The Federal Role in Corporate Takeovers: A Framework for a Limited Second Congressional Intervention to Protect the Free Market

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Few subjects in corporate law have generated so much controversy as the hostile takeovers of the last two decades. Not only the substance of the appropriate regulation, liberal or restrictive, but also its source, federal or state, have been debated at length. In the present Essay, a compromise innovative approach will be outlined to strengthen the role of the securities markets through federal law with minimal interference in state regulation of corporate internal affairs.

There is little question that, at the state level, the policy issue has been resolved against "hostile" takeovers. An avalanche of state antitakeover statutes of different types survived constitutional challenge in *CTS Corp. v. Dynamics Corp. of America*[1] and *Amanda Acquisition Corp. v. Universal Foods Corp.*,[2] and are being constantly reinforced by a lenient, pro-management judicial interpretation of the general provisions of state law, especially the "business judgment rule."[3] These developments have enabled management to erect formidable barriers against stock concentrations not approved by management (management and shareholder consent requirements, diminution of voting rights or imposition of high voting percentages, denial of resale profits, reduction or elimination of shareholder rights to call meetings or to act by consent, and, most of all, poison pills) and to pursue other antitakeover action (lock-ups, sales or purchases of assets, financing arrangements, golden parachutes, coercive competing tender offers) with virtual impunity. This transfer of the power to decide who shall own and control the public corporation from the shareholders and the securities markets to management represents a radical departure from the traditional corporate ethos, unprecedented in history. Yet, the statutes were enacted without any substantive debate. The combined clout of corporate management and labor, and the absence of organized challenge, made the struggle one-sided and opposition futile. The important, if not principal, issues of whether the price offered for the stock is substantially higher than market and many shareholders find it attractive and adequate and, secondarily, of whether competition in a free securities market is the best way to shift corporate control have been obscured by the smokescreens generated by antitakeover rhetoric. To be sure, the securities markets may not be perfect and there is room for regulation of the tender offer to maximize the disclosure of information and to allow time for

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1. 481 U.S. 69 (1987) (control share acquisition statute).

2. 877 F.2d 496 (9th Cir.), *cert. denied*, 110 S. Ct. 367 (1989) (anti-merger statute).

3. The ultimate blow against any serious judicial control over management oppositionism has been dealt by the Delaware Supreme Court in the recent case of Paramount Comm., Inc. v. Time Inc., 1989 WESTLAW 180702 (Del. Supr.). A defensive strategy which had been instituted without the approval and over the opposition of many shareholders, and which had a devastating effect on stock values, was upheld under the pretense of preserving "long-term profitability," maintaining corporate "independence," and safeguarding the corporate "culture," as perceived (or imagined) by management.

alternatives to develop. But the antitakeover forces swept under the rug the evil of management's inherent conflict-of-interests and motive for self-perpetuation and have exacerbated the parochial fears of local communities and employees to produce a fundamental distortion of what is happening and what is at stake. The corporate fortifications have become so strong now that only an extraordinarily determined, patient, and powerful suitor dare challenge management. Even then, the battle for control is bound to be expensive, slow, and unpredictable, frequently requiring a cumbersome and wasteful proxy fight to unseat the incumbents.

Congress is now faced with the dilemma of whether to interfere again in this field, and, if so, in what way. The Williams Act of 1968 sought to protect the interests of the shareholders in takeovers mostly by regulating the activities of tender offerors in the direction of fuller disclosure, longer time periods, and some equal treatment and fairness obligations. While the Act appeared to be motivated by a policy of neutrality between the tender offeror and management, its operative language contained virtually no limitations on management power to obstruct the takeover in any way permissible under state law. This is precisely what management did in the late 1980s, in the context of a significant increase in takeover activity spurred by the greater and more orchestrated availability of private capital through borrowing and foreign investment, and by laxity in antitrust enforcement. While such increase did not affect the overwhelming favorable ratio of friendly to hostile takeovers (about fifteen-to-one), the management-labor coalition has recently been able to generate pressures on Congress to impose additional obligations, mostly on the tender offerors, leaving the abusive management countermeasures to benign neglect. The various bills currently being reintroduced in Congress reflect this imbalance in the regulatory targets and methods.

It is submitted that, in the reconsideration of its takeover policy, Congress should take a more thorough and longer-range view of the interests and stakes involved in this controversy, steering away from the expediency of patchwork responses under the political pressures of the moment. If the thrust of such policy is to remain the same, that is to promote informed choices by individual shareholders through a free securities market, Congress should also address the serious threats now posed by management obstructionism. Indeed, now that the market has penalized the excesses of leveraged takeovers and cooled the fervor of suitors, it is quite appropriate to shift the focus to those abuses, not amenable to comparable market discipline, which restrict the rights and freedoms of shareholders in dealing in their stock without any plausible benefit either to the shareholders themselves or to the corporation other than the entrenchment of management paternalism. The Securities and Exchange Commission (SEC) has been increasing its efforts to limit management abuses, for example, by requiring documentation of claims that the tender offer price is inadequate and by changing its interpretation of the proxy rules in favor of shareholder proposals on golden parachutes. A more serious step has been the adoption of the one-share-one-vote concept in rule 19c-4. However, the authority of the SEC to so protect shareholder substantive rights has been challenged in the courts by the Business Roundtable and, whatever the outcome, it is unlikely that it will pur-

sue this course with any degree of vigor. Thus, congressional encouragement and support is needed both to strengthen legitimacy and to chart out the main avenues of action.

One way of redressing the balance of power between tender offerors and the management of targets would be to repeal the Williams Act altogether, leaving the field entirely to private forces. This would have been a viable alternative before the state antitakeover juggernaut virtually eliminated the free play of the market and placed hostile takeovers at an irreducible disadvantage. Another method would be for Congress finally to take notice of the reality that most national corporations are, in all material respects, interstate in ownership, management, and operations and have no real connection with the chosen state of incorporation, that state chartering is not only anachronistic and artificial but also harmful because it encourages a race to the bottom in search for state revenues rather for than for best rules, and that a federal code for national corporations, in full or on a minimum-standards basis, should be adopted, balancing and optimizing the rights and interests of all the corporate constituencies. There is no question that the Commerce Clause of the Constitution provides ample support for the exercise of such congressional power. As to content, both the Revised Model Business Corporation Act and the American Law Institute's recently adopted "Principles of Corporate Governance: Analysis and Recommendations" provide helpful models. It is worth noting that the European Economic Community, although less integrated and homogenous than the United States, recognizes the need for unification of corporate law and is pursuing a program both of harmonizing state corporate law through common guidelines and of creating a community-wide single corporate form (*societas europea*) for multistate enterprises. It is politically unrealistic, however, to expect that Congress will follow either one of these diametrically opposed alternatives. There is apparent satisfaction with the Williams Act, so far as it goes, and the state regulation of corporate affairs, with the choice among organizational forms that it offers, has produced no disasters.

Assuming that Congress will stay with the current limited jurisdictional reach of "federal" corporate law, defined by reference to the interstate trading of securities, two imperatives must be respected. First, the philosophy of takeover neutrality and of committing transfers of corporate stock and control to free, informed markets should be reaffirmed and implemented effectively. Second, the federal measures should not intrude into the general domain of internal corporate affairs entrusted to the states.

The innovative approach proposed in this Essay, which centers on the concept of "interstate stock," pursues these two objectives efficiently and with minimal conflict and overlap with the coordinate state authority.

First, it is proposed that the federal law should not preempt state corporate law at all. The means of pursuing a federal regime of transferability within a framework of maximum information and adequate time should not be the preemption of non-conforming state law but the exclusion of non-qualifying securities from the interstate markets.

Second, it is further proposed that federal law should not intrude into corporate structure and management as such. Interfering with management au-

thority to make business decisions, including those that are intended to oppose a takeover such as defensive sales or purchases of assets, golden parachutes, financing arrangements, counter-tender offers, and the like, would not only be duplicative of state regulation in an area where state law has the potential of becoming effective in controlling egregious abuses but would likely prove complicated, expensive, and messy. The transferability issue can and should be addressed solely through the objective features of the stock itself and the related corporate constitutive documents which create and define it.

Third, the federal transferability standards can be easily enforced through the registration process currently in effect in section 12 of the 1934 Act. Only interstate corporations of some dimension in assets (five million dollars) and of diversified stock ownership (five hundred shareholders of a class of equity securities) would come within the purview of the regulation. The objective features of the securities and of the issuing corporations will determine original registrability and continuing eligibility. Such a system would be simple and practical and would operate prophylactically, thus avoiding initial confusion, reducing subsequent litigation, and eliminating potential unexpected liabilities of management. Furthermore, the objectified approach may and should be drafted so as to protect transferability not only against management-imposed but also from fellow-shareholder-approved restraints.

Fourth, the proposed federal system, whose aim would be to protect the freedom of each shareholder to transfer his stock as he chooses, would disqualify "interstate stock" from being traded in the interstate markets if it is subject to any of the following restrictions:

a) direct restraints on stock transferability, for example, shareholder or management approval requirements, as well as indirect burdens on stock acquisitions or concentrations such as diminution of voting rights or other unfavorable differential treatment;

b) discriminatory treatment at the corporate or shareholder levels of transfers or concentrations of stock, through such antitakeover devices as poison pills and antimerger provisions as well as such other common defensive tactics as lock-ups for assets or stock, golden parachutes, options, and debt accelerations but only if triggered by changes in stock ownership; and

c) any structure which interferes with the transferability of corporate control through the market by denying to the registered securities the total and equal voting power of the corporation.

This free transferability regime may and should be reinforced by two additional special rules:

a) an obligation that purchases or sales of shares by the corporation in the context of a tender offer be made only through pro rata offers to all shareholders, thus reducing the opportunity for discrimination through greenmail and through placing diluted stock in friendly hands; and

b) a minimum open period for management-approved mergers and similar fundamental-change transactions equal in length to the one applicable to tender offers, so that friendly and hostile acquisitions are put on the same timetable in terms of allowing for due deliberation as well for other choices to develop for the benefit of shareholders and any other corporate constituencies.

The proposed approach focuses on management abuses but is not intended to preclude also strengthening further the existing provisions that are aimed at

the tender offerors, for example, by extending the minimum open period for tender offers from twenty to thirty-five or sixty days, inviting competition and giving shareholders more time to decide, or by reducing the ten-day reporting window for substantial acquisitions of stock. Neither does it deny the authority of management, despite its conflicting interests and manipulative powers, not only to pursue competitive friendly mergers but even to enter directly the securities markets as a trader, alone or with its allies, and compete with the tender offer on equal footing.

Fifth, protecting the transferability of securities in the interstate markets is not tantamount to abandoning other constituencies affected by corporate takeovers, such as labor or local communities, to their fate. The legitimate interests of such groups could be protected through more narrow and efficient means which do not impede the transfer of productive resources to more qualified users and which operate neutrally, that is not only in hostile but also in friendly acquisitions, which constitute the vast majority of corporate combinations. A good example of such legislation is the recent federal "plant-closing-notice" statute. By contrast, generic antitakeover tactics, such as the elimination of cumulative voting, may end up harming labor interests.[4]

In conclusion, Congress should modernize and extend the federal takeover law. The damage inflicted by one-sided state regulation goes beyond mere corporate dysfunction through management entrenchment, reduction of shareholder power, and inefficiency. Not only is the freedom of the interstate securities markets also seriously compromised but the very allocation of the productive resources themselves throughout the nation is distorted by parochialist state barriers. In practical terms, Congress has many options and choices. As outlined in this Essay, a wise approach would: a) limit federal intervention to protecting the transferability of interstate securities through objective means and without interfering in corporate governance and management; b) treat friendly and hostile acquisitions alike; and c) safeguard the interests of corporate constituencies other than the shareholders through more specific and better aimed measures.

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4. For example, absent cumulative voting, labor recently failed to elect a union representative on the Board of Pacific Enterprises. *Elimination of Cumulative Voting Forecloses Union Official's Effort to Gain Seat on the Board*, Corp. Couns. Wkly. (BNA) No. 10, at 6 (Mar. 7, 1990).