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March 31, 1983

Re: SEC Advisory Committee on Tender Offers

Dear Ray and Frank:

Enclosed is a memorandum dealing with the general question of the proper relationship of federal and state securities and corporate laws. I received a call from Robert S. McConnaughey, Associate General Counsel, American Council of Life Insurance to express the interest of the insurance industry in our Subcommittee's work. I asked him to submit a statement setting forth the views of the industry. Their argument essentially is that for reasons peculiar to the insurance industry continued state regulation of changes of control is desirable.

After Frank has sent us any thoughts he has, we can arrange a conference call to review where we are.

Sincerely,

Irwin Schneiderman

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[Enclosure]

cc: David B. H. Martin, Esq.
Securities and Exchange Commission

STATE REGULATION OF THIRD-PARTY ACQUISITION OF SECURITIES.

As we all realize, all of the matters being considered by the Committee are interrelated. This is particularly true when we consider the relationship between federal and state securities and corporate laws. Currently, the Williams Act reflects the congressional policy that federal law should be "neutral." As a result, the courts have viewed state law and tested it against the federal policy of neutrality. When state law has interfered with this neutrality, the state law has been stricken down as being unconstitutional. If the basic objective of federal law changes, permissible state action will also change.

In Edgar v. Mite Corp., 102 S.Ct. 2629 (1982), the U.S. Supreme Court held the Illinois Takeover Act unconstitutional on the ground that it imposed a burden on interstate commerce that was excessive in relation to the local interest to be served by the state statute. The Court noted that Congress had not expressly prohibited states from regulating takeovers but had left it to the courts. While a majority of the Court did not agree that the Illinois statute was preempted by the Williams Act,

the Court did discuss the congressional policy of "neutrality" underlying the Williams Act.

> "Congress sought to protect the investor not only by furnishing him with the necessary information but also by withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice." (102 S.Ct. at 2636-7)

* * *

> "Congress intended to strike a balance between the investor, management and the takeover bidder." (id. at 2637)

Only three Justices concluded that various features of the Illinois statute conflicted with the policy underlying the Williams Act and that the statute was, therefore, preempted.

A majority of the Court held the Illinois statute violative of the Commerce Clause. The Court pointed to the "nation-wide reach which purports to give Illinois the power to determine whether a tender offer may proceed anywhere" and the effects thereof including depriving shareholders of the opportunity to sell shares at a premium, hinderance of reallocation of economic resources to their highest valued use and reduction of

management's incentive to perform well. The Court dismissed two proffered "legitimate local interests" of protecting resident shareholders and regulating the internal affairs of corporations formed under Illinois law.

The Court was able to muster a majority of five only because Justice Powell felt that the opinions of "Commerce Clause reasoning leaves some room for state regulation of tender offers." (p. 2643)

A new Ohio statute (made by amendments to the Ohio Corporation Law and the Ohio Securities Law effective November 19, 1982) requires prior authorization by shareholders of a target for any "control share acquisition." Such term is defined to include acquisition by any means (whether tender offer, open market purchase or privately-negotiated purchase -- with certain limited exceptions) of 20% or more of the voting power of an "issuing public corporation." Basically, an issuing public corporation is an Ohio corporation with 50 or more shareholders that has its principal place of business, principal executive offices or substantial assets in Ohio.

A bill has been introduced in the Maryland Legislature designed to deter front end loaded tenders.

A merger with a 10% stockholder would require favorable vote of 80% of all voting shares and two-thirds of disinterested shares if the consideration to be paid in the second step is not as favorable as that paid in the first step.

In view of the lack of unanimity in the Mite case, one cannot predict whether the Supreme Court would strike down the Ohio or Maryland statute on the basis of current federal law. The National Association of State Securities Administrators has indicated an interest in being heard on this subject. We should review their submission and those of others interested in the matter before reaching a conclusion as to whether to recommend that statutes such as the Ohio or Maryland statutes be stricken in view of an overriding federal policy.

Moreover, as noted above, if federal policy in the change of control area changes, the scope of permissible state regulation will also change.

With respect to regulated industries such as insurance and broadcasting, a weighing of policy considerations is involved. Representatives of the insurance industry have expressed the view that state law should

govern transfers of control. They will be submitting a statement setting forth their point of view. Whether there is a federal interest in superseding state control of regulated industries depends on the federal policy involved.

LAW APPLICABLE TO TARGETS" RESPONSES

It is true that generally speaking, bidders' activities are regulated by federal securities laws and targets' responses by state law. This need not be the case.

In most cases, the courts have approved defensive tactics on the basis of the state law business judgment rule. Applying this rule the courts have upheld the sale of "crown jewels", the issuance of a controlling block to a prospective "white knight", an acquisition that would create an antitrust obstacle to a takeover offer, etc.

On the other hand some federal courts applying federal law have held certain defensive tactics to violate the Williams Act (Section 14(e)) which proscribes fraudulent, deceptive or manipulative acts or practices in connection with a tender offer.

In Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) the court held that the grant of an option on crown jewels as well as on an option to purchase a controlling block of stock violated the Williams Act saying:

> "In our view, it is difficult to conceive of a more effective and manipulative device than the "lock-up" options employed here, options which not only artifically affect, but for all practical purposes completely block, normal healthy market activity and, in fact, could be construed as expressly designed solely for that purpose." (at 374)
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> * * *
>
> "The Yates Field option and the stock option, both individually and in combination, have the effect of circumventing the natural forces of market demand in this tender offer contest. * * * The purpose of the Williams Act, protection of the target shareholders, requires that Mobil and any other interested bidder be permitted an equal opportunity to compete in the marketplace and persuade the Marathon shareholders to sell their shares to them" (at 376).

The reasoning in the Mobil case has not been universally accepted but has received some support.

In San Francisco Real Estate Investors v. Real Estate Trust of America, et al. (1st Cir., March 9, 1983) (CCH Fed.Sec.L.Rep. ¶ 99115) the Federal Court of Appeals noted its concern that business enterprises by internal by-laws or charter amendments can insulate themselves from takeover efforts. Because it was un-

necessary to decide the matter, it stated "Whether or not the Williams Act proscribes such action is a matter on which we express no opinion." (See f.n. 10.) The Court did, however, note in its opinion that Congress has endeavored in enacting the Williams Act to assure a "policy of neutrality in contests for control" which is frustrated by unjustifiably delaying tender offers. It noted that other actions which chill or freeze a takeover effort also frustrate federal policy.

Thus, if it is concluded that the present policy underlying the Williams Act remains valid, the Commission has considerable authority to adopt regulations prohibiting various defensive tactics undertaking without stockholder approval as well as certain tactics, such as front end loaded tenders, employed by bidders.

Irwin Schneiderman

March 31, 1983