of such person; provided, however, that the term "interested stockholder" shall not include (x) any person who

(A) owned shares in excess of the 15% limitation set forth herein as of, or acquired such shares pursuant to a tender offer commenced prior to, ________, 198_ or pursuant to an exchange offer announced prior to the aforesaid date and commenced within 90 days thereafter and continued to own shares in excess of such 15% limitation or would have but for action by the corporation or (B) acquired said shares from a person described in (A) above by gift, inheritance or in a transaction in which no consideration was exchanged; or (y) any person whose ownership of shares in excess of the 15% limitation set forth herein is the result of action taken solely by the corporation provided that such person shall be an interested stockholder if thereafter he acquires additional shares of voting stock of the corporation, except as a result of further corporate action not caused, directly or indirectly, by such person. For the purpose of determining whether a person is an interested stockholder, the voting stock of the corporation deemed to be outstanding shall include stock deemed to be owned by the person through application of paragraph (8) of this subsection but shall not include any other unissued stock of such corporation which may be issuable pursuant to any agreement, arrangement or understanding, or upon exercise of conversion rights, warrants or options, or otherwise.

(6) "person" means any individual, corporation, partnership, unincorporated association or other entity.

(7) "voting stock" means stock of any class or series entitled to vote generally in the election of directors.

(8) "owner," including the terms "own" and "owned", when used with respect to any stock means a person that individually or with or through any of its affiliates or associates:

(i) beneficially owns such stock, directly or indirectly; or

(ii) has (A) the right to acquire such stock (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding, or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise; provided, however, that a person shall not be deemed the owner of stock tendered pursuant to a tender or exchange offer made by such person or any of such person's affiliates or associates until such tendered stock is accepted for purchase or exchange; or (B) the right to vote such stock pursuant to any agreement, arrangement or understanding; provided, however, that a person shall not be deemed the owner of any stock because of such person's right to vote such stock if the agreement, arrangement or understanding to vote such stock arises solely from a revocable proxy or consent given in response to a proxy or consent solicitation made to 10 or more persons; or

(iii) has any agreement, arrangement or understanding for the purpose of acquiring, holding, voting (except voting pursuant to a revocable proxy or consent as described in item (B) of clause (ii) of this paragraph), or disposing of such stock with any other person that beneficially owns, or whose affiliates or associates beneficially own, directly or indirectly, such stock.

(d) No provision of a certificate of incorporation or bylaw shall require, for any vote of stockholders required by this section, a greater vote of stockholders than that specified in this section.

(e) The Court of Chancery is hereby vested with exclusive jurisdiction to hear and determine all matters with respect to this section.

SYNOPSIS

Section 203 is intended to strike a balance between the benefits of an unfettered market for corporate shares and the well documented and judicially recognized need to limit abusive takeover tactics. To achieve this end, the statute will delay for three years business combinations with acquirors not approved by the board unless the acquiror is able to obtain in his offer 85% of the stock as defined in the statute. This provision is intended to encourage a full and fair offer. Following the principles of corporate democracy, two-thirds of the stockholders other than the acquiror may vote to exempt a given business combination from the restrictions of the statute. Any corporation may decide to opt out of the statute within 90 days of enactment by action of its board or, at any time, by action of its stockholders. The effect of stockholder action in this regard is delayed for 12 months to avoid circumvention of the statute.

The statute is not intended to alter the case law development of directors' fiduciary duties of care and loyalty in responding to challenges to control or the burden of proof with regard to compliance with those duties. Nor is the statute intended to prevent the use of any other lawful defensive measure.

MEMORANDUM

TO: The Members of the Corporation Law Section

FROM: Edward M. McNally/Stephen E. Jenkins

RE: The Proposed Delaware Business Combination Statute

DATE: December 30, 1987

After a nine month, intensive study and the receipt and consideration of hundreds of comments from across the United States, the Council of the Corporation Law Section of the Delaware State Bar Association has proposed the adoption by the Delaware General Assembly of a new Section 203 to the Delaware General Corporation Law. This new Section 203 is a compromise measure designed to strike a balance between the benefits to stockholders of an unfettered market for corporate shares and the well documented and judicially recognized need to limit abusive takeover tactics that hurt corporations and their stockholders.

Section 203 has been subject to much comment within the bar, as well as in the public press. Although much of this comment has been helpful, some has shown that several misconceptions have developed about the statute. Accordingly, this memorandum is designed to pull together certain background information, the arguments on the merits of the statute and an update of the commentary previously provided to you.

I. BACKGROUND

By the early 1970's there arose a growing concern over the tactics then being developed to take over corporations, often with little notice or time to consider the acquiror's proposal being given to stockholders and at prices that appeared to be well below the corporation's value. In response, numerous states adopted what have become known as "first generation" takeover statutes. These first generation statutes generally operated to slow down the takeover process, by requiring that specific information be supplied in advance to stockholders and providing them with additional time to consider any proposal.

Delaware shared these concerns. In 1976 the Delaware General Assembly passed a statute, codified at 8 Del. C. 203, regulating tender offers by, among other things, requiring pre-offer notice. While the Delaware statute was narrower in its scope than similar statutes then in effect and later passed in other states, its constitutionality from the beginning was in doubt because it was thought to conflict with the federal Williams Act that also regulated tender offers. In Edgar v. MITE Corp., 457 U.S. 624 (1982), the United States Supreme Court invalidated an Illinois tender offer statute which (although broader than the Delaware law) had features in common with the Delaware statute. While there was no clear majority of the Supreme Court coming together in the MITE decision, the Court found that the Illinois statute was preempted by the Williams Act. Since the decision in MITE, it was generally accepted that Section 203 of our General Corporation Law was unconstitutional and, accordingly, effective July 1, 1987, the statute was repealed.

Nonetheless, the concerns that prompted enactment of the first generation takeover statutes continued following the decision in MITE. As a result, a "second generation" of state takeover statutes were enacted. These second generation statutes employed a variety of alternative approaches to address certain of the problems created by non-negotiated acquisitions instigated by investors with short-term rather than long-term objectives. One such approache was exemplified by the so-called Indiana Control Share statute. The Indiana statute, in essence, allows stockholders after a period of delay to decide whether stock acquired by a large and controlling stockholder has the right to vote.

Delaware did not adopt such a second generation statute, largely because there was substantial doubt as to the validity of those statutes on the basis of the Williams Act, Commerce Clause and the MITE decision. That doubt, however, was laid to rest by the decision of the United States Supreme Court in CTS Corp. v. Dynamics Corporation of America, 481 U.S. (1987). That decision sustained the Indiana statute against both Williams Act preemption and the Commerce Clause assaults. The Court confirmed the interest of the state of incorporation in regulating a corporation's internal affairs, found that the Indiana statute did not conflict with the provisions of the Williams Act but rather could be made to work in tandem with the federal statute, noted the body of learning which had recognized the potentially coercive aspects of tender offers, and stated that it was for the states to make judgments with respect to issues of shareholder rights for those corporations incorporated therein.

Following the CTS decision, there occurred renewed interest in second generation takeover statutes and in just the 9 months since CTS was announced, many other states have joined the states that have enacted such second generation statutes. (Attached to this memorandum is a review of these statutes submitted to the drafting Subcommittee in September.) Given these developments, the Council of the Corporation Law Section of the Delaware State Bar Association has been studying the desireability of such a statute since late April, 1987. In May a discussion draft was widely circulated. However, in early June the Council unanimously determined to propose no legislation for consideration by the General Assembly during the then current session. The CTS model had caused widespread concern that while an Indiana-type statute was designed to protect stockholders against certain takeovers, it could create the opposite effect by making it easy and inexpensive to put a company into play. Under these circumstances the Council did not feel it appropriate to recommend any statute to the General Assembly.

Beginning again in August, the Council and the Subcommittee met at least weekly to consider draft legislation in this area. On November 11, 1987, a draft statute was widely circulated and more than a hundred comments were received and considered. These comments led the Council to revise the proposed statute in an attempt to effectuate a compromise that would provide greater protection to stockholders than currently exists against unfair takeovers, but not limit the ability of acquirors to make and stockholders to receive fair and fully priced bids. On December 22, 1987, the Council overwhelming approved the draft Section 203. For the reasons that follow, we urge its adoption by our State.

II. THE MERITS OF THE LEGISLATION

As previously noted, Section 203 attempts to strike a balance between the stockholders' interest in having an unfettered market for corporate shares and their interest in protection from coercive and unfair takeover tactics. It is designed to strengthen the hand of a corporation's board of directors in carrying out is fundamental duty "to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source,"[1] and thus, encourages a potential bidder to negotiate with the board rather than to take advantage of the fragmented stockholder body. Yet, at the same time, Section 203 recognizes the practical problem that some corporate boards "may be acting primarily in [their] own interests rather than those of the corporation and its shareholders."[2] Thus, it contains a series of meaningful "outs" that permit an acquirer to by-pass a board of directors through an offer that is fully priced and non-coercive.

It should be noted from the start what Section 203 does not do. Although there have been calls for Delaware to ban all takeovers that have not been approved by a corporation's directors, or to take steps designed primarily to protect corporate management, the Council has rejected these approaches. Delaware's experience in these

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1 Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954 (Del. 1985).

2 Id.

matters has shown the undesirability of the former, while fundamental principles of corporate law repudiate the latter. Instead, Section 203 is designed to fit the overall scheme of Delaware corporate law by allowing corporate managers and directors to carry out their fiduciary duties to protect the stockholders, while still allowing takeovers that are fair and non-coercive.

(a) The Problem of Coercion in Takeovers

There is no doubt that some corporate takeover tactics are deliberately chosen to coerce stockholders into accepting inadequate consideration for their shares. For example, in describing Mesa Petroleum's proposal to buy 51% of Unocal's stock for cash in a tender offer (the "front end" of the proposal) and to thereafter force out the remaining 49% of the stock for junk bonds (the "back-end" of the proposal), the Delaware Supreme Court found:

> [T]hat such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.[3]

Just this year, the United States Supreme Court reaffirmed this very point in the CTS decision:

> The Indiana Act operates on the assumption, implicit in the Williams Act, that independent shareholders faced with tender offers often are at a disadvantage . . .. If, for example, shareholders believe that a successful tender offer will be followed by a purchase of nontendering shares at a depressed price, individual shareholders may tender their shares-even if they doubt the tender offer is in the corporation's best interest-to protect themselves from being forced to sell their shares at a depressed price. As the SEC explains: "The alternative of not accepting the tender offer is virtual assurance that, if the offer is successful, the shares will have to be sold in the lower priced, second step." Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs, SEC Exchange Act Rel No. 21079 (June 21, 1984), [1984 Transfer Binder] CCH Fed Sec L Rep 83,637, p. 86,916 (footnote

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3 Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946, 956 (1985).

omitted) (hereinafter SEC Release No. 21079). See Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249, 307-309 (1983)[4]

Significantly, opponents of statutes regulating takeover tactics do not deny that some tactics are coercive. Instead, they argue that the benefit of higher stock prices that result from unfettered takeover activity outweighs the harm of occasional abuse by a few unprincipled raiders. Much academic work has been done on this subject, and there are studies that both purport to show that takeovers increase aggregate stockholder welfare,[5] and those that show that defensive tactics by management in fact cause greater gains to the stockholder body.[6] Undoubtedly, further studies will be done to address these points.

This issue, however, has already been addressed and decided by Delaware courts. They have repeatedly held that directors have a fiduciary duty to protect their own stockholders from harmful takeover attempts even if takeovers in general can be shown to help the welfare of stockholders as a class. Indeed, any attempt to make boards of directors responsible to a wider concept of stockholder welfare instead of to their own actual stockholders runs contrary to the entire thrust of corporate law. Section 203 is designed to implement this philosophy by giving corporate boards adequate tools to fulfill their duties in this regard.

In addition, from a corporate law standpoint, these studies are inadequate since they necessarily compare the market value of stock to the premium offered in a

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4 CTS Corp. v. Dynamics Corp. of America, 481 U.S. ___, 95 L. Ed.2d 67, 81, 109 S. Ct 1637 (1987).

5 See generally, Dent, Unprofitable Mergers: Toward a Market Based Legal Response, 80 Nw. U.L.Rev. 777, 778-79 (1986).

6 See generally studies set forth in Unocal, 493 A.2d 956 at n.11; and studies cited in Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, (1987), at 27 n.117.

tender offer. They neglect, however, the inherent values of the corporations in question, which experience has shown are often significantly above market value.[7] Thus, while these studies might show an overall gain to stockholders form otherwise coercive takeovers, they do not show, or purport to show how stockholders fare in such takeovers relative to the inherent value of their corporations.[8]

Moreover, proposed Section 203 does not prohibit takeovers. Unlike some second-generation takeover statutes, Section 203 contains several meaningful methods to acquire a corporation, even without the consent of the corporation's board of directors. In fact, these mechanisms have been carefully drawn to encourage full-priced, all-stock offers, once the decision is made to acquire a corporation.

Finally boiled down to the basic issues, the opponents of Section 203 urge that Delaware permit coercive takeover tactics because some undefined, but greater "good" will result. But even assuming that a few persons may benefit from those coercive tactics, it is simply wrong to permit these unfair takeover schemes to exist. Of course, this is a policy judgment that ultimately is for the General Assembly to determine. However, we must note that since the <u>CTS</u> decision upholding the states' "substantial interest" in preventing "unfair business dealing" by regulating takeover activity,[9] many states other than Delaware now have some form of statute similar to Section 203.

This wide-spread legislative response to the abuse of takeover tactics should be considered when evaluating Section 203 because it demonstrates a significant public

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7 <u>See</u>, <u>e.g.</u>, <u>Smith v. Van Gorkom</u>, 488 A.2d 858 (1985); <u>Chicago Corporation v. Munds</u>, 172 A. 452 (Del. Ch. 1934) (rejecting use of market value alone in an appraisal proceeding).

8 <u>Unocal Corp. v. Mesa Petroleum Co.</u>, Del. Supr., 493 A.2d 946, 956, fn.11 (1985).

9 <u>CTS Corp. v. Dynamics Corp. of America</u>, 481 U.S. ___, 95 L. Ed.2d 67, 88, 109 S. Ct. ___ (1987).

revulsion with some takeover tactics. As our sister states have responded so too should Delaware, but in a reasonable, moderate fashion as provided by Section 203.[10]

(b) The Appropriateness of Section 203

Under Section 203, a potential acquiror is prohibited from engaging in a "business combination" with the target corporation for three years after he becomes a 15% stockholder. This three-year moratorium is designed to keep the acquiror from using the corporation's own assets to finance its acquisition. The statute prevents such a use of the corporation's own assets because it is that practice that has often permitted some acquiring parties to coerce stockholders, through such tactics as using junk bonds secured by the acquired corporation's assets to "cash-out" those stockholders who do not want to sell their stock.

To avoid the three-year moratorium, Section 203 requires the acquiror either to (1) obtain the approval of the target's board of directors or (2) secure the approval of a large percentage of the target's stockholders. Each of these alternative requirements is entirely appropriate.

First, as previously discussed, it has long been recognized that a corporation's board of directors should play a key role in representing its stockholders in the context of an acquisition of the corporation. Indeed, the board has a duty to do just that under Delaware law. This is the law virtually everywhere.[11] This is necessary because there is no practical alternative to the board acting in such a capacity. There is

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10 We note the recent decision in TLX Acquisition Corp. v. Telex Corp., D.W. Okl., C.A.-87-2056-R, Nov. 3, 1987) which held that a Delaware corporation could not invoke the protection of the Oklahoma Control Share Act (a second-generation takeover statute). Telex was unquestionably correct in holding that only Delaware law applied to a Delaware corporation. However, the practical result of the Telex ruling is that stockholders and their corporations are now disadvantaged by being chartered in Delaware to the extent that Delaware lacks a statute regulating takeover tactics.

11 Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946, 955 (1985).

no one else that will represent all the stockholders as a group. Thus, the board of directors of necessity has a key role as the stockholders' elected representatives.

That the board of directors be charged with this responsibility is also appropriate given the ability of our courts to oversee their conduct and to apply now well-established guidelines to prevent abuses. For example, it is settled Delaware law that the board of directors must have reasonable grounds for acting to oppose a takeover and they must conduct a reasonable investigation before, in good faith, they determine what to do. Moreover, their response must be balanced. Any defensive measure must be reasonable in response to the threat posed to the stockholders. In short, the board's discretion is not unfettered.[12]

Section 203 continues this important role of the corporation's board of directors. Under Section 203, the three-year moratorium is not imposed if, prior to acquiring a 15% position, the acquiror obtains the board's approval of either the business combination the acquiror intends to use to complete the acquisition (e.g., a merger) or the transaction by which the acquiror obtains 15% or more of the corporation's voting stock. It is intended that as a result of these provisions an acquiror will, initially at least, negotiate with the representative of all the stockholders, the corporation's board of directors.

If, however, those negotiations fail, then Section 203 still permits an acquiror to go forward with a takeover and to avoid the three-year moratorium. This may be done by obtaining the stockholders' approval directly, in either of three ways. First, the acquiror may make such an attractive offer that he obtains 85% of the corporation's voting stock (not counting stock held by director-officers and certain employee stock plans). Second, he may proceed free of the moratorium if, after he gains

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12 Revlon v. McAndrews & Forbes Holdings, Inc., Del. Supr., 506 A.2d 173 (1986); Smith v. Van Gorkum, Del. Supr., 488 A.2d 858 (1985); Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984).

control of the board, his plan is approved by 66-2/3% of the outstanding voting stock not owned by him. Third, he may conduct a proxy contest and if he can convince the stockholders to vote his way, throw out the board of directors in favor of his own slate of directors. The new board would then presumably approve his proposal, in response to the stockholders' mandate. In short, if the acquiror wins stockholder approval in any one of these three ways, he may complete his proposal.

Opposition to Section 203 comes from two quarters. First, those favoring a stronger measure against takeovers contend that allowing a two-thirds vote of stockholders or an 85% acquisition "out" will undermine the board. We believe that it would be inappropriate to give unfettered power to the board and that Section 203 is a reasonable limitation on that power.

Second, those that favor a weaker statute contend that Section 203 gives too much power to the board. These opponents argue that requiring 85% of the disinterest stockholders to tender their shares or 66-2/3% of the disinterest stockholders to vote for the proposed business combination is an unfair change to the principle of majority-rule. We also believe this view is incorrect.

The votes required by Section 203 have been carefully calculated to provide the least intrusive measure possible that will still allow the statute to limit the abusive takeover tactics to which it is directed. Thus, Section 203 permits an acquiror to go forward with a business combination within three years if he acquires 85% of the stock because that should require him to make his best offer as the way to maximize his chances of success. Anything less than his best offer will jeopardize that success.

The 85% threshold is set at that level because there is evidence that less-than-full-price, coercive tender offers are frequently able to obtain stock tenders of 80%

or better.[13] Thus, unless Section 203 set a greater than 80% threshold requirement, it would not preclude the very evil it seeks to prevent.

On the other hand, the 85% level is sufficiently low and flexible so as not to preclude legitimate proposals. In calculating whether the 85% level has been reached, Section 203 excludes stock held by insiders (those persons who are both directors and officers) and stock that may be subject to insider coercion (stock held by employee stock plans where the employees are not able to confidentially direct if the stock is to be tendered in a takeover). As a result, as the percentage of stock held or controlled by these insiders increases, the percentage of stock the acquiror must obtain to avoid the moratorium actually decreases. For example, if insiders hold no stock, the acquiror must obtain 85% of the stock outstanding, but if insiders held 10% of the stock, then the acquiror must obtain only 75.5% of the total stock outstanding (i.e., 85% of the 90% not held by insiders).[14]

Similarly, the 66-2/3% vote of disinterested stockholders required to lift the moratorium once an acquiror has control is also calculated to have a meaningful impact on coercive takeover schemes, but still allow stockholders to accept a fully-priced second-step transaction. The 66-2/3% level was set because there is evidence that a coercive tender offer will force 75%-80% of the stockholders to tender or sell their stock, in the latter case usually to arbitrageurs who in turn will tender. In a tender offer for 51% of the stock, this will mean that the coercive offer will result in about 25%-30% of the stock tendered being returned to the arbitrageurs once the offer for 51% expires

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13 See, e.g., Moran v. Household International, Inc., Del. Supr., 500 A.2d 1346 (1985).

14 A commissioner of the S.E.C. suggested to the Council that "the threshold should be set at about 75 percent" to take into account management and ESOP holdings and holdings by unresponsive stockholders. By not counting such insider holdings, Section 203 effectively adopts this suggestion. See letter from Joseph A. Grundfest, Commissioner of the Securities and Exchange Commission, December 18, 1987.

(i.e., if 80% tendered and 51% accepted, 29% will be returned). A vote of the disinterested stockholders taken at that point (after the coercion has had its initial impact of driving out many long-term investors) will result in certain approval for the acquiror because 29% of the stock (or about 58% of the disinterested stock) will be held by arbitrageurs who want any short-term deal, no matter how inadequate it is from the standpoint of long-term value.

To avoid this possible circumvention of the statute by use of the very coercion it seeks to prevent, Section 203 requires a 66-2/3% vote of disinterested stockholders to approve the acquiror's proposed business combination. That vote level takes into account that the acquiror's tactics have, at that point, already influenced the electorate. Any lesser level of approval would significantly weaken the statute and might even encourage the very abuses it seeks to prevent by rewarding the truly coercive offeror.

III. COMMENTARY TO PROPOSED SECTION 203

General Comment

It is fundamental premise of the Delaware General Corporation Law that the business and affairs of a corporation are governed by its board of directors. Where, for example, a merger is proposed which will cause the corporation's stockholders to be cashed out, the board is the bargainer for the stockholders. It determines, subject to its fiduciary duties, when and whether to recommend the merger and, if so, at what price.

The evolution and popularization of the takeover phenomenon has, in many instances, operated to remove the board from its traditional role as bargainer for the stockholders. Partial, front-end loaded tender offers tend to stampede stockholders into surrendering their shares for fear that they will get less if they wait. Any-and-all tender offers, while not containing the pressure of front-end loading, but pressure on stockholders who know (or fear) that if they do not tender they will be locked in as minority owners of a newly controlled enterprise, or cashed out - either at the tender offer price, or less.

Variations on this theme are virtually endless. The tender offer o will often precede its offer with open market or negotiated purchases to get a foothold. Sometimes open market purchases will follow the tender offer. Occasionally control will be sought through the market. But a common theme, running through all the takeover techniques, is that acquirors frequently believe it is to their economic advantage to bypass the target's board, and deal directly with its fragmented stockholder interests.

Section 203 is consistent with Delaware's historic legislative policy that the board should manage the corporation's business and affairs. Acquirors will now be encouraged to seek board approval before acquiring a substantial interest in a target's stock, or face delay in effecting a subsequent self-dealing business combination.

Proposed Subsection (a)

This is the heart of the statute. It applies to a proposed acquiror which wishes to become an interested stockholder (later defined as owning 15% or more of the corporation's voting stock) and wishes to do a business combination (later defined to include a variety of potentially self-dealing transactions) within three years of its acquisition. To effect such a transaction it must, before its acquisition: (1) gain the board's permission to become an interested person or (2) acquire 85% of the corporation's voting stock in the same transaction in which it became an interested stockholder with the further condition that the stock held by directors who are also officers and by certain employee stock plans are excluded in determining whether the 85% level has been reached or (3) obtain the approval of 66.6% of the disinterested stockholders for the proposed business combination.

Nothing in the statute prevents a proxy contest by a proposed acquiror if a board of directors turns down its proposal. If the proposed acquiror wishes to try to persuade stockholders that they would be better served by a board of its nominees who might be more favorable to its proposal, the will of the stockholders will prevail.

This section in no way affects a proposed acquiror's right to buy stock, whether by tender offer or in the open market or by private purchase. Nor does it prevent a stockholder, who takes control, from electing his own board. It simply means that unless the acquiror has gotten the pre-acquisition board's approval, or meets one of the two other criteria, it must wait three years before doing a potentially self-dealing transaction.

Proposed Subsection (b)

This provides when the section will not apply.

1. Original certificates of incorporation are allowed to opt out.

2. Considerable debate attended the question of whether there should be a director opt-out. It was concluded that an opt-out, very limited in time, was appropriate. The time was kept to 90 days to make it difficult for potential acquirors to evade the statute by moving immediately to gain control and causing a subserviant board to opt out.

3. Stockholders may opt out by certificate of incorporation or bylaw amendment, but there will be an 12-month wait before the opt-out becomes effective, and the opt-out will not apply to a business combination with a person who is an interested stockholder at the time of the opt-out.

4. The section will apply only to substantial public companies or smaller companies who "opt in" by a charter amendment.

5. If a person becomes an interested stockholder inadvertently, steps may be taken to avoid such status.

6. Subsection (6) is designed to assure that management does not unfairly take advantage of the three-year prohibition against self-dealing transactions by

providing that a tender offer, merger or sale of more than half of a company's assets, if approved by a board of directors, will release the interested stockholder from the restrictions of the statute.

Proposed Subsection (c)

Subsections (1), (2), (3), (4), (6), (7) and (8) are to be read in combination with subsection (5). They define an interested person as one owning 15% or more of the corporation's voting stock. Shares owned by affiliates and associates of the potentially interested person are counted in determining whether the 15% level is reached. Subsection (3) defines business combinations, subject to the three-year moratorium, to include self-dealing mergers and consolidations, asset sales, stock transfers, or other transactions involving preferential treatment.

Proposed Subsection (d)

This provision prohibits requiring in a certificate of incorporation or bylaw that a greater vote of stockholders be obtained than otherwise specified in Section 203.

Proposed Subsection (e)

As with other issues involving the internal affairs of Delaware corporations, it is logical to vest the Court of Chancery with jurisdiction under Section 203.

IV. CONCLUSION

Section 203 is a well-balanced, reasonable response to the abuses that have occurred and may continue to occur in hostile takeovers. Section 203 does not preclude proxy contests. It will impact only upon those tender offers whose viability depends upon the ability of the acquiror promptly to consummate a second-step, self-dealing transaction that coerce stockholders into selling their shares. Even then, the affect of Section 203 will be to first encourage negotiation with the stockholders' elected representatives, the board of directors. If that fails, the acquiror may still proceed. He may elect to moratorium. He may elect to make his best offer, for all the stock, to

abide by the

maximize his ability to obtain 85% of the stock in his offer and thereby avoid the moratorium. Or, he may take control of the board and make a proposal for a self-dealing business combination that is sufficiently attractive to obtain 66-2/3% approval of the disinterested stockholders.

This is a balanced approach to a complex problem and one that we hope has your support.

CRB

DRAFT 8/14/87

DESCRIPTION OF STATE STATUTES RELATING TO CONTESTS FOR CONTROL

At present, there are four principal approaches to state regulation relating to contests for control: (i) control share acquisition laws; (ii) fair price laws; (iii) control share cash-out laws; and (iv) five-year, freeze-out fair price laws. All of these statutes promote the interests of shareholders and are aimed at protecting shareholders from abusive tender offer tactics.

Control share acquisition laws are designed to ensure that shareholders acting as a group, as opposed to individually, can make collective decisions regarding a change of control. These laws reflect a legislative determination that shareholder decisions regarding a change of control are no different from other shareholder decisions on matters such as mergers, consolidations, reincorporations in a new state, sales of all assets, elections of directors, or amendments of the articles of incorporation. In all these other instances, shareholders are permitted, after receiving full disclosure materials, to vote at a shareholders meeting before the proposed transaction can be approved or action taken. Without these control share acquisition laws, a change of control could be effected in a major corporation by an acquiror's simple purchase of a controlling block of stock, which could be a block amounting to as little as 20% to 30% of the outstanding shares. This change of control could be effective even if such acquisition was against the wishes of a majority of the shareholders. Thus, these laws provide that a majority vote of the shareholders should control the outcome of a decision as important as a change of control, just as such a vote controls the outcome of the other important corporate decisions. In essence, these statutes legislatively embody the notion of shareholder democracy in its best form.

Fair price laws are designed to address a different problem. A frequent tactic has been to tender for a controlling block of stock, say 51% of the outstanding shares, at a specified price, say $50 cash, and then threaten to "squeeze-out" in a merger the remaining 49% at a lower price, or for less attractive consideration (such as preferred stock). Shareholders, even those who firmly believe that the $50 price was too low, are forced to tender into the offer out of a fear that if they don't the acquiring person will still obtain the 51% of the shares he seeks from other shareholders and then force these objecting non-tendering shareholders out of the company at the lower price or for the less desirable form of consideration. The fair price laws state, in essence, that if an acquiring person wishes to engage in such a squeeze-out merger, they can do so, but they have to offer the same amount and form of consideration in the merger as they did in acquiring their control block. Thus, fair price laws stop coercive "front-end-loaded-two-tiered tender offers." Unlike control share acquisition laws, the fair price laws are not concerned with whether a person can acquire control of a company, even against the wishes of a voting majority of the shareholders. The fair price laws protect only minority shareholders who are left in a corporation after a controlling block of stock is acquired, where the acquiring person causes a merger that "squeezes-out" the minority shareholders.

Control share cash-out laws serve a different purpose again. Like the fair price laws, but unlike the control share acquisition laws, cash out laws are unconcerned with how a person acquires a controlling block, or whether the majority of shareholders are in favor of the change of control. Again, like the fair price laws, the cash out laws are designed to protect the minority. But the cash out laws operate <u>whenever</u> a person acquires a control block, permitting the minority shareholders to sell their shares in the corporation to the acquiring person at an appraised fair value. Thus, they are intended to ensure, unlike the fair price laws, that minority shareholders are entitled to receive a fair value for their shares -- not just the same value as that received by shareholders who sold originally to the acquiring person -- and to ensure that shareholders will receive that value even if the acquiring person does not attempt to squeeze-out the minority. Thus, cash out laws protect shareholders whose corporation is subject to a change of control where the new controlling person may, for example, engage in self-dealing or other tactics that the minority shareholders may not like. Cash out laws, obviously, also provide protection against front-end-loaded-two-tiered offers because the minority shareholders can demand fair value under the cash out laws if the value offered in the squeeze-out merger is insufficient.

Finally, the five year, freeze out fair price laws address not only the two-tiered problem addressed by the fair price laws described above, but also the self-dealing types of problems addressed by a cash-out law. But these five-year freeze out statutes address these problems simply by prohibiting squeeze-out mergers and self-dealing transactions altogether for a five-year period, and permitting them thereafter only if certain conditions are satisfied.

Thus, in sum, the control share acquisition laws protect the majority's wishes, without providing much protection to the minority. The other laws assume that the majority can take care of itself, but protect the minority, in some cases only in the narrow context of two-tiered offers, in other cases in the broader context of ensuring minority shareholders a method for cashing-out at a fair value, and in still other cases by preventing self-dealing and squeeze-out mergers generally.

As is obvious, various states have responded to different concerns, and to the extent the same concerns are addressed by different states, they have occasionally chosen different paths. This experimentation and flexibility in the rapidly changing environment of hostile takeovers is necessary and beneficial to shareholder interests. As those in favor of federal preemption know well, this flexibility and responsiveness can only be achieved at the state level -- not the federal level.

Control Share Acquisition Laws

Control share acquisition statutes prohibit an acquiring person, depending on the statute, either from purchasing a control block or from voting a control block of stock unless the "disinterested shareholders" approve the purchase or grant the voting rights. Simply put, the statutes provide shareholders the opportunity to vote collectively on a change of control. Shareholders are no longer put in a "prisoner's dilemma" where they are forced to sell out at an inadequate price out of fear that if they do not, but other shareholders do, they will remain as shareholders in a corporation with a new controlling shareholder. Under these laws, shareholders are able to determine -- collectively and in accordance with the procedure utilized in approving every other fundamental corporate action from mergers to elections of directors -- whether they wish to approve the change of control. Moreover, by requiring shareholder approval of the acquisition of shares or voting rights over a specified threshold, these laws limit, without shareholder approval, "sweeping the street" or creeping tender offers which are currently wholly unregulated by the Williams Act.

The following fourteen states have adopted control share acquisition laws: Arizona, Florida, Hawaii, Indiana, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, North Carolina, Ohio, Oklahoma, Utah, and Wisconsin. Similar legislation is pending in California, Illinois, and Michigan.

Mechanically, the control share acquisition statutes require shareholder authorization prior to the acquisition of shares or voting rights above certain threshold percentages. A person desiring to acquire shares or voting rights in excess of the threshold must file an acquiring person statement and may demand a special meeting of shareholders to vote on the proposed acquisition. The target shareholders exclusive of "interested shareholders" (which includes the acquiring person as well as management and the board of directors of the target company) must then approve the proposed acquisition. If it is not approved, the acquisition of shares or voting rights is precluded.

Fair Price Laws

Fair price laws are designed to protect minority shareholders who did not tender to a bidder. Ordinarily, once a bidder acquires a controlling stake in a company, it can "force out," or "squeeze out" the remaining minority shareholders in accordance with the state's merger law. Frequently, these minority shareholders receive securities -- usually junk bonds or some form of preferred stock -- in the squeeze out. In addition, not only may the form of consideration be unattractive (e.g., junk bonds as opposed to cash) but the amount of consideration may be far less than the amount offered by the bidder in acquiring its controlling stake. Without a fair price or other protective law, shareholders are forced to tender into an inadequately priced tender offer out of fear of being squeezed out for even less consideration in the second step. Fair price laws prohibit the bidder from paying a lower price to the minority in the second step than the majority received in the initial stage of a two-tier bid. Unlike the control share acquisition laws, however, they have no mechanism that would preclude a bidder from acquiring control in the first instance -- even if a majority of the shareholders would have voted against that shift in control.

The following thirteen states have adopted fair price laws: Connecticut, Florida, Georgia, Illinois, Kentucky, Louisiana, Maryland, Michigan, Mississippi, North Carolina, Virginia, Washington and Wisconsin. Similar legislation is pending in South Carolina.

In operation, the fair price statutes require that a two-tier offer must be recommended by the board and approved by a super-majority vote of shareholders (e.g., eighty percent of the outstanding shares and two-thirds of the shares not held by the bidder), unless the second step transaction satisfies certain fair price criteria, such as the form and amount of consideration offered in the second step being the same as that offered in the first step.

<u>Control Share Cash-Out Laws</u>

Control share cash-out laws ensure that shareholders receive fair value for their shares upon a change of control. Currently, a person can acquire a controlling block of stock without offering fair value, or any value, for the other outstanding shares. For example, a person could acquire 51% of a company's shares through a partial tender offer, or a creeping tender offer, and never offer anything to the remaining minority shareholders. By contrast, if a change of control were to occur through a merger, or sale of assets, shareholders under many corporate laws would be entitled to dissent and receive an appraised fair value for their shares. The control share cash-out laws provide that same remedy to shareholders in the event there is a change of control of their company effected through the simple mechanism of a purchase of a controlling block of stock. Because minority shareholders are afforded the opportunity to have their shares purchased by the acquiring person at an appraised fair value, these laws will generally prevent abusive two-tier offers as well as creeping or partial offers where shareholders would otherwise not have any rights or remedy once there has been a change of control.

Control share cash-out laws have been adopted in Maine, Pennsylvania, and Utah.

Mechanically, under these laws, once a shareholder acquires a specified controlling interest (e.g., 30%) of a corporation, the other shareholders are afforded the opportunity to sell their remaining shares to such acquiring person at an appraised fair value. Such value is generally determined under the traditional state-law appraisal procedures applicable to mergers and consolidation.

Five-Year Freeze-Out Fair Price Laws

Five-year freeze-out fair price laws preclude certain business combinations for five years after a hostile acquisition of control. Among the purposes of the law is to protect shareholders from raiders who finance bids with target company assets or otherwise engage in self-dealing. Frequently, a raider will acquire a controlling interest in a company and then squeeze out the minority for junk bonds or preferred shares issued by the target company, or engage in various self-dealing or other transactions that may be in the controlling shareholder's own interest, but not in the interest of the other shareholders. These laws preclude such actions for a five-year period and permit them thereafter only if certain protections exist. They address abusive two-tier offers as well as junk-bond financed takeovers by precluding the target company from being required, by its new controlling shareholder, to accept the junk bond obligations as liabilities of the target.

The following eight states have adopted five-year freeze-out fair price laws: Arizona, Indiana, Kentucky, Minnesota, Missouri, New Jersey, New York and Washington.

Operationally, these laws prohibit a business combination between a controlling shareholder and a target company for five years from the date of the controlling shareholder's acquisition of shares. After the expiration of the five-year period, the controlling shareholder can engage in a business combination with the target only if one of the following two conditions is met: (i) a majority of disinterested shareholders (i.e., the shareholders other than the acquiring person) approves the transaction or (ii) the interested shareholder offers a fair price for all outstanding shares.

Other Types of State Laws Relating to Contests for Control

Some states have adopted statutes which codify certain aspects of the business judgment rule. For example, in Ohio and Pennsylvania, the directors of a corporation are explicitly permitted, in considering the best interests of the corporation, to take into account the effects of actions on, among others, employees and communities.

In addition, Ohio has adopted a provision which specifically authorizes the board to adopt -- as a corporate law matter -- a shareholder rights plan (a "poison pill"). The adoption of such a rights plan in any particular context is, of course, subject to the directors' fiduciary duty obligations and must be shown to protect shareholder interests, not entrench management. Otherwise, despite the fact that such a plan is not per se invalid under the corporate law, its application in that particular instance will be enjoined. This is a perfect example of how state regulation exactly squares with shareholder interests.

State Law Citations

Control Share Acquisition Laws

adopted:

Arizona: Ariz. Rev. Stat. Section 10-1211 (Ariz. Stat. Chap. 3, 1987 Special Session)
Florida: Fla. Stat. Section 607.109
Hawaii: Haw. Rev. Stat. Section 416-171 to 172
Indiana: Ind. Code Ann. Section 23-1-42
Louisiana: La. Stat. Section 12:135 to 140.2
Massachusetts: Mass. Gen. Laws Chap. 272
Minnesota: Minn. Stat. Ann. Section 302A.671 (1987 Special Session, Chapter 1)
Missouri: Mo. Ann. Stat. Section 351.407
Nevada: Nev. Stat. Chap. 327, 1987 Law
North Carolina: N.C. Gen. Stat. Sections 55-90 to 55-98
Ohio: Ohio Rev. Code Ann. Section 1701.831
Oklahoma: Oklahoma Stat. Sections 1145-56 (1987 Session)
Utah: Utah Code Ann. Section 61-6-1 to 61-6-12
Wisconsin: Wis. Stat. Ann. Section 180.25(9)(a)

pending:

California
Illinois
Michigan

Fair Price Laws

adopted:

Connecticut: Conn. Gen. Stat. Sections 33-374a to 374c
Florida: Fla. Stat. Section 607.108
Georgia: Ga. Code Ann. Sections 14-2-232 to 234
Illinois: Ill. Ann. Stat. Chap. 32 Section 7.85
Kentucky: Ky. Rev. Stat. Sections 271A.396 to .398
Louisiana: La. Rev. Stat. Ann. Sections 12:132 to 134
Maryland: Md. Corps. & Ass'ns. Code Ann. Sections 3-601 to 603
Michigan: Mich. Comp. Laws Ann. Sections 450.1776 to .1784
Mississippi: Miss. Code Ann. Sections 79-25-1 to -7
North Carolina: N.C. Gen. Stat. Sections 55-75 to 55-79
Virginia: Va. Code Ann. Sections 13.1-726 to 13.1-728
Washington: Wash. Rev. Code Ann. Section 23A.08.425
Wisconsin: Wis. Stat. Ann. Section 180.725

pending:

South Carolina

Control Share Cash-Out Laws

adopted:

Maine: Me. Rev. Stat. Ann. Title 13-A Section 910
Pennsylvania: Pa. Stat. Ann Title 15 Section 1910
Utah: Utah Code Ann. Section 16-10-76.5

Five Year Freeze-Out Fair Price Laws

adopted:

Arizona: Ariz. Rev. Stat. Section 10-1221 to 1222 (Ariz. Stat. Chap. 3, 1987 Special Session)
Indiana: Ind. Code Section 23-1-43
Kentucky: Ky. Rev. Stat. Section 271A.396 to .398
Minnesota: Minn. Stat. Ann. Section 302A.673 (1987 Special Session, Chap. 1)
Missouri: Rev. Stat. Mo. Section 351.459
New Jersey: N.J. Stat. Ann. Section 14A:10A
New York: New York Bus. Corp. Law Section 912
Washington: Wash. Rev. Code (1987 Session)

August 20, 1987

STATE STATUTES REGULATING
CONTESTS FOR CONTROL

STATE	CONTROL SHARE	FAIR PRICE	CASH-OUT	FIVE-YEAR FREEZE-OUT
I. Adopted				
Arizona	X	--	--	X
Connecticut	--	X	--	--
Florida	X	X	--	--
Georgia	--	X	--	--
Hawaii	X	--	--	--
Indiana	X	--	--	X
Illinois	--	X	--	--
Kentucky	--	X	--	X
Louisiana	X	X	--	--
Maine	--	--	X	--
Maryland	--	X	--	--
Massachusetts	X	--	--	--
Michigan	--	X	--	--
Minnesota	X	--	--	X
Mississippi	--	X	--	--
Missouri	X	--	--	X
Nevada	X	--	--	--
New Jersey	--	--	--	X
New York	--	--	--	X
North Carolina	X	X	--	--
Ohio	X	--	--	--
Oklahoma	X	--	--	--
Pennsylvania	--	--	X	--
Utah	X	--	X	--
Virginia	--	X	--	--
Washington	--	X	--	X
Wisconsin	X	X	--	--
TOTAL NUMBER	14	13	3	8

STATE	CONTROL SHARE	FAIR PRICE	CASH-OUT	FIVE-YEAR FREEZE-OUT
II. Pending				
California	X	--	--	--
Illinois	X	--	--	--
Michigan	X	--	--	--
South Carolina	--	X	--	--
TOTAL NUMBER	3	1	0	0

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December 29, 1987

Grover C. Brown, Esquire
Morris, James, Hitchens & Williams
1105 N. Market Street
P.O. Box 2306
Wilmington, Delaware 19899

Re: <u>Proposed Section 203</u>

Dear Grover:

By now you should have received a revised version of proposed Section 203, together with the notice of a meeting of the Corporation Law Section to be held on January 4, at which a vote will be taken with respect to the proposed legislation. In this letter I would like to pass on a few of my personal thoughts with respect to the process by which the proposed legislation has been adopted and with respect to its merits, with the hope that you will support the proposed legislation at the January 4 meeting.

If you attended the December 11 meeting of the Section, you will recall that, while there was a consensus that the Section should proceed with the drafting of legislation along the lines of the November 19, 1987 draft of proposed Section 203, there was also a strong view expressed within the Section that the Council should seek to reach a compromise with respect to a number of points raised by Norm Veasey at the meeting. Following that meeting, the Council and the drafting subcommittee met repeatedly to consider not only the suggestions made from the floor of the meeting, but also to review each and every one of the approximately 150 comment letters received with respect to the proposed legislation. As a result of that process, a number of drafting changes were made to the November 19 draft. In addition, changes were made in response to every one of the substantive points raised at the Section meeting. Thereafter, the Council approved the compromise version of Section 203 by a vote of 14-1. I would like to take a moment to discuss certain of the changes approved by the Council, since I believe they have had the effect of improving the statute and making it one that all of us should feel comfortable in supporting.

As originally proposed in the November 19 draft, there were three ways in which a self-dealing business combination with an interested stockholder could go forward within the three-year moratorium period contemplated by the statute. These included approval of the business combination or of interested stockholder status by the board of directors prior to a person becoming an interested stockholder, the acquisition of 90% of the outstanding stock of the corporation by the interested stockholder in the same transaction in which he became such, or the acquisition of 90% of the corporation's outstanding stock by any means together with an approval of a majority of disinterested stockholders. While the board approval "out" is essentially unchanged, the other two "outs" have been materially altered.

First, the 90% "out" has not only been lowered to 85%, but also has been changed to provide that, in calculating the percentage, outstanding shares owned by persons who are directors and also officers and by employee stock plans which do not give to employees the right to determine confidentially whether shares held subject to the plan will be tendered (hereafter "nonpass-through plans") are excluded. Accordingly, in many corporations the amount required to be purchased in a tender offer to obtain release from the moratorium will be considerably less than 85%.[1] The lowering and redefinition of the 85% ownership "out" should also be read in conjunction with the further action taken by the Council to increase from 10% to 15% the amount of stock which must be held in order for a person to achieve the status of "interested stockholder." As a result, a person would be required to move in a tender offer from just under 15% ownership to 85% (or less, depending upon the number of shares owned by officer/directors and nonpass-through employee stock plans), rather than from 10% to 90% under the previous version of the statute, in order to avoid the moratorium.

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1 For example, if 10% of a corporation's stock were held by director/officers, an acquiror would need to end up with only 77% of the corporation's stock in a tender offer to be released from the moratorium.

The final "out" in Section (a) has also been liberalized. The 90% ownership prerequisite in the November 19 draft has been completely eliminated, permitting the consummation of a self-dealing business transaction within the three-year moratorium period if, in addition to any other approvals required by law, 66-2/3% of the disinterested stockholders approve it.

Two other significant changes were made as a part of the compromise. First, the time during which a board of directors may act unilaterally to opt out of the statute following its effective date has been increased from 45 to 90 days, and the time period after which a bylaw amendment adopted by a vote of the holders of a majority of outstanding voting stock would be effective to make the statute inapplicable has been shortened from 18 months to 12 months. Thus, if a majority of stockholders in fact do not want the protections offered by Section 203, the statute gives them the right to amend the bylaws to cause the corporation to opt out, whether or not the board of directors concurs.

As presently drafted, Section 203 should encourage prospective acquirors to structure offers in such a way as to provide full value to all stockholders of Delaware corporations, while discouraging those thinly-financed acquirors who, for their own advantage and at a price only marginally above market, would put a Delaware corporation into play by taking advantage of the fact that stockholders are in no position to act in a concerted manner vis-a-vis an acquiror. Very simply, the statute provides to an offeror who desires to avoid the three-year moratorium a strong incentive to make his offer one which is conditioned upon receiving 85% of the stock held other than by officer/directors and nonpass-through plans and is structured and priced to achieve that objective. In the event that the offeror miscalculates in fixing a tender offer price and, for example, only 83% of stock were tendered, he retains the ability to amend his offer to increase the consideration to be paid to <u>all</u> tendering stockholders so as to bring in the extra 2%.

Much of the debate in the Council over the past two weeks has centered upon the question whether the 85% "out," as defined in the statute, should be higher or lower. Those who advocated a higher number pointed, among other things, to the expert testimony presented on behalf of Household International, Inc. in <u>Moran v. Household</u>, which testimony was argued by Household to have clearly established that it is not uncommon for a tender offer to attract 90-95% of outstanding shares. A concern was expressed by some that, in moving to a percentage lower than 90%, the statute might not provide a meaningful incentive to offerors to make fully-priced offers and might not be perceived by the market as a deterrent even to concededly inadequate offers. On the other hand, one member of the Council consistently advocated that the percentage should be 80% or lower, including the elimination of shares held by officer/directors and nonpass-through plans. In compromising these conflicting views, the Council members not only brought to bear their own experience in various takeover situations, but also reviewed statistical information from a number of sources, including Commissioner Grundfest of the Securities and Exchange Commission. One table provided by Commissioner Grundfest suggested that in a typical tender offer between 3% and 5% of available shares will be held by nonresponsive shareholders, and that in approximately two-thirds of any and all cash tender offers more than 90% of stock is tendered. Further statistics provided by Commissioner Grundfest indicated that as of 1980 director share ownership for one-half of Fortune 500 firms consisted of less than 3.5% of outstanding shares, and that the mean ownership by directors for all firms in the Fortune 500 as of 1980 was 10.6%, of which 6.3% was held by the top two officers, whose shares under proposed Section 203 would normally be expected to be excluded from the 85% calculation.

As is the case with most matters of statistics, arguments can be made on either side of an issue utilizing the same data. Suffice it to say that, in this case, all data was looked at by the Council, the conflicting views were thoroughly aired, and a compromise was reached at 85%, with the exclusion of stock held by officer/directors and nonpass-through plans. In my view, the result is a balanced statute which, on the one hand, should inhibit the ability of a thinly-capitalized acquiror, whose financing requires that he gain quick access to all of the target's assets, to put a Delaware corporation irretrievably up for sale at a time and in a manner most advantageous to buyers, rather than to the selling stockholders. On the other hand, the statute should not deter the solidly-financed acquiror and will provide strong incentives for all acquirors to pay a full and fair price to stockholders of Delaware corporations and to structure their acquisition in a manner designed to permit all stockholders to share equally in its benefits.

If, after reviewing the revised draft of proposed Section 203 and my comments in this letter, you have any questions with respect to the operation of the statute, I urge you to either call me or any one of your other representatives on the Council, who I am sure will be happy to take the time to discuss the matter with you.

Very truly yours,

Gil

A. Gilchrist Sparks, III

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December 31, 1987

MEMORANDUM

TO: Members of the Corporation Law Section

FROM: A. Gilchrist Sparks, III

RE: Proposed Section 203

Like many of you, I read today the editorial in the Wall Street Journal opposing the adoption of proposed Section 203. While I have hesitated in the past to engage in a debate over matters appearing in the press, the use of source material and statistics in this particular editorial is so unfair as to warrant an immediate response.

The Wall Street Journal reports that "the major pension funds, such as California Public Employees' Retirement System, College Retirement Equities Fund, and even the Delaware Board of Pension Trustees, are screaming bloody murder on shareholders' behalf against the bill." Enclosed with this memo is a copy of the letter received on December 18 by the Council from the State Board of Pension Trustees, which states that "the Board takes no position on the issue" of proposed Section 203. With respect to the other pension funds mentioned, the Council has received one letter from each opposing the earlier draft of proposed Section 203.

The rest of the materials cited by the Wall Street Journal consists primarily of various quotes from and characterizations of letters received by the Council from SEC Commissioner Joseph Grundfest. I have reviewed each of those letters this morning. The first quote in the Wall Street Journal article is from a December 18 letter from Commissioner Grundfest, in which he states that data in his letter suggests that for Fortune 500-type firms "the average firm already has a blocking percentage of about 15%." This statement was made by Commissioner Grundfest based upon statistics which include holdings by directors who are also officers of corporations and thus has no validity in the context of the present proposed Section 203 which excludes such holdings in calculating the 85% base. Commissioner Grundfest's later letter of December 22, which the Wall Street Journal does not quote, states that mean ownership by the board of directors for Fortune 500 firms is 10.6%, of which the top two officers (whose shares one would expect would be excluded under proposed Section 203) own 6.3%. In short, the analysis in the Wall Street Journal editorial, which never even mentions the exclusion from the 85% calculation of shares held by director/officers and nonpass-through ESOP's, and the statistics upon which it relies, are incomplete and erroneous.

In reviewing Commissioner Grundfest's letters, I was also struck by the extent to which the compromise approved by the Council met Commissioner Grundfest's original objections to proposed Section 203, as set forth in his December 10 letter to the Council. I have attached to this memorandum pages 8-9 of that letter, in which Commissioner Grundfest urged that the 90% threshold be lowered, that the approval percentage be expressed as a percentage of disinterested stockholders, and that a combination of the two approaches may be better than either one alone. Further, he suggests at footnote 19 that the Council should also consider excluding shares held in employee plans from the independent stockholder category. The compromise version of proposed Section 203 takes action with respect to every one of these suggestions.

Finally, in light of the use made by the Wall Street Journal of statistics in its article, I was struck by the following quote from Commissioner Grundfest's December 18 letter dealing with the subjective nature of the conclusions to be drawn from his use of statistics in this area:

> Fourth, I explain why it is difficult to infer from observed tender offer percentages what actual tender offer ratios would be in the event the Delaware statute becomes law. Such predictions are difficult because they rely on a series of counterfactual assumptions that must be applied to a heterogeneous sample that is small relative to its degree of variability. Nonetheless, I offer some observations about how such data might be interpreted.

I look forward to seeing all of you at the Section meeting on Monday.

STATE OF DELAWARE
STATE BOARD OF PENSION TRUSTEES
AND
OFFICE OF PENSIONS
THOMAS COLLINS BUILDING
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December 18, 1987

David B. Brown, Esquire
Secretary
Council of Corporation Law Section
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350 Delaware Trust Building
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Wilmington, DE 19899

SUBJECT: **LETTER ON TAKEOVER LEGISLATION**

Dear Mr. Brown:

Further to letter of December 9, 1987 signed by Mr. Bruce Kallos, the Board of Pension Trustees has discussed the issue of takeover legislation at considerable length and recognizes that there are valid issues on both sides of the question. Individual members of the Board hold different points of view on the desirability of legislation in this area. Accordingly, the Board takes no position on the issue.

Sincerely,

Ernst Dannemann
Chairman
Board of Pension Trustees

ED:cwj

cc: Governor Michael N. Castle
Secretary of State Michael E. Harkins
Senator Richard S. Cordrey
Senator Thomas B. Sharp
Senator Myrna L. Bair
Senator Nancy W. Cook
Representative Terry R. Spence
Representative Joseph R. Petrilli
Representative Orlando J. George, Jr.
Representative Philip J. Corrozi
Members of the Board of Pension Trustees

Economist of all hostile tender offers between 1982 and 1987 (144 offers) has also found not a single case in which a hostile bidder received over 90% of the outstanding shares.[18]

Apparently, the combination of opposition by the target's managers, who do not tender their own shares, the existence of some stockholders who accept management's recommendation not to tender, and the inevitable presence of some nonresponsive stockholders who would not tender into any offer, no matter how attractive, makes it extremely difficult to purchase more than 90% of the outstanding shares in a single step without management support. Nonresponsive stockholders are not opposed to the offer, they are simply nonresponsive. The presence of nonresponsive stockholders--who can account for more than five percent of a publicly traded corporation's shares--stacks the deck against any bidder who must accumulate a 90 percent block. It also means that a very small percentage of a corporation's stockholders (target managers, for example, or an ESOP) may have effective veto power over use of this exception.

The exception should be revised to prevent a small group of dissenters from thwarting the preferences of a substantial majority. This can be accomplished in at least two ways. First the threshold can be lowered from 90 percent to 75 percent or some other realistic figure. That would require meaningful opposition in addition to the usual background noise generated by nonresponsive stockholders. Second, the approval percentage can be expressed as a percentage of shares

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[18]Source: Memorandum from Kenneth Lehn, Chief Economist, Securities and Exchange Commission (December 8, 1987). In only one case did a nominally hostile acquisition result in more than 90% of the outstanding shares being tendered. That case was Pantry Pride's tender offer for Revlon, Inc., where no merger agreement was signed but management decided to tender its own shares and facilitate an orderly transfer of control after Pantry Pride won a lawsuit enjoining Revlon's lock-up option. See Wall St. J., Nov. 4, 1985, at 2 col. 2.

tendered by disinterested stockholders.[19] A combination of the two approaches may also be better than either alone.[20]

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[19]This would prevent a target's managers from vetoing an attractive bid simply by refusing to tender their own shares. This proposal is analogous to the provision in Section 203 for waiver of the three-year freeze if a majority of independent stockholders approve a second step transaction after the original bidder exceeds ten percent ownership.

The Council should also consider excluding shares held in employee plans from the independent stockholder category. Otherwise management may be able to create a virtually absolute bar to use of the exception by contributing shares to an employee plan with pass-through voting.

[20]By observing that improvements can be made that would limit the harmful effects of the proposed bill, I do not mean to suggest that I would endorse the bill if so modified.