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

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

9 CTS Corp. v. Dynamics Corp. of America, 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 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.

<u>Proposed Subsection (b)</u>

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 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.

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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 whenever 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.

<u>Control Share Acquisition Laws</u>

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.

Control Share Cash-Out Laws

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