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STRENGTHEN CORPORATE TAKEOVER LAWS

House Bill 4548 (Substitute H-1)
First Analysis (4-24-89)

Sponsor: Rep. John Bennett
Committee: Corporations and Finance

THE APPARENT PROBLEM:

The last decade has seen a marked increase in corporate takeover activity. States, concerned about a takeover's effect on shareholders and local economic stability, have sought to regulate takeover offers in ways consistent with federal court decisions. Not until April 21, 1987, when the U.S. Supreme Court upheld an Indiana statute which allows target company shareholders to vote on whether the shares being acquired by a corporate "raider" are to be accorded voting rights (CTS Corporation v. Dynamics Corporation of America, 107 S.Ct. 1637), were other states able to adopt takeover laws which withstood constitutional requirements. Michigan adopted similar minority shareholder protections under Public Act 58 of last year. However, as state laws designed to protect shareholders from certain abusive practices are implemented, raiders alter their takeover tactics in order to circumvent these laws. An increasingly familiar tactic involves the use of the debt financing market, where "junk bonds" are sold to pay for a takeover. Because of the high cost of these low-grade securities the raider is often forced to "bust up" and sell the target corporation after a successful bid, in order to reduce or repay this debt -- often resulting in economic and social upheaval for the corporation's employees and the communities in which it operates (see BACKGROUND INFORMATION). Some feel additional amendments, patterned after Indiana's statute, are needed to address current takeover practices.

THE CONTENT OF THE BILL:

The Business Corporation Act was amended in 1984 to provide Michigan-based companies protection, greater than that provided by federal law, from corporate takeovers. The bill would provide general amendments to the act.

For two companies to be combined, the act currently requires that at least an 80 percent majority vote of the company's shareholders is required to approve the merger. The bill would increase the majority required to at least 90 percent. Under the act, certain conditions must also be met from the time a shareholder has expressed interest in a takeover or merger and before consummating the takeover or merger. The bill would require additionally that before the combination could take place, there would have to be five years between the date a person became an interested shareholder and the date the business combination was consummated.

The term "beneficial owner," as it is used with respect to any voting stock, means a person who individually or with associates has certain rights to acquire voting shares. The bill would amend this definition to specify that a person could not be considered the owner of voting shares which were tendered pursuant to a tender or exchange offer made by the person, or the person's affiliate or associate, until the tendered voting shares were accepted for purchase or exchange. Also, a person could not be considered the beneficial owner of voting shares if the person's right to vote the shares arose solely from a revocable proxy or consent given in response to a proxy or consent solicitation to 10 or more persons. Currently, only business combinations involving a covered Michigan corporation or its domestic subsidiaries are subject to the act. The bill would delete the word "domestic" before "subsidiary" to expand the list of business combinations that would be covered under the act. In addition, "subsidiary" would be defined as a legal entity of which a majority of the voting shares were owned, directly or indirectly, by another person.

MCL 450.1776 et al.

BACKGROUND INFORMATION:

Since late in the nineteenth century the U.S. has experienced a number of significant corporate merger movements. The most recent of these began in the mid-1970s, referred to as the "strategic planning" movement, in which companies have carefully examined other industries, fields of research, and management and financing techniques in order to devise the best possible strategies for their own corporate growth. During this time companies have found that takeovers of other profitable companies, particularly those strong in high technology fields, have offered the most lucrative business opportunities. Michigan initially responded to this business climate by enacting a takeover statute (Public Act 179 of 1976) to help protect domestic companies from corporate raiders. Apparently, raider tactics were adjusted correspondingly to circumvent such state takeover laws.

In the early 1980s states tried to regulate takeovers in ways consistent with federal court decisions (and the federal Williams Act, which regulates buy-out offers) of the time. In Edgar v. MITE Corp. (457 U.S. 624, 102 S. Ct. 2629), the U.S. Supreme Court struck down an Illinois takeover statute, ruling that the burdens on interstate commerce presented by the act were excessive compared to the local benefits. Following this 1982 decision, the U.S. Court of Appeals for the Sixth Circuit held that aspects of Michigan's law were preempted by federal law under the supremacy clause (Martin-Marietta Corp. v. Bendix Corp. (1982) 690 F.2d 558; L.P. Acquisition v. Tyson (1985) 772 F. 2d 201). But Michigan, again, responded with legislation specifically aimed at deterring takeover tactics of this period.

A raider of this time typically offered to purchase for cash approximately 50 percent of a target corporation's stock, and then used its control position to force remaining shareholders to sell their stock for less valuable consideration (often "junk bonds"). These offers were designed to stampede shareholders into selling their stock out of fear of receiving only the less valuable consideration in the final "freeze-out" transaction. Michigan's response to this was Public Act 115 of 1984, referred to as the "fair price statute," which was designed to restrict a corporate

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raider from freezing-out the target corporation's shareholders who did not desire to sell their stock. Among other things, the act provides that before a takeover occurs it must either a) be approved by a supermajority (at least 80 percent) of the company's shareholders or b) meet minimum price and procedural requirements.

Over the last five years raiders, due to a huge growth in the debt financing market, have continued and even increased their use of junk bonds in takeover bids. Rather than directly issuing junk bonds to a target corporation's shareholders, a raider typically sells these bonds (which are sold on the basis of the target company's cash flow and asset loan value) to institutional holders, and then uses the proceeds from such financing to satisfy the act's minimum price requirements in a takeover. The resulting expense to the raider from this type of financing can then be mitigated by selling the newly acquired corporation.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill would have an undetermined fiscal impact on the state. (4-21-89)

ARGUMENTS:

For:

The ill effects of a corporate takeover battle can include the weakening of a firm whose management became more attentive to financial maneuvering than running the company for long-term soundness, the loss of local jobs, the reduction of capital investment, and the conversion of equity to debt. Although shareholders usually benefit from an increase in the value of their stock, large payments made to "buy off" a corporate raider ("greenmail") are generally paid out of what would otherwise be shareholder money. States have a legitimate interest in protecting shareholders, maintaining economic stability, and ensuring continued economic growth within their borders.

The bill would strengthen provisions added to the act last year by inserting an additional requirement into the act's exception to the supermajority approval provision: under the bill, an interested shareholder (that is, one interested in a takeover bid) would have to maintain its investment in a target company for at least five years before consumating a freeze-out transaction. At least 19 other states, including New York and Delaware, have imposed a holding period requirement in such situations, and this provision has withstood a number of constitutional challenges thus far. In addition, the bill would increase the vote required to circumvent the fair price provision (and the proposed 5-year holding period requirement) from 80 to 90 percent. Thus, a freeze-out transaction could not occur within the first five years after an interested shareholder crossed the ten percent stock ownership threshold, unless the business combination was approved by 90 percent of the target company's stock, in addition to other requirements for approval currently in the act. In fact, many states do not allow any level of shareholder vote to override the holding period requirement. The bill would not prevent a takeover, nor would it prevent a corporation from busting-up and selling the target company following a takeover. However, the bill could help encourage a potential bidder for a Michigan company to negotiate with the board of directors of a target company prior to accumulating the stock needed to complete a transaction, which would enable the board to better protect the interests of its many constituents.

Against:

Congress has before it a number of proposals to enact nationwide regulation of takeover activity. Moreover, the chairmen of the Securities and Exchange Commission has urged Congress to give the commission clear authority to preempt state laws that he says "threaten to create a maze of overlapping and conflicting regulation." To enact the bill now would be premature in light of potential federal developments.

Response: It may be some time before Congress acts. If the bill is considered good public policy, there is no reason not to move it forward.

Against:

In testimony before the House Corporations and Finance committee, a representative of the treasury department expressed some concern about the effect of the bill on the state's pension fund investments. Until these concerns are explored, it would be premature to enact the bill.

POSITIONS:

The Michigan Manufacturers Association supports the bill. (4-20-89)

Consumers Power Company supports the bill. (4-20-89)

Detroit Edison Company supports the bill. (4-20-89)

Federal-Mogul Corporation supports the bill. (4-19-89)

Gerber Products Company supports the bill. (4-19-89)

K-mart Corporation supports the bill. (4-19-89)

Michigan Consolidated Gas Company supports the bill. (4-20-89)

The Michigan State Chamber of Commerce has no position on the bill. (4-20-89)

The Department of Treasury has not yet taken a position on the bill. (4-24-89)

The Department of Commerce has not yet taken a position on the bill. (4-24-89)