COMMENT: TIME TO AMEND THE DELAWARE TAKEOVER LAW

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As Professor Subramanian demonstrates with cogent statistical evidence, now is the time for the courts to put Section 203 in the dock and examine its constitutional merits. Better still, the Delaware legislature should clean house and amend the criteria of this provision. In practical effect, it forbids a competitive tender offer, injuring shareholders who benefit from tender offer premiums, and the national economy, which benefits from the gravitation of industrial resources to their highest-valued uses.

Following the Supreme Court's decision in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), which invalidated an Illinois takeover statute, the federal district court in Delaware routinely enjoined application of the 1977 version of the Delaware takeover law at the commencement of tender offers. But uncertainty followed the Supreme Court's decision in *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), sustaining Indiana's so-called "second generation" tender offer statute. As Harvey Pitt once said, students of the Supreme Court tend to hear the "mood music" of opinions, sometimes glossing over specific rulings; the mood music in *Edgar* was martial, while the music in *CTS* was soothing. Some surmised that second- and third-generation takeover laws were invulnerable provided the legislature tinkered with their mechanism after *Edgar*.

Looking more carefully at this issue, Delaware district court judges have disabused lawyers of that misunderstanding. The *BNS*, *RP*, and *City Capital* cases cited by Professor Subramanian (*Delaware's Choice*, *supra* p. 18 n.47) make clear that Section 203 would violate the federal constitution if it foreclosed a "meaningful opportunity" for bidders to make a successful tender offer by promising a generous premium to investors. Now, it appears, under Delaware corporate law there is not only no "meaningful opportunity for success"—there is no opportunity at all. Can anyone refute the statistical facts Professor Subramanian sets forth? The silence is deafening. The situation described in *BNS* in fact has come to pass: "an appreciable number of hostile bidders" have not "navigat[ed] the statutory exceptions." That means "reconsideration of the statute's congruence with the Williams Act will be warranted." *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 470-472 (D. Del. 1988).

Professor Subramanian asks: "If these arguments are correct, why hasn't the challenge come?" In the midst of any major corporate acquisition, a hundred people run in a hundred directions. They have little time to ponder the meaning of *Edgar* and *CTS*, much less contemplate lengthy litigation in the district court, the court of appeals, or the Supreme Court. Ordinarily, the deal rises or falls long before litigation finishes its course. For its part, the SEC has little opportunity to formulate a position as amicus curiae. The Supreme Court did not help matters in *Edgar* by issuing a plurality opinion based on federal preemption and a concurring opinion based on a medley of commerce clause rationales. For its part, the *CTS* opinion did not agree or disagree with the preemption analysis of Chief Justice Burger and Justices Blackmun and White in *Edgar*. It simply distinguished *Edgar* and based the majority opinion on general commerce

clause principles. After *CTS*, eight new Justices have joined the Supreme Court. The time is ripe for clarification.

What would federal courts think of the Delaware statute if Professor Subramanian's factual findings were presented today? In our view, the statute would be declared unconstitutional. Both *Edgar* and *CTS* concur on the governing principles. As Judge Schwartz stated in the *BNS* case: "preemption scrutiny of the Delaware Act must begin with the proposition that the power of the states to regulate tender offers does not extend to complete eradication of hostile offers." 683 F. Supp. at 468.

The constitutional problem with the Illinois takeover statute was threefold: the statute discouraged tender offers by requiring a twenty-day precommencement waiting period (which invited managerial maneuvers to stymie offers), by requiring a hearing with no time limit before the offer could commence, and by requiring the secretary of state to decide whether the offer was "equitable." Shareholders could not decide for themselves. This frustrated a core purpose of the federal Williams Act. As Justice White explained: "Congress intended for investors to be free to make their own decisions." 457 U.S. at 639. The Illinois law was unconstitutional because, under its inhibiting provisions, "[s]hareholders are deprived of the opportunity to sell their shares at a premium." *Id*. at 643.

CTS upheld the Indiana takeover statute not because the Court disagreed with the legal principles laid down in *Edgar*, but rather, as Justice Powell said, because "[t]he Indiana Act differs in major respects from the Illinois statute." 481 U.S. at 80. As for the preemption analysis in *Edgar*, Justice Powell stressed that "[w]e need not question that reasoning." *Id.* at 81. The Indiana statute avoided invalidation because, unlike the Illinois law, it allowed investors "to make their own decisions." *Id.* The decision to accept or reject the tender offer was not made by a government official or by corporate directors, but rather by the shareholders themselves rendering a collective judgment with an ordinary majority vote. Through this collective voting process, the Indiana statute protected shareholders from coercion—a stampede triggered by the bidder in a two-step acquisition culminating in a freeze-out merger. The law thus allowed "shareholders to vote as a group" and "protects them from the coercive aspects of some tender offers." *Id.* at 83. The Indiana statute also operated within the time frames of federal law and did not discourage offers because the bidder could "make a conditional tender offer, offering to accept shares on the condition that the shares receive voting rights within a certain period of time. The Williams Act permits tender offers to be condition[al]." *Id.* at 84. In short, the "Indiana Act avoids the problems the plurality discussed in *MITE*." *Id.* at 83. It "allows shareholders to evaluate the fairness of the offer collectively." *Id.* at 84.

The Indiana Takeover Act ultimately passed muster because, the Supreme Court concluded, the bidder's "contention that the Act will limit the number of successful tender offers" was *factually unsupported*: "There is little evidence that this will occur." *Id*. at 93. As three dissenting Justices explained in *CTS*, evidence of that sort should be dispositive. Such a limiting effect would "substantially interfere[] with this interstate market" and "conflict[] with the Commerce Clause" while subverting the goals of the Williams Act. *Id*. at 101.

How does Section 203 square with these Supreme Court precedents? Alas, it conflicts with the rationale of both of them. Shareholders do not get to decide whether to accept lucrative tender offer premiums. For the last quarter century, that option has been taken away from them by the Delaware legislature. This constitutional infirmity deeply concerns securities law scholars. See, e.g., 1 Loss, Seligman & Paredes, *Fundamentals of Securities Regulation*, 880-881 (6th ed. 2011):

> "[T]he New York and Delaware statutes vest existing managers with the power to block tender offers, and thus appear to be inconsistent with the Williams Act purpose of ensuring investor choice with respect to accepting or rejecting a tender offer and the more general policy to avoid tipping the scales either in favor of management or in favor of the person making the takeover bid. While the 50-day delay in the Indiana statute is within the 60-day congressional limit, a moratorium of three or five years obviously exceeds it. The purpose of corporate voting or staggered board terms can be stated in terms unrelated to tender offers; the purpose (or inevitable effect) of a successful moratorium statute, however, is to deter tender offers. * * * * These acts seriously tilt in favor of incumbent management and jeopardize what SEC Chairman Ruder termed 'the free transferability of securities.' * * * * Given the magnitude of target shareholder premiums that state moratorium statutes may block, and the likelihood that this money would be re-circulated back into the economy, there is a real possibility that the more significant state laws do more harm than good. At the very least the moratorium statutes may significantly tilt the balance in favor of target management. At a certain point the price of federalism comes too high."

As Professors Loss, Seligman and Paredes put it in the bible of federal securities law, *Securities Regulation*, vol. 5, p. 195 (4th ed. 2010), lengthy moratorium periods are "clearly intended to frustrate hostile takeovers." *See also* 3 Hazen, *Law of Securities Regulation* 463 (6th ed. 2009) (criticizing "highly questionable freeze statutes" and noting the "considerable question whether such statutes can withstand constitutional scrutiny").

It is true that *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989), upheld a Wisconsin takeover statute also imposing a three-year moratorium. But the court there did not have before it the factual information now proffered by Professor Subramanian. Nor did it apply the preemption test recognized in the Delaware district court opinions cited by Professor Subramanian—the court that will actually decide this issue. The Seventh Circuit believed that the legislature could "block beneficial transactions" so long as it did not "tinker[] with any of the procedures established in federal law." 877 F.2d at 504. That narrow view of conflict preemption, however, is out of line with the views advocated by the Department of Justice and the

SEC in *Edgar*, which stressed that the states may not "tip the balance of advantage in favor of the subject company's incumbent management" or undermine "Congress' adoption of a 'free market' approach to tender offer regulation." SEC Brief Amicus Curiae at 7, 1981 WL 389721, at *4. "Achievement of the goals of a federal statute often depends on adherence to deliberately selected limitations on the scope of regulation. * * * In such cases, preservation of the line between what the law regulates and what it leaves alone may be essential to the success of the statutory strategy." *Id.* at 8, 1981 WL 389721, at *7.

It would be perverse for defenders of the Delaware statute to invoke the opinion of Judge Easterbrook. He made clear that "[i]f our views of the wisdom of state law mattered, Wisconsin's takeover statute would not survive. * * * [W]e believe that antitakeover legislation injures shareholders." 877 F.2d at 500. That is a timely message for the Delaware legislature. Judge Easterbrook's narrow conception of federal preemption, focusing on procedural inconsistency with federal rules, also does not accord with broader "conflict preemption" principles advocated by the SEC and endorsed in numerous Supreme Court opinions. *See, e.g., Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 153 (1982) (preemption arises to the extent that "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress"). In Judge Easterbrook's view "[i]nvestors have no right to receive tender offers." 877 F.2d at 504. But once a corporation issues shares and creates a free interstate market in securities, management cannot switch on and off a three-year moratorium period to stymie a disfavored tender offer. That would be contrary to the "overriding concern" of Congress in the Williams Act, which was to avoid tipping the balance of advantage "to favor management against offerors, to the detriment of shareholders." *CTS*, 481 U.S. at 81-82 (citing legislative history).

Applying the conflict preemption standard laid down by the Supreme Court in both *Edgar* and *CTS*, the First Circuit granted injunctive relief against a Massachusetts takeover statute in *Hyde Park Partners v. Connolly*, 839 F.2d 837 (1st Cir. 1988), issuing a panel opinion joined by now-Justice Breyer and Judges Coffin and Bownes. The statute there at issue imposed a far less significant deterrent than the Delaware law. It merely imposed a five-day precommencement notice requirement on the bidder. If the bidder failed to make that simple disclosure, it was forbidden to consummate the merger for one year. But like the Delaware law, which imposes an 85% acceptance requirement and a three-year moratorium, this burden could be switched on and off by the target company's management. This, the First Circuit explained, violates a fundamental purpose of the Williams Act because it tips the balance of advantage between bidder and target and thereby discourages hostile tender offers to the detriment of shareholders. The First Circuit found that the statute operated to the detriment of shareholders—contrary to the preemption standards laid down in both *Edgar* and *CTS*—given the "deterrent to tender offers caused by the disclosure." *Id.* at 850. The precommencement notice "likely will discourage takeover attempts to a much greater extent than that envisioned by Congress." *Id.* at 852 (evaluating legislative history discussed in *Edgar* and *CTS*). And "[b]y giving management the option of effectively waiving the disclosure and penalty provisions * * * the Massachusetts Act lets management decide for investors instead of

letting investors decide for themselves." *Id*. at 852-853. The same is true of the more draconian 85% requirement and three-year moratorium prescribed in the Delaware law.

What is to be done? First, sound the tocsin as this article does. Second, bidders and their counsel should consult with policy makers, economists, and regulators of tender offers at the SEC. At least on regulatory issues (as opposed to liability issues), the lower federal courts and the Supreme Court still defer heavily to the SEC. The plurality opinion followed the SEC's recommendations on preemption in *Edgar*, and in *CTS* the SEC again argued in favor of invalidation of the state takeover statute. The federal government's concern about investor harm resulting from such laws has been consistently expressed by the SEC, FTC, and the Department of Justice. Although it is true that the Roberts Court shows more deference to state law than the Burger Court, the Justices can be expected to adhere to prior precedent of the Court itself, reaffirming the investor autonomy principles laid down in both *Edgar* and *CTS*. Bidders testing the statute in the federal district court in Delaware can quote prior district court opinions noted above, and show that the facts now demonstrate that bidders have "no meaningful opportunity" to offer premiums to investors given the straitjacket of Section 203. A successful challenger on both commerce clause and preemption grounds could earn a substantial fee. *See, e.g., Dennis v. Higgins*, 498 U.S. 439 (1991), *Maher v. Gagne*, 448 U.S. 122, 132 n.15 (1980) (recognizing that fees should be awarded because the plaintiffs advanced some claims under the Commerce Clause).

In addition to providing amicus support, the SEC could also issue a new regulation with preemptive force. See *Fidelity Federal v. de la Cuesta*, 458 U.S. at 153 ("Federal regulations have no less pre-emptive effect than federal statutes."). It should consider doing so because, as former SEC Chief Economist Gregg Jarrell has said, Professor Subramanian has "proven statistically what practitioners already know: Section 203 killed the hostile tender offer." "In short, eliminating Section 203 would bring back the hostile tender offer as the most important feature of the market for corporate control." *A Trip Down Memory Lane: Reflections on Section 203*, 65 Bus. Law. 779, 779, 787 (2010). That is a national market, not a state market, and its healthy performance has profound importance for the sluggish national economy. No individual state should attempt to freeze the national market in corporate control.

Should the Delaware legislature await this development on the theory that sleeping dogs are best left undisturbed? The answer, we believe, is no. It was an embarrassment in the 1980s to see Delaware takeover law enjoined in case after case. The unfortunate impression this created was that Delaware corporate legislation was out of step with modern constitutional law, if not part of a "race to the bottom." Many years passed between the decision in *Edgar* and the enactment of a new version of the statute that has continued to impose an unconstitutional burden on nationwide tender offers. Revising the statute to prescribe a lower standard of shareholder approval—the Indiana statute upheld in *CTS* required only a "majority vote" of shareholders—would satisfy the constitution while leaving management reasonable latitude to oppose misguided or inadequate offers and negotiate better deals from "white knights." The legislature would win applause by increasing shareholder wealth, contributing to economic progress, and

leaving directors room to protect their companies through debate on the merits of acquisition proposals and exercise of sound negotiation skills.

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