CORPORATE TAKEOVERS

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This report provides legislators with necessary background to understand the Minnesota Corporate Takeover law. In addition to an overview and status report on corporate takeovers regulation, policy and constitutional issues are also discussed.

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INTRODUCTION

The acquisition of one corporation by another or the merger of two separate corporations into a new business entity has long been an accepted practice when voluntarily arranged by the management and directors of both affected corporations. In recent years there has been a real or perceived increase in the number of situations where a corporation or individual, known as the bidder, obtains control of a corporation, known as the target, without the agreement of the target's management and directors. This phenomenon, commonly referred to as a hostile corporate takeover, has aroused substantial public debate about its economic and social impact.

In 1968 Congress passed the Williams Act, which contains disclosure requirements and procedural rules for hostile tender offers, a kind of corporate takeover where the bidder attempts to buy a controlling proportion of a corporation's shares without management approval. Because the regulation of tender offers did not seem to be entirely pre-empted by this federal statute, various states in subsequent years also adopted statutes on tender offers. In 1973 Minnesota became one of these states when it enacted Minnesota Statutes, Chapter 80B. The 1973 act was substantially amended in 1984. In 1987 state concern about hostile corporate takeovers increased when an attempt was made to take over the Dayton Hudson Corporation. At a 1987 special session, Minnesota substantially toughened its corporate takeover statute in light of a U.S. Supreme Court decision which upheld an Indiana statute on the subject.

This report provides legislators with necessary background to understand the Minnesota corporate takeover law. It covers the following:

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Key Points

OVERVIEW AND STATUS REPORT

Parts 2, 3 and 4 of this report summarize major parts of the 1987 Minnesota Corporate Takeover Act, list other states with similar statutes, and provide the current status of congressional proposals on the subject of corporate takeovers regulation.

POLICY ISSUES

To help legislators understand state and federal corporate takeover activity, Part 1 of the report describes the policy concerns raised by both proponents and opponents of corporate takeovers. Specifically:

- Restrictions on takeovers may deprive society of efficiencies that may result from allowing the free market to operate.
- It is strongly debated whether takeovers create new wealth or merely transfer existing wealth from one set of investors to another.
- It is also debated whether takeovers deprive certain financial sectors of credit or merely briefly remove credit from the economy before again making it generally available.
- Takeovers may result in lost jobs for employees of the target and disrupted relations between the target and its suppliers.
- Takeover attempts may leave the target seriously in debt. This can occur either if the bidder borrows to accomplish the deal or if the target borrows funds to avoid being taken over.
- It is debated whether stock prices rise over the long-term as a result of takeover activity. There is a clear short-term tendency for prices to increase.

CONSTITUTIONAL ISSUES

Part 5 of the report summarizes and discusses a United States Supreme Court decision upholding part of an Indiana statute on which the 1987 Minnesota act was based. <u>CTS Corp. v. Dynamics Corp. of America</u>, 107 S.Ct. 1637 (1987). In the early 1980s an Illinois statute regulating corporate takeovers was invalidated by the Supreme Court. The <u>CTS</u> decision encouraged state legislatures by legitimizing a state role in corporate takeover regulation, as well as providing a model for one specific valid type of regulation. Because <u>CTS</u> does not answer all the constitutional questions that might be raised about the 1987 Minnesota act, Part 5 also points out what issues still might be open to litigation.

1. Policy Issues in Regulating Hostile Takeovers

Economists, investment bankers, corporate executives, and others who have studied or been involved in hostile corporate takeovers have raised a number of policy concerns about the activity. Attention has focused on both the advantages and disadvantages of hostile takeovers as a type of business transaction and the somewhat separate issue of the advisability of government regulation of takeovers.

FREE MARKET THEORY

Proponents of a pure free market approach tend either to approve of hostile corporate takeovers or at least to disapprove of government restrictions on such activity. Free market theory holds that economic entities should be allowed to act in accord with their natural tendency to maximize profits. Supporters of the free market theory argue that so-called corporate raiders or takeover specialists usually go after weak, poorly managed companies. When this occurs, the benefit of changing ownership of a company is that the assets often move into stronger hands. Corporate takeovers, therefore, may have a positive effect on restructuring some companies and raising money to create new companies.

Critics of hostile takeovers argue that the transactions may have a negative effect on the free market by giving the false impression that new wealth is being created and by hampering investment in corporate assets. Critics claim that takeovers promote the making of a quick profit for the financiers, bidders and shareholders of the target. The result is not the creation of new wealth, goods, services, or technologies but, rather, merely the nonproductive exchange of existing wealth. Moreover, critics point out that even the possibility of a hostile takeover may threaten the trust on which economic efficiency depends. For example, suppliers may hesitate to invest in new equipment for fear that a company will use different suppliers, adopt unfair business practices or go out of business entirely. For these reasons, critics of hostile takeovers argue for a departure from free market theory, in favor of regulating and limiting takeover activity.

RECYCLING OF CREDIT

Those who question the value of hostile corporate takeovers express concern about the societal effect of borrowing money to fund takeovers. Critics believe that strong demand for funds and credit in connection with takeovers raises interest rates and makes credit less available to other economic sectors, such as small businesses and farmers.

In contrast to the above position, some economists believe that funds expended on corporate takeovers represent, not the consumption of wealth, but rather the transfer of it from the bidding corporation's shareholders to those of the target organization. This analysis holds that most of the proceeds from mergers are taken out of the credit market for only a brief time. The money is then recycled into the market by deposits in bank accounts or investments in other ventures, including building new plants and purchasing improved equipment.

EFFECT ON EMPLOYEES, SUPPLIERS, AND COMMUNITY

Those who question the social utility of hostile takeovers often focus on how the transactions affect the community as a whole. Frequently after a purchase, the target is restructured and many of its parts are sold to repay the debt incurred to accomplish the takeover. Restructuring is usually a traumatic and destructive event in the lives of the employees, suppliers, customers and residents of surrounding communities. It often involves layoffs or reduced compensation for managers, staff and production workers, which directly harms those individuals and indirectly affects retailers and others who relied on spending by those individuals.

In response to concerns about effects on employees, critics of legislation to regulate takeovers note that most layoffs occur for reasons other than the takeover itself. For example, employees may be laid off because they are doing uncompetitive work. Continuation of their jobs in an unproductive situation would be unfair to the shareholders who bear the cost. In addition, restructuring after a corporate takeover may save jobs by bringing new capital and increased efficiency to the target firm and keeping firms alive that might otherwise fail. Even if some jobs are lost, new jobs created in other locations, as a result of the takeover, offset the losses.[1]

EFFECT ON THE TARGET COMPANY

One concern about hostile takeovers is that whether or not successful, the attempts may leave the target seriously in debt. The debt may reduce immediate profitability and eliminate jobs, as well as harm the company's long-term prospects. Debt may result from a successful takeover financed by borrowing against the target's assets. Debt may also be incurred if a target defeats a takeover attempt by using borrowed funds to take the company private or by paying the bidder greenmail, which is discussed below.

EFFECTS ON THE SHAREHOLDERS

It is debated whether hostile takeovers benefit shareholders, especially over the long term. Some commentators raise a separate question about how shareholder interests are affected by certain common takeover defenses.

Stock Price

Several economists who see societal advantages in hostile takeovers argue that these undertakings benefit shareholders by increasing the value of the target's stock. According to various studies, the stock price of the target increases for approximately one month surrounding the initial announcement of a takeover.[2] For example, in the Texaco takeover of Getty, Getty shareholders realized stock price gains of $4.7 billion, or 78.6% of the total equity value.[3]

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[1]*Proposals Affecting Corporate Takeovers, Legislative Analyses*, American Enterprise Institute (1985), p. 31.

[2]See Jensen, *Harvard Business Review*, "Takeovers: Folklore and Science," Nov. 1984, p. 111.

[3]Id., p. 113.

In response to takeover proponents, other economists claim that even though stock prices rise while a takeover is occurring, the price then declines within the next two years. This makes it difficult to argue that economic value has been created by the corporate takeover. Of course, it is true that a temporary price gain does benefit those who were shareholders at the time and realized their gain by selling their stock.

Defenses

Greenmail. Critics of hostile takeovers state that the common use of greenmail by a target corporation to prevent a takeover, negatively affects the value of a target's shares. Greenmail is an amount well above the market price which a corporation pays to buy back its stock from a bidder in order to end the takeover attempt. The use of greenmail often results in a substantial price decline for most shareholders other than the bidder. According to some economists, of nine firms known to have paid greenmail in 1985 and 1986, all experienced declines in their stock prices in the period from five days before the greenmail announcement to one month after the announcement, even though the New York Stock Exchange Index usually increased during the same period.[4] Critics argue that each greenmail payment encourages other similar attempts and is not in the best interest of the shareholders, who suffer both directly by the price decline and indirectly by the waste of corporate assets. In contrast to this, supporters of greenmail argue that greenmail may be the only method a target can use to avoid a hostile takeover.

Golden Parachutes. Those who question the value of hostile takeovers argue that senior level managers may encourage takeovers in order to advance their own positions at the expense of the shareholders. This may be accomplished through the use of golden parachutes, which are large severance contracts granted to corporate executives in the event of a takeover. The purpose of providing top management a golden parachute is to discourage hostile bidders, who must assume the contract following a takeover. In practice, when a bid is made, golden parachutes may put managers in an awkward position and encourage directors who are also employees with a "golden parachute" to violate their fiduciary duty. Specifically, if the severance pay provided by a golden parachute is generous, those directors may be eager to sell at a low price to the first bidder, to the detriment of the shareholders.

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[4]Browne and Rosengren, *New England Economic Review*, "Should States Restrict Takeovers?" July 1987, p. 18.

2. Overview and Derivation of the 1987 Act

Takeovers may be accomplished in several ways. One method is to merge with the target. Another popular approach is to buy a controlling interest in the target's stock on the open market and replace the original board with one of the buyer's choosing. Still another tactic is to make an offer to buy shares which is typically more generous to the first shareholders who sell. This kind of transaction is known as a front-end loaded, two-step takeover. It is considered coercive of shareholders, who are forced to sell quickly or receive much less for their shares later.

The 1987 Minnesota corporate takeover law regulates all of these transactions. It does so primarily by:

- requiring the approval of a majority of disinterested shareholders--those other than the bidder, target officers, or target employees who are also target directors--before a bidder can get voting rights for a controlling share of stock in the target. (control share acquisition provision page 7);
- requiring approval of disinterested target board members--those who are not also target employees--before the bidder can enter into a merger or various other business combinations with the target (business combination provision, page 9); and
- allowing directors to consider a broad spectrum of interests in discharging their duties (director responsibility provision, page 9).

Following is a description of significant provisions of the 1987 act, with a note on the origin of each. Several provisions were modeled on the Indiana statute upheld by the U. S. Supreme Court in 1987. (See Part 5.) Although the 1987 legislation is broad, it should be noted that it does not address every possible way of accomplishing a corporate takeover.

CORPORATIONS COVERED

Except for amendments to two definitions in Minnesota Statutes, Chapter 80B on corporate takeovers (See Appendix A, sections 1 and 2), the 1987 provisions on corporate takeovers apply to a target incorporated under Chapter 302A of Minnesota Statutes and having at least 50 shareholders. In addition, the target must:

(1) have its principal place of business or executive office located in the state, or have assets in the state with a value of at least $1,000,000; and

(2) have more than ten percent of its shareholders residing in the state, have more than ten percent of its shares owned by state residents, or have more than 1,000 shareholders residing in the state.

Derivation

Both the control share acquisition and business combinations provisions of the Minnesota act use the same definition of corporation as the Indiana Control Share Acquisition Act. Indiana Code §23-1-42-4.

However, the Indiana Business Combinations Act covers more corporations than the parallel Minnesota law; Indiana includes all Indiana corporations with at least 100 shareholders. Indiana Code §23-1-43-13.

CONTROL SHARE ACQUISITIONS

This portion of the 1987 act makes various changes in the way a bidder obtains voting rights and thereby obtains control of a target. It affects takeovers by tender offer, which is the purchase of shares.

Information Statement

A corporation covered by the Minnesota control share acquisition section designates in advance the threshold of stock ownership by a bidder at which the potential target wishes to invoke the protection of the section. The statutory options from which the corporation may choose its "designated threshold" are ownership of the following percentages of company stock:

- 20% to less than 33-1/3%,
- 33-1/3% to 50%, or
- over 50%.

Under prior law an information statement was required from a party intending to acquire target stock in an amount that would bring the bidder's ownership level to the target's designated threshold. The 1987 act expands the bidder's choices regarding the time for filing the information statement to either:

(1) the time of acquiring shares that exceed the designated threshold, or

(2) a time subsequent to such acquisition when the bidder wants to obtain voting rights.

The 1987 amendments also expanded the required contents of the information statement. One new provision requires the statement to disclose any intention by the bidder to "change materially [the target's] charitable or community contributions or its policies, programs, or practices relating thereto."

A second significant new provision is that voting rights for the bidder will not be considered unless it has submitted "a definitive financing agreement . . . with one or more responsible financial institution or other entity having the necessary financial capacity, for any financing of the control share acquisition not to be provided by funds of the acquiring person." Minn. Stat. 1987 Supp. §302A.671, subds. 2, 3, and 4.

Derivation

Expanding the choices regarding the time for filing the information statement is based on Indiana law. Indiana Code §§23-1-42-6, 7.

The changes in the required contents of the information statement appear to have originated in Minnesota.

Deadline for Special Shareholder Meeting

After a bidder files an information statement and offers to make a control share acquisition or seeks voting rights for shares it already owns above the designated threshold amount, the target must call a special shareholders meeting to determine whether shareholders agree to give voting rights to the bidder's shares above the designated threshold. The 1987 amendments extended the deadline for holding this meeting from 20 to 55 days after receipt of the information statement. Minn. Stat. 1987 Supp. §302A.671, subd. 3.

Derivation

The 55-day deadline was chosen because it is within the 60-day deadline provided by the federal Williams Act for completing a tender offer. The U.S. Supreme Court in <u>CTS Corp. v. Dynamics Corp. of America</u>, ruled that state statutes must be consistent with the Williams Act deadline. For discussion of <u>CTS,</u> see Part 5.

Approval Margin for Voting Rights

The bidder's shares in excess of the target's designated threshold will receive voting rights only if the bidder obtains the specified margin of shareholder approval. Under the 1987 amendments the bidder must win two separate votes:

(1) a majority of all shares entitled to vote (shares of the bidder below the designated threshold are entitled to participate in this vote); and

(2) a majority of the shares entitled to vote, excluding all shares held by the bidder, target company officers, and target company employees who are also directors. Minn. Stat. 1987 Supp. §302A.671, subd. 4a.

Derivation

Indiana Code §23-1-42-9.

BUSINESS COMBINATIONS

This portion of the 1987 act restricts certain transactions between the bidder and target for five years after a hostile takeover. Its effect may be to (1) discourage takeovers without target consent, or (2) prevent sale of target assets to pay debt incurred to finance a hostile takeover. The provision does not prevent accomplishing a takeover through borrowings, as long as the loan is not repaid by selling the target's assets for five years after the takeover. Similarly, it does not prevent the sale of target assets within five years after a takeover, as long as the proceeds are not used to pay for the takeover.

A bidder may not engage with a target in a merger, stock exchange, sale, or the liquidation, dissolution or similar reorganization of the target for five years after the bidder becomes an interested shareholder, unless the target and bidder comply with this section.

An "interested shareholder" (1) owns ten percent or more of the target's voting power, or (2) is an affiliate of the target which, sometime during the five-year period before the date in question, owned ten percent or more of the target's voting power. To satisfy the business combination provision, before a bidder becomes an interested shareholder, a committee of the target's board must approve either the bidder's acquisition of shares or the proposed business combination. If this advance approval is not given, the interested shareholder is barred for five years from merging with, selling, or otherwise reorganizing the target.

Derivation

Indiana Code, Title 23, Chapter 43.

Shareholder Call of Special Meeting

Under prior law, shareholders holding ten percent of the voting power of all shares entitled to vote could call a special shareholder meeting for any purpose. The 1987 act requires a vote of 25 percent or more of the voting power of all shares entitled to vote in order to call a special shareholder meeting for the purpose of (1) facilitating a business combination or (2) changing the board of directors in order to approve a business combination. Minn. Stat. 1987 Supp. §302A.433, subd. 1.

Derivation

This proposal originated in Minnesota.

Director Responsibility

Corporate directors may consider the interests of employees, customers, suppliers, creditors, the community, and the long-term and short-term interests of the corporation in discharging their duties. Minn. Stat. 1987 Supp. §302A.433, subd. 1.

Though its application is not limited to hostile takeovers, this provision is relevant to both tender offers and the transactions included in the definition of business combinations. The effect of this section is to authorize target directors to consider factors beyond the immediate impact on stock price, when evaluating a tender offer or business combination.

Derivation

Ohio Rev. Code Ann. 1986 Supp. §1701.59(E).

RESTRICTIONS ON TAKEOVER DEFENSES

The 1987 act prohibits two takeover defenses, golden parachutes and greenmail, described in Part 1.

Golden Parachutes

A corporation may not, during a tender offer, enter or amend agreements that increase officer or director compensation, except for routine increases. Minn. Stat. 1987 Supp. §302A.255, subd. 3.

Derivation

S. 1323, 100th Congr., Second Session, §14 (1987). However, the version of S. 1323 passed by the Banking Committee of the United States Senate on September 30, 1987 no longer contains this provision.

Greenmail

A corporation may not purchase, at a price greater than the average market value, the shares of a shareholder who owns more than five percent of the corporation's stock, if the shareholder purchased the stock within the six months preceding the proposed purchase, unless the purchase is approved by a majority of eligible voting shares or the same offer is made to all shareholders. Minn. Stat. 1987 Supp. §302A.553, subd. 3.

Derivation

S. 1323, 100th Congr., Second Session, §14 (1987). However, the version of the bill passed by the Banking Committee of the U. S. Senate on September 30, 1987, no longer contains this provision.

3. Corporate Takeover Statutes in Other States

Besides Indiana, the following states have enacted provisions similar, in at least broad outline, to the 1987 Minnesota act.

CONTROL SHARE ACQUISITIONS

Arizona
Florida
Louisiana
Massachusetts
Missouri
Nevada
North Carolina
Ohio
Wisconsin

The statutes in Arizona, Florida, Louisiana, Massachusetts, North Carolina, and Wisconsin also apply to at least some corporations incorporated under the laws of another state.

BUSINESS COMBINATIONS

Arizona
Kentucky
Missouri
New Jersey
New York
Washington

Of the above statutes, Arizona and Washington apply to some corporations organized under the laws of another state.

4. Federal Action on Takeover Regulation

Part 1 of this report summarized policy issues raised by commentators regarding whether there should be any government regulatory role in corporate takeovers. If government regulation is to be adopted, the next question is whether it may occur at the state level or whether Congress should provide controlling federal legislation.

Although about half the states have some form of takeover regulation, the more active approach taken in laws passed after the Supreme Court decision in CTS has aroused concern in the financial industry that the number of interstate corporate mergers may be reduced or the process may be complicated by the adoption of potentially conflicting state regulations. The financial industry in turn generated opposition to a United States Senate proposal that would have permitted states to regulate takeovers. In September, 1987, the Chairman of the federal Securities and Exchange Commission asked Congress to give his agency rule-making authority to supersede the Indiana statute upheld in CTS, as well as any other state statute that interferes with trading or voting of shares in companies listed on national stock exchanges. Later the same month, the United States Senate Banking Committee refused to approve the draft provision that would have let states restrict takeovers without the threat of being pre-empted by federal law. At the time this report was published, Congress was still in session and had not acted on the issue.

As a matter of public policy, the best answer to the question whether Congress or the states should regulate takeovers may depend on the specific type of takeover strategy at issue. Traditionally, state corporation laws have governed activities within a firm, specifically the relationship between directors and shareholders. Since the 1930s, when the federal government became involved in corporate regulation, federal law has focused on disclosures to shareholders and supervision of interstate transactions. Federal law has not affected the substance of the relationship between shareholders and directors.

Currently, tender offers like those regulated by the 1987 Minnesota act are one popular way of attempting a hostile corporate takeover. Tender offers involve both interstate market transactions and dramatic changes in the relationship between target directors and shareholders. Federal regulation of interstate tender offers is consistent with the federal role under the Commerce Clause of the Constitution. However, one commentator believes that state regulation of tender offers is also appropriate public policy, at least when tender offers are used as an alternative to various voting mechanisms (such as derivative suits and proxy fights) by which shareholders traditionally have monitored their directors pursuant to state law.[5]

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[5] Thompson, "What Federal Role is Appropriate in the Regulation of Tender Offers?" *National Law Journal*, Sept. 28, 1987, p. 24.

5. Constitutional Issues in State Regulation of Corporate Takeovers

This part of the report summarizes the United States Supreme Court opinion in CTS Corporation v. Dynamics Corporation of America, discusses the significance of CTS for the 1987 Minnesota Act, and describes litigation on the constitutionality of the Minnesota act.

SUPREME COURT DECISION

In April, 1987, the United States Supreme Court departed from earlier caselaw on the validity of state regulation of corporate takeovers when it decided CTS Corp. v. Dynamics Corp. of America.[6]

Facts

CTS was a challenge to the Indiana Control Share Acquisitions Act (CSAA), adopted in 1986. Generally, the Indiana CSAA required certain disclosures from a bidder to a target; required the approval of a majority of shareholders not connected with the bidder in order for a bidder to exercise control of the target; and specified the deadline for a special shareholders' meeting to decide whether to give the bidder's shares voting rights and thus the power to control the target.

Days after the Indiana law took effect, Dynamics Corporation of America announced a tender offer for shares of CTS Corporation, an Indiana corporation. If successful, the tender would have increased Dynamics' ownership interest in CTS from 9.6 percent to 27.5 percent. The board of CTS immediately voted to be governed by the new CSAA, which provided that it applied only to Indiana corporations that chose to be governed by it. Dynamics then amended its complaint in a pending federal lawsuit against CTS to argue that the Indiana Act was pre-empted by the federal Williams Act and was a violation of the Commerce Clause of the federal Constitution. The District Court ruled in favor of Dynamics on these issues. The Court of Appeals for the Seventh Circuit affirmed the District Court, relying on the Supreme Court's decision in Edgar v. MITE Corp. for its conclusion on the pre-emption issue.[7] The Supreme Court reversed.

Issues and Conclusions

Does the federal Williams Act pre-empt the Indiana Act?

No.

Does the Indiana Act violate the federal Commerce Clause?

No.

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[6]107 S.Ct. 1637 (1987).

[7]457 U.S. 624 (1982).

Discussion

Pre-emption Issue. The Supremacy Clause of the Constitution makes federal law superior to state law.[8] A state statute will be held pre-empted by federal law if Congress expressly indicates such an intent, if compliance with both state and federal law is a physical impossibility, or if the state statute frustrates the purposes of the federal law.[9]

In 1968 Congress passed the Williams Act, which provides disclosure requirements and procedural rules for hostile tender offers (attempts to buy stock from shareholders without management approval). In Edgar v. MITE Corp., a plurality of the Supreme Court found that an Illinois statute regulating corporate takeovers conflicted with the Williams Act and was pre-empted by it.[10] In contrast, the majority in CTS determined that the Indiana CSAA did not suffer from what it called "three offending features" which had caused the Court in MITE to find the Illinois statute pre-empted by federal law. The three problem features of Illinois law not present in the Indiana statute were (1) a 20-day period during which management could contact shareholders but offerors could not communicate their offers; (2) lack of a deadline for a hearing on the tender offer, allowing management indefinite delay; and (3) provision for the Secretary of State to review the fairness of a tender offer, which reduced investor autonomy.

In CTS, the Supreme Court concluded that the Illinois statute at issue in MITE had favored "management against offerors, to the detriment of shareholders," while the Indiana statute protected the shareholder against both management and offerors.[11] The Court found the Indiana CSAA approach to be consistent with the Williams Act.

The only specific provision of the Indiana CSAA analyzed by the Court in its discussion of the pre-emption issue in CTS was the statutory time period delaying consummation of a tender offer for up to 50 days after commencement. The Court concluded that the Indiana time period was not unreasonable, given that an offeror would receive full voting rights, if successful, within the 60 day maximum set by the Williams Act for completing a tender offer.

Commerce Clause Issue. The Constitution expressly authorizes Congress to "regulate Commerce. . . among the several states."[12] The United States Supreme Court has established that the Commerce Clause is not only an affirmative grant of authority to Congress, but also restrains the states from taking various actions that interfere with interstate commerce, even absent Congressional action.

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[8]U.S. Const. Art. VI, cl. 2.

[9]CTS Corp v. Dynamics Corp. of America, 107 S.Ct. 1637, 1644 (1987).

[10]457 U.S. 624 (1982).

[11]107 S.Ct. at 1645.

[12]U.S. Const. art I, §8.

In analyzing state action for compliance with the Commerce Clause, the Supreme Court previously relied on a test that distinguished "direct" from "indirect" regulation of interstate commerce. Under that test, state statutes which directly regulated interstate commerce were invalidated, while statutes that only indirectly regulated interstate commerce were upheld. More recently, the Court has shifted to using a test of state regulation that balances the burden of any discrimination against interstate commerce with the weight of the state interest in enforcing the regulation.[13] In CTS the Court appears to have relied on the newer balancing test rather than the direct-indirect test.

Reviewing the Indiana CSAA, the Supreme Court noted in CTS that the statute does not discriminate against interstate commerce because it is drafted to apply the same way to all tender offerors, whether they are residents or non-residents of Indiana. The Court rejected the argument that as a practical matter, the statute would discriminate against interstate commerce in that most offerors would be from out-of-state.

The Court then considered whether the statute should be invalidated for subjecting an activity to inconsistent regulation. Since Indiana only regulates voting rights for Indiana corporations, the Court found no danger that one corporation would be subject to the potentially conflicting laws of several states. In effect, the Court seemed to find that the statute did not unreasonably burden interstate commerce.

Next the Court rejected the argument that the CSAA was unconstitutional because it might hinder tender offers. The Court noted that corporations owe their existence to state law and that states have an interest in promoting stable relationships among parties to the corporation. In particular, the Court found the possibility of shareholder coercion in some tender offers to be a justification for what it called "Indiana's decision to promote the autonomy of independent shareholders."[14] This justification was found applicable even to efforts to protect nonresident shareholders, given that the statute applies only to corporations with a substantial number of shareholders (10% or 10,000) residing in Indiana. Thus, the opinion implicitly finds that the state interest in the kind of regulation under review outweighed whatever burden the regulation placed on interstate commerce.

SIGNIFICANCE OF CTS FOR THE MINNESOTA TAKEOVER STATUTE

The Supreme Court decision in CTS Corp. v. Dynamics Corp. of America was the immediate impetus for the approach taken by the 1987 Minnesota corporate takeover act and for legislation in several other states. In upholding the validity of the Indiana CSAA, the Court signaled at least one constitutional method states could use in regulating certain hostile tender offers. However, at least a few questions about constitutional issues in state regulation of corporate takeovers were not answered by CTS.

Pre-emption Issues

Two features of the Minnesota statute may be vulnerable to a challenge that they are pre-empted by the federal Williams Act. The control share acquisitions provision requires a bidder to file a "definitive financing statement" which is more detailed than the Williams Act provides. A court might find that this stricter state regulation is more burdensome to bidders than the Williams Act and thus is pre-

[13]Sargent, *Do the Second Generation State Takeover Statutes Violate the Commerce Clause?* 8 CORP. L. REV. 3, 13 (1985).

[14]107 S.Ct at 1651.

empted because it frustrates the purposes of the federal Act. The Minnesota financing statement provision is not modeled on the Indiana statute upheld in CTS, so it is an open question whether the Minnesota provision would survive a pre-emption challenge.

The second Minnesota provision that may be vulnerable to attack on pre-emption grounds is the requirement that specified business combinations be approved by a committee of the target board before the bidder achieves ten percent ownership of the target.[15] Without this advance approval, transactions listed in the statute cannot be undertaken for five years after the bidding company attains ten percent ownership. It has been argued that the advance approval provision frustrates the purposes of the Williams Act by (1) denying shareholders any role in the specified corporate activities and (2) tipping the balance toward target management rather than maintaining neutrality between target and bidder.[16] The Supreme Court indicated in CTS that the latter effect would invalidate a state statute on pre-emption grounds. Although the Minnesota business combination law is very similar to the Indiana Business Combination Act, that portion of the Indiana law was not reviewed by the Supreme Court in CTS. Thus, it is an open question whether the Minnesota business combination provision would be upheld against a pre-emption challenge.

Commerce Clause Issues

With two potentially significant exceptions, the 1987 amendments to the Minnesota control share acquisition statute are closely patterned after the Indiana provision upheld in CTS. One difference is that the Minnesota law may apply to corporations with fewer resident shareholders than the Indiana CSAA covers.[17] Because the Supreme Court emphasized that a state has a justifiable interest under the Commerce Clause in regulating all corporations incorporated under its laws, the proportion of shareholders living in the state might not have any significance for constitutional analysis. On the other hand, the majority opinion in CTS noted approvingly that the Indiana statute applies only to corporations with a substantial number of resident shareholders.[18] Thus, it is an open question whether the lower threshold for protection under the Minnesota Act would be deemed an impermissible interference with interstate commerce if litigated.

A second difference between Minnesota law and the Indiana CSAA upheld in CTS is the broader Minnesota provision regarding the contents of the financing statement. It has been argued that the Minnesota financing statement requirements burden the interstate acquisition of credit and the interstate market for corporate control. Specifically, determining whether a particular financing statement satisfies the statutory requirement of being "definitive" may cause lengthy litigation that prevents the completion of a takeover.[19] One response to this argument is that if the statute is found merely to discourage the front-end loaded, two-step type of hostile takeover, it may not be ruled an unconstitutional burden on interstate commerce because the Commerce Clause does not protect any

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[15]Minn. Stat. 1987 Supp. §302A.673.

[16]Lipton v. Dayton Hudson Corp., D. Minn. 3-87-661, Plaintiffs Memorandum re Motion for Preliminary Relief, at 22-24 ("Lipton Memorandum").

[17]The Minnesota law can apply to a corporation with as few as 1,000 state resident shareholders; the Indiana law covers only those with at least 10,000 resident shareholders. See Part 1.

[18]107 S.Ct. at 1653.

[19]Lipton Memorandum, note 16, at 18-19.

particular way of doing business.[20] As already stated, the Minnesota provision on financing statements is not identical to the Indiana statute upheld in CTS. Therefore, whether the Minnesota provision violates the Commerce Clause is an open question.

Finally, it has been argued that the Minnesota business combination provision significantly interferes with interstate commerce by delaying for five years an extensive list of interstate corporate transactions, unless approved in advance by a committee of the target board.[21] One response to this argument is that business combination statutes are a form of internal corporate affairs regulation, which the Supreme Court has not yet characterized as an interference with commerce.[22] Thus, even if the business combination legislation appears as a practical matter to burden interstate commerce, the Supreme Court may be reluctant to find it unconstitutional and, thereby, create questions about the validity of many other established laws on corporate internal affairs. Further, even if the provision is found to interfere with interstate commerce, it still might be constitutional under Commerce Clause analysis if the state interest in enforcing the regulation outweighs the burden on interstate commerce.[23] Possible qualifying state interests include:

- discouraging front-end loaded, two-step takeovers, because they coerce shareholders;
- promoting corporate democracy by letting nontendering shareholders vote on changes in corporate control;
- reducing the risk of a hostile takeover in order to encourage management to focus on long-range planning rather than defensive tactics; and
- eliminating the threatening effect of greenmail tactics on target management.[24]

LITIGATION OVER THE 1987 MINNESOTA ACT

In September, 1987, suit was filed in federal District Court in Minnesota requesting, among other things, a declaration that both the financing portion of the control share acquisition provision and the business combination provision are in violation of the federal Constitution and the Minnesota Constitution. In part, plaintiffs claimed that these portions of the 1987 act are pre-empted by the Williams Act and violate the Commerce Clause. The suit was filed against the Dayton Hudson Corporation by Illinois residents who are shareholders of the corporation and object to the corporation's conduct in regard to an attempted takeover that was in process at the time the suit began. The suit is pending as of the publication of this report.

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[20]Sargent, note 13 at 27-28.

[21]Lipton Memorandum, note 16, at 14-17.

[22]Sargent, note 13, at 28.

[23]Ibid. at 13.

[24]Ibid. at 32.

Appendix A

Glossary of Takeover Terms

The following terms related to corporate takeovers are either used in this report or frequently appear in discussion of the subject.

Bidder; bidding corporation: Used in this report to mean a corporation or other entity attempting to take control of a corporation.

Controlling interest: Ownership of enough stock in a corporation that the party with such ownership can elect the board of directors. Especially in a large corporation, this does not require a majority of the stock, but only a greater proportion than any other shareholder has.

Corporate takeover: In the broadest sense, control of a corporation passes from one set of owners to another, by any of a variety of transactions, such as merger, tender offer, or proxy fight. Usually involves a change of management as well as ownership.

> ***Friendly takeover:*** Change of control has the approval of current management.
>
> ***Hostile takeover:*** Change of control is against the wishes of current management.

Derivative suit: A suit brought by a shareholder to enforce a corporation's legal rights, which the corporation has failed either intentionally or otherwise to enforce.

Directors: Members of the board of a corporation, elected by the shareholders. They have ultimate responsibility for the corporation.

> ***Disinterested directors:*** Those who are not also employees of the corporation.
>
> ***Inside directors:*** Those who are also corporate employees.
>
> ***Outside directors:*** Same as "disinterested directors."

Golden parachute: A large severance contract benefiting corporate executives which takes effect in the event of a hostile takeover.

Greenmail: An amount well above market price paid by a corporation to buy back its stock that has been purchased by a bidder making a takeover attempt.

Merger: The absorption of one company by another; the latter retains its identity while the former ceases to exist as a separate business entity. The latter company acquires the assets, liabilities and powers of the former company.

Proxy: Authorization given by a shareholder to another person to represent the shareholder and vote his or her shares at a shareholder's meeting.

Proxy fight: A struggle between nonmanagement and management to obtain sufficient proxies to elect a majority of the board of directors and thereby gain control of the corporation.

Raider: Same as "bidder," above.

Redeem; redemption: Repurchase by the corporation itself of a corporation's stock from shareholders.

Take a company private: Current management or majority shareholders purchase the company's stock on the open market so that the company is no longer publicly traded but instead is privately held. This makes a hostile takeover impossible.

Target: A corporation over which another corporation or entity is attempting to gain control by any method, such as purchasing a controlling share of the corporate stock or electing a new board which would agree to a merger.

Tender offer: A corporation, other entity, or individual offers to buy shareholders' stock in a company. A corporation may make such an offer to its own shareholders. In the context of takeovers, the term refers to a bidder offering to buy shares from target shareholders in order to obtain a controlling interest in the target.

> ***Front end loaded, two-step takeover:*** A particular kind of tender offer from a bidder in which the first shareholders to sell are paid substantially more than those who sell after the bidder obtains control.

Appendix B

Section-by-Section Summary of the 1987 Minnesota Act

Following is a summary of Laws 1987, First Special Session, Chapter 1.

Section 1 **OFFEROR.** Clarifies the definition of "offeror" for purposes of Chapter 80B. When two or more persons jointly agree to acquire, own or vote shares of a target company (whether or not the agreement is in writing), all persons participating in the agreement constitute a person.

Section 2 **TARGET COMPANY.** Amends the definition of "target company" for purposes of Chapter 80B. A target company must either have its principal place of business or principal executive office in Minnesota, or assets which have a market value of at least $1 million located in Minnesota. In addition, the target company must have (i) more than ten percent of its beneficial or record shareholders that are residents of Minnesota, (ii) more than ten percent of its shares that are beneficially (see definition in section 7) or of record owned by Minnesota residents, or (iii) more than 1,000 beneficial or record shareholders that are Minnesota residents.

> *NOTE: Chapter 80B applies to takeover attempts of target companies incorporated in any state. An offeror must file a registration statement with the Commissioner of Commerce. Copies of the registration statement must also be delivered to the target company and all broker dealers in the state that currently quote the target company's stock. All materials used to solicit shareholders to accept or reject the offer by the offeror or the target company must be filed with the Commissioner. In addition, the person attempting the takeover must make substantially the same offer to shareholders in Minnesota as to shareholders in other states.*
>
> *The remaining sections of the act amend Chapter 302A and apply only to corporations incorporated in Minnesota and governed by Chapter 302A.*

Section 3 **ACQUIRING PERSON.** Amends the definition of "acquiring person" to generally match the definition of "offeror" in section 1.

Section 4 **CONTROL SHARE ACQUISITION.** Amends the definition of "control share acquisition" to mean the acquisition of shares, directly or indirectly, which results in the acquiring person exercising a new range of voting power (ranges are outlined in section 302A.671, subdivision 2). In addition, this section adds an item to the list of exclusions from control share acquisition: the acquisition of shares, for the benefit of another, by a person who may not exercise or direct the exercise of the voting power of those shares without the instruction of others.

All shares acquired in a 120-day period and all shares acquired pursuant to a takeover plan are part of the same acquisition.

Section 5 **ISSUING PUBLIC CORPORATION.** Amends the definition of "issuing public corporation" to generally follow the definition of "target company" in section 2. An 'issuing public corporation" must have at least 50 shareholders.

Section 6 Technical change to definition of "publicly held corporation."

Section 7 **BENEFICIAL OWNERSHIP.** Provides that an agreement that results in "beneficial ownership" does not have to be in writing. "Beneficial ownership" does not include those shares tendered by a person who makes a tender or exchange offer, until the tender or exchange offer is accepted. In addition, a person is not a beneficial owner of shares where the person has the power to vote or direct the voting resulting from specified proxy solicitations.

Section 8 **INTERESTED SHARES.** Defines "interested shares" as those shares where the voting power for the election of directors is exercised or directed by an acquiring person, any officer of the corporation, or any employee who is also a director of the corporation.

Section 9 **AFFILIATE.** Defines "affiliate" as a person who controls, is controlled by, or is under common control with a specified person.

Section 10 **ANNOUNCEMENT DATE.** Defines "announcement date" when used in reference to a business combination, as the date of the first public announcement of the final, definitive proposal for the business combination.

Section 11 **ASSOCIATE.** Defines "associate" when used to indicate a relationship with any person, as any of the following:

(a) Any corporation or organization of which the person is an officer or partner or is directly or indirectly the beneficial owner of ten percent or more of any class or series of shares entitled to vote or other equity interest;

(b) Any trust or estate in which the person has a substantial beneficial interest;

(c) The spouse or any relative of the person or the person's spouse who resides in the person's home.

Section 12 **BUSINESS COMBINATION.** Defines "business combination" as including the following transactions:

(a) Mergers of an issuing public corporation with an interested shareholder (defined in section 15) or a corporation that is or that would be an affiliate or associate of the interested shareholder, after the merger.

(b) Exchanges of shares of the issuing public corporation or any subsidiary, for shares of the interested shareholder or any other domestic or foreign corporation that is, or after the exchange would be, an affiliate or associate of the interested shareholder.

(c) Sales, pledges, transfers or other dispositions to or with one interested shareholder or any affiliate, of assets of the issuing public corporation or any subsidiary: (1) having an aggregate market value of ten percent or more of all the corporation's assets, determined on a consolidated basis, (2) having an aggregate market value equal to ten percent or more of all the outstanding shares of the corporation, or (3) representing ten percent or more of the earning power or net income of the corporation.

(d) Issuance or transfer by the corporation or any subsidiary of the corporation, of any shares of the corporation that have an aggregate market value equal to five percent or more of the value of all outstanding shares of the corporation.

(e) The adoption of a plan or proposal for the liquidation or dissolution of the corporation or reincorporation in another state or jurisdiction on behalf of the interested shareholder or affiliate.

(f) Any reclassification of securities, exchange of shares with any subsidiary or other transaction proposed by or with the interested shareholder or affiliate, that increases the proportionate share of outstanding shares of any class of shares entitled to vote.

(g) Any receipt by the interested shareholder or affiliate of any financial benefit or assistance (e.g. loan) provided by the corporation or any subsidiary.

<u>Section 13</u> **CONSUMMATION DATE.** Defines "consummation date" with respect to any business combination as the date of consummation of the business combination.

<u>Section 14</u> **CONTROL.** States that "control" means the possession of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.

<u>Section 15</u> **INTERESTED SHAREHOLDER.** Defines "interested shareholder," when used in reference to any issuing public corporation, as any person that is:

(1) The beneficial owner of ten percent or more of voting power of the shares entitled to vote, or

(2) An affiliate or associate of the issuing public corporation and was the owner of ten percent or more of the voting power of the then outstanding shares entitled to vote, at any time within the five-year period immediately before the date in question.

<u>Section 16</u> **MARKET VALUE.** Defines "market value" when used in reference to shares or property of any issuing public corporation.

(1) <u>Shares</u> - the highest closing sale price of a share during the 30-day period immediately preceding the date in question.

(2) <u>Property</u> - the fair market value of the property on the date in question as determined in good faith by the board of the issuing public corporation, subject to arbitration.

<u>Section 17</u> **SHARE ACQUISITION DATE.** States that the "share acquisition date" means the date that the person first becomes an interested shareholder of the issuing corporation.

Section 18 **SCOPE OF DIRECTORS' DUTIES.** Provides that directors, in discharging their duties may consider the interests of:

-- employees,
-- customers,
-- suppliers,
-- creditors,
-- state and national economy,
-- community,
-- society,
-- the long-term and short-term interests of the corporation and its shareholders. The directors may also consider the possibility that these interests may be best served by the continued independence of the corporation.

Section 19 **COMPENSATION AGREEMENTS ("GOLDEN PARACHUTES").** During any tender offer other than one made by the corporation, section 19 prohibits publicly held corporations from entering into or amending agreements with officers and directors that increase their current or future compensation. This section does not prohibit routine increases in compensation or other routine compensation agreements undertaken in the ordinary course of business.

Section 20 **SPECIAL SHAREHOLDERS MEETINGS.** Requires that a special meeting of the shareholders to consider a business combination may only be called by a vote of 25 percent or more of all shares entitled to vote.

Section 21 Cross-reference made consistent with section 20.

Section 22 Cross-reference to section 23.

Section 23 A publicly held corporation shall not purchase, at a price over the average market price, shares entitled to vote from a person who beneficially owns more than five percent of the voting power of the corporation, if the shares were beneficially owned by the person for less than six months, unless:

(1) The purchase is approved by a majority of the voting power of all shares entitled to vote; or

(2) The corporation makes an offer, of at least equal value per share, to all holders of shares of that class and all holders of any class into which the shares may be converted.

Remainder of section defines "average market price" for purposes of the section.

Section 24 **CONTROL SHARE ACQUISITION.** Modifies the previous control share acquisition law in several substantial ways.

Information Statement

The information statement that an acquiring person must provide in a control share acquisition is expanded to include greater detail on the acquiring person, the acquisition plan, and whether the acquiring person would change the corporation's community involvement. In addition, material changes in the facts in the information statement, such as a one-percent increase or decrease in the number of shares to be acquired, must be noted in an amendment and promptly delivered to the corporation.

Shareholder Meeting Deadline

The act lengthens the deadline for holding a special shareholder's meeting on voting rights for an acquiring person from 20 to 55 days after an information statement is filed.

The act shifts the expense of the special shareholders meeting to the acquirer, except the expense of opposing the control share acquisition.

Meeting Purpose

Under the act, the purpose of the meeting is to determine the voting rights of the shares acquired in the control share acquisition. (Under prior law, the meeting determined whether the acquisition of the stock could occur.) The corporation need not call a special shareholders meeting if the acquiring person does not provide copies of a financing agreement with a financial institution(s) to finance the acquisition.

Threshold Ownership

The control share acquisition law provides for the board of the target to elect one of three alternative threshold percentages of voting shares to which the law will apply: (1) 20 percent, (2) 33-1/3 percent, or (3) 50 percent. Shares acquired in excess of the appropriate threshold percentage have no voting rights, unless approved by a resolution at the special shareholders meeting. Approval of voting rights requires a majority of both:

(1) The holders of a majority of all shares with voting rights (except that acquiring person shares in excess of the threshold have no voting rights) and

(2) The holders of a majority of all shares with voting rights, excluding interested shares (shares owned by officers, inside directors, and the acquiring person).

The voting rights of separate classes of shares apply, as otherwise provided in the corporation's articles.

Disqualified shares regain their voting rights only upon transfer to a third party other than the acquiring person or its affiliates or associates.

Redemption

The issuing corporation may redeem the shares acquired in a control share acquisition at a price equal to market value if (1) the information statement is not delivered within ten days after the control share acquisition, or (2) voting rights were not granted to the shares at the special shareholders meeting. The call for redemption must be made within 30 days after the event allowing the corporation to redeem the shares. Shares must be redeemed by 60 days after the call.

Section 25 **BUSINESS COMBINATIONS.**

Subd. 1 **FIVE YEAR PROHIBITION.** Prohibits an issuing public corporation from engaging in a business combination with an interested shareholder (defined in section 15) for five years after the share acquisition date, unless a committee of the board of directors, consisting of all the disinterested (outside) directors, approved the acquisition or combination before the acquisition date. If the board has no disinterested directors, the board must select three or more disinterested persons to be committee members. ("Business combination" is defined in section 12.)

The board must respond in writing within 45 days after submission of a good faith definitive proposal for a business combination. Failure to respond within the 45-day time period is the same as disapproval of the proposal.

Subd. 2 **WHEN PERMITTED.** Permits business combinations to be made with an interested shareholder if (1) the board approved the combination before the share acquisition date, or (2) the holders of a majority of the outstanding disinterested shares approved the combination five years after the acquisition date.

Business combinations with an interested shareholder are permitted (1) if the consummation date is five years after the share acquisition date and (2) the compensation paid to all holders of the corporation's shares satisfies a series of formulas for calculating market value. (Note: these rules only apply when the disinterested shareholders have not approved the combination.) In essence these formulas require the shareholders to receive an amount equal to the higher of:

(1) The highest price paid by the interested shareholder either in the transaction in which it became an interested shareholder or when it owned more than five percent of the voting shares, plus compound interest from the date the highest price was paid; or

(2) The market value of the stock on the announcement date or the share acquisition date, whichever is higher, plus compound interest. In the case of preferred stock, the amount the shares are entitled to on voluntary liquidation or dissolution of the corporation (plus unpaid dividends) is used, if it is higher.

Interest in all cases is calculated at the rate on one year treasury bills. Consideration must be paid in cash or in the same form that the interested shareholder used to acquire the largest number of shares of the class of shares. The interested shareholder may not have acquired additional shares after the acquisition date and before the consummation date (except through stock splits, share dividends, or by paying compensation that satisfies the formulas).

Subd. 3 **APPLICABILITY.** Provides that the section does not apply to a nonpublicly held corporation unless the corporation elects to be subject to it in its by-laws or articles.

The section applies to publicly held corporations unless the corporation elects not to be subject to it:

(1) In its original articles or by-laws,

(2) In by-laws adopted before September 1, 1987,

(3) In an amendment to the articles or by-laws adopted by a majority of the shareholders, other than interested shareholders, opting out of the section, which amendment (a) is not effective until 18 months after its adoption or August 1, 1989, whichever is earlier, and (b) does not apply to business combinations with interested shareholders who acquired their stock before the effective date of the amendment.

The section does not apply to a business combination with a shareholder who inadvertently became an interested shareholder, if the interested shareholder divests sufficient number of shares so that it no longer owns ten percent. The section also does not apply to business combinations with shareholders who were interested shareholders on June 1, 1987 or to business combinations where a binding agreement was entered before the act took effect.

Finally, this section does not apply to business combinations with persons who became interested shareholders on or after August 1, 1989 unless the articles or by-laws of the corporation provide otherwise.

Section 26 **REPEALER.** Repeals prior effective dates of the control share acquisition law.

Section 27 **EFFECTIVE DATE.** Section 19 ("golden parachute" provision) was active the day following final enactment (June 26, 1987). Sections 22 and 23 ("anti-greenmail" provisions) are effective March 1, 1988. The remainder of the act was effective retroactive to June 1, 1987.

Appendix C

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