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Corporate law in the United States involves dual regulation. Although state and federal corporate law typically function without mutual interference, the last thirty years have revealed potential conflicts, chiefly in two situations. One involves civil remedies for investors under federal securities statutes; the other is state anti-takeover regulation and its relationship to the federal Williams Act. The postwar years until 1975 saw perhaps too much reliance on the federal component of corporate regulation. Since 1975, there has been a renaissance of state law. Recently, however, appreciation for state regulatory authority may have degenerated into hostility to the will of Congress. The authors argue that the core interpretive task in federal securities law is preservation of both regimes to maximum effect, because the Congress has expressly declared that state authority should continue adjacent to federal regulation.

Corporations organized under United States laws are strange beasts. A public corporation can have a worldwide economic impact, involving billions of dollars of commerce. Its investors may live in every state and numerous foreign countries. Yet a single state's statutory and decisional law controls much of the relationship among corporate investors and managers. State law delineates important "rules of the game" regarding investor selection of managers, disclosure, judicial review of managerial behavior, and fundamental corporate changes. States are not the sole corporate regulators, however. Federal law also defines fundamentally important manager-investor relationships as a consequence of its securities regulations. These statutes and rules require significant public disclosure in connection with a corporation's initial issuance of its securities, and they demand regular reports about ongoing business operations to facilitate secondary market trading in already issued securities. As a consequence of the federal regulatory system, federal securities law also influences the substantive structure and timing of corporate financial transactions.

State corporate law and federal securities regulation thus overlap to some extent because both impose duties on corporate managers. Most of the time, this dual regulation generates few conflicts. During some corporate disputes, however, participants present legal arguments based on the consequences of differential regulation. Dual regulation problems appear primarily in (1) cases delineating the availability and scope of fraud actions under federal securities law and (2) cases challenging the reach of various states' corporations acts and of Securities and

Exchange Commission (SEC) regulations when these laws influence securities transactions that alter corporate control. In federal securities fraud cases, the U.S. Supreme Court now uses the presence of parallel state corporate law as one reason to limit the reach of federal law, particularly in cases where the claimed federal remedy is an implied private right of action. The Supreme Court and courts of appeals also have permitted state law to continue its preeminence in determining the dynamics of corporate control transactions, even though these transactions typically are interstate in nature. The cases reveal federal judicial deference to a state's regulatory power over its corporations, most clearly by the judges' notions of statutory construction. A strong federalism component leads to an increasingly narrow vision of preemption as well as a narrowing of the role of the commerce clause in invalidating state law. These trends in corporate jurisprudence parallel developments in other areas of law.

Dual regulation of manager-investor relationships creates difficult questions of federalism, in no small part because federal securities law itself contains a clear congressional command that state corporate law be preserved,[1] even as federal statutes and regulations establish important national standards for securities market behavior. This state regulatory function has survived in part because states have lobbied to preserve their incorporation revenues. However, the Congress also safeguards state corporate regulation alongside federal securities regulation because of federalism's normative virtues. A traditional argument for a federal system is that political decisionmaking ought to be dispersed among multiple centers rather than located in a single national center because competition among the states tends to create optimum law while reducing the impact of mistaken governmental actions. Multiple decision centers permit experimentation in local communities. Successful regulatory schemes can be copied, while the negative effects of poorer strategies should not reach beyond those communities willing to adopt them. National regulation is to be reserved for situations beyond the states' individual or combined regulatory resources, when otherwise tolerable variations among the states may in fact exacerbate the problem.

These arguments concerning the benefits and burdens of a federal system are especially relevant to problems of corporate federalism and have been partially persuasive to courts. The arguments recognize the importance of both state and federal authorities in corporate regulation, and partially support the historic notion of specialization between the two regimes: federal law primarily addresses disclosure problems even as state law remains the basic authority governing investor-manager relationships. Our thesis, however, is that a federalism respectful of both state and federal roles in corporate regulation does not *require* such specialization. Moreover, disclosure mechanisms are not easily isolated from governance mechanisms; the information disseminated to comply with federal disclosure obligations usually is the sort of information necessary to permit state-law governance mechanisms to function.[2] Disclosure itself is a governance mechanism, according to Louis Brandeis' famous dictum that "sunlight is said to

[1]See Securities Act of 1933, Section 18; Securities Exchange Act of 1934, Section 28.

[2]See *Goldberg* v. *Meridor*, 567 F.2d 209 (2d Cir. 1977).

be the best disinfectant; electric light the most efficient policeman." Consequently, a facile partition of federal and state authority over corporate activity is an imperfect basis for analysis. State and federal law are jointly at the core of corporate governance; the interpretive task is to obey Congress' dual command to combat national corporate problems while preserving state corporate law. Federal law does more than simply "fill the gaps" in state corporate law: as new problems develop in national markets, federal regulators should be empowered to respond. At the same time, traditional state regulation and innovation should not be casually displaced.

FEDERALISM, CORPORATE GOVERNANCE, AND PRIVATE RIGHTS OF ACTION

Implied Remedies for Damages

Corporate governance doctrine is that body of legal rules concerned primarily with the internal relationships among the board of directors, the corporate officers, and the shareholders. Historically, the states have set the legal content of these relationships as part of their power to issue corporate charters. State chartering of ordinary business corporations continues, and has resulted in a substantial body of state law regarding corporate governance. Among these are a myriad of specific statutory rules as well as the common-law duties of care and loyalty imposed on corporate directors and officers.

Widespread federal regulation of corporate matters did not begin until the middle portion of the twentieth century, with the Securities Act of 1933 and the Securities Exchange Act of 1934. The primary, but not exclusive, goal of both these statutes is to enhance disclosure by market participants. The federal statutes explicitly reject any federal preemption of state plenary authority over corporate affairs. The result is a system of federal securities-trading statutes and administrative regulations coexisting with state corporations codes and judicial doctrines.

Although federal and state corporate regimes function autonomously to a large degree, federalism is implicated by judicial enforcement of federal securities provisions. The Congress has authorized federal judges to hear civil enforcement suits brought by the SEC, as well as criminal prosecutions brought by the U.S. Department of Justice. These judges also hear civil claims brought by injured private parties under express and implied remedies. Judges inevitably must interpret the language of the securities statutes and regulations in these enforcement suits, and their interpretations will marginally increase or decrease federal power as the statutes are read broadly or narrowly.

The Congress has created express private actions that apply in a range of business contexts related primarily to the original issuance of securities under the 1933 act. Implied rights are distinct developments, although they have been long recognized under the 1934 act's two broadest provisions, sections 14(a) and 10(b). These implied rights work to enforce federal disclosure obligations in connection with shareholder voting and secondary market transactions in already issued stock.

The courts faced federalism issues explicitly for the first time in the implied private-right-of-action cases. These cases reflect styles of argument in federalism cases generally. During the Warren Court era, federal power was viewed expansively. Post-Warren Court decisions have tended to take a more restrictive approach. Although federal courts began to recognize implied claims under the federal securities laws as early as 1946, the Supreme Court first addressed the problem of implied rights in 1964 in *J.I. Case Co.* v. *Borak.*[3] Writing for a unanimous court, Justice Tom Clark determined that the plaintiffs' claim was cognizable under Section 14(a) of the 1934 act. This opinion is the most assertive implication of a private right under federal securities law. Although Section 14(a)'s legislative history contains no evidence of any congressional intent to provide a private right of enforcement for misleading proxies, Clark was able to cite language of congressional concern for "fair corporate suffrage" and for "recurr[ing] abuses which [had] frustrated the free exercise of the voting rights of stockholders." The opinion suggested that private civil enforcement is an appropriate supplement to regulatory action because the SEC's ability to provide scrutiny of proxy statements is necessarily limited.

The *Borak* Court showed no inclination to treat the possibility of state-law relief as a reason to deny an implied claim or to limit the remedies available to prospective relief. Federal policy regarding shareholder voting is "overriding," and would "control the appropriateness of redress despite the provisions of state corporation law." Moreover, deference to state law would risk underenforcement of federal policy because the states may or may not impose penalties on corporate fiduciaries for misleading proxy statements. Even if the state common law did regard director or officer participation in promulgating a misleading proxy statement to be a breach of fiduciary duty, the states' procedural requirements in derivative suits (such as the requirement of a contemporaneous shareholder, security for expenses, and demand on directors) might still result in uneven national enforcement of a federal policy involving conduct that is not restricted to any one state.

Subsequently, the Court acknowledged the existence of private claims under Section 10(b) and Rule 10b-5 in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*[4] without any discussion of federalism issues in the main body of the opinion. *Bankers Life* effectively ratified the lower federal courts' twenty-five years of case law that had inferred private claims from Section 10(b) and Rule 10b-5, and firmly established these claims as devices by which shareholders could challenge inadequate or fraudulent disclosures in connection with share transactions in the secondary markets, and in the primary markets as well. These federal lawsuits were very attractive to securities litigants, and to the lawyers who specialized in representing them. Because federal securities claims often could be brought as direct claims, federal pleading of corporate misconduct avoided many of the severe state-law procedural restrictions on derivative suits. Federal discovery rules also provided distinct advantages over many states' pretrial procedures. Moreover, the 1934 act authorized nationwide service of process in civil suits, which in itself would make 1934 act claims under sections 10(b) and 14(a) extremely attractive to plaintiffs' counsel.

[3] 377 U.S. 426, 431-435 (1964).
[4] 404 U.S. 6 (1971).

More frequent litigation during the 1970s coincided with several new appointments to the Supreme Court, and eventually resulted in diminished judicial enthusiasm for implied federal claims and the articulation of more restrictive implication standards with a significant federalism component. This restrained view was stated most clearly in *Cort* v. *Ash*.[5] In a unanimous decision authored by Justice William Brennan, *Cort* denied a private right of action under the Federal Election Campaign Law to a shareholder suing derivatively to challenge Bethlehem Steel Corporation's allegedly illegal expenditures during the 1972 presidential election. The Court discussed four factors for determining when an implied federal claim would be permitted: (1) whether the plaintiff is one of the class for whose *especial* benefit the statute was enacted; (2) whether there is any indication of legislative intent, explicit or implicit, either to create or to deny the private remedy; (3) whether an implied remedy is consistent with the legislation's underlying purposes; and (4) whether it is appropriate to recognize an implicit private right because the cause of action is one traditionally relegated to state law in an area that fundamentally is a matter of state concern.

In applying the four *Cort* factors, Brennan suggested that "except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[6] *Cort* did not explicitly involve federal securities laws, but Brennan's reasoning supports the notion that state law should become the background norm in construing whether the interface between federal securities statutes and state corporate law permits an implied federal claim. Brennan's language is consistent with a specific interpretive canon requiring clear congressional expression to supersede or supplement state corporate law before implying a federal securities claim, because corporate governance is an area traditionally reserved to the states. This approach is not incompatible with the general structure of the 1933 and 1934 acts and with their legislative histories. Of course, the state-law background norm is one that Congress can disregard by explicitly creating a federal regulatory requirement or cause of action that intrudes on state law duties. It has done this in the area of insider trading.[7]

The federal courts appear to have abandoned any pretense of strict adherence to the four *Cort* factors.[8] A restrictive reading of federal legislation is nonetheless apparent in several post-*Cort* cases that reject implied claims under particular provisions of the federal securities laws, but the Supreme Court does not always justify its result by pointing to preexisting state law.[9] Nor do these post-*Cort* cases all go in the same direction.[10] Consequently, despite both the clear congressional command to preserve state corporate law and *Cort's* interesting suggestion for considering existing state law when trying to identify implied federal claims, the

[5]422 U.S. 66 (1975).

[6]422 U.S. 66, 84 (emphasis added).

[7]See Insider Trading and Securities Fraud Enforcement Act of 1988, amended Section 20A of the 1934 act.

[8]See *State of California* v. *Sierra Club,* 451 U.S. 287 (1981).

[9]See *Touche Ross & Co.* v. *Redington,* 442 U.S. 560 (1979); *Transamerica Mortgage Advisors, Inc.* v. *Lewis,* 444 U.S. 11 (1979).

[10]See *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353 (1982); *Herman & MacLean* v. *Huddleston,* 459 U.S. 375 (1983).

Supreme Court has abandoned any predictable use of principled federalism as an interpretive aid in construing federal securities laws. It did so without a clear explanation of the *Cort* approach's inadequacy in explicating implied securities claims, and without substituting an alternative analysis that explicitly treats the problem of preserving state corporate law within the design of federal securities regulation.

Federalism and the Scope of Implied Remedies

Although the courts have not overruled their earlier decisions that recognized implied private enforcement of sections 10(b) and 14(a), cases interpreting the scope of these remedies have invoked federalism to justify narrow readings of the existing causes of action. In 1975, just prior to *Cort,* the Supreme Court began to narrow its interpretations of private claims under Section 10(b) and Rule 10b-5. In *Blue Chip Stamps* v. *Manor Drugs Stores,*[11] the Court limited the class of proper Section 10(b) and Rule 10b-5 damage plaintiffs to purchasers or sellers of securities. In so ruling, the majority did not directly discuss deference to state law. However, Justice Lewis Powell's concurring opinion suggested that the existence of state common-law fraud remedies undercut the dissenters' insistence that a federal Section 10(b) purchaser-seller rule permitted fraud to go unremedied.

The following year, the Court decided *Ernst & Ernst* v. *Hochfelder,*[12] another Rule 10b-5 case, and one that did have a hidden federalism component. Plaintiffs were First Securities' customers who claimed that they had been injured by Ernst & Ernst's failure to perform audits properly, a failure that aided and abetted securities fraud because the audits were used in filing false and misleading annual reports with the SEC. The Supreme Court dismissed the plaintiffs' claim, requiring proof of "scienter"—intent to deceive, manipulate, or defraud—in private claims under Section 10(b) and Rule 10b-5. Although not explicitly discussed by the Court as a federalism issue, the scienter question implicates the scope of an accountant's liability under state common law. For our purposes, state regulatory authority can be measured by a state's willingness to permit brokerage customers (or shareholders) to sue when their broker's (or corporation's) accounting firm makes a negligent audit that affects their investment. If the Court had been correct in its assumption that applicable state law created no claim against the accountants in favor of the customer, creating a negligence-based federal standard would have gone further than state law in regulating accountant liability. Read this way, *Hochfelder* can be seen as an attempt to preserve state hegemony in regulating accountants' malpractice. However, the state-law trend has been to expand accountants' liability for negligent audits. *Hochfelder* thus was a rejection of what became the state common law, and was a significant doctrinal pronouncement buttressed by little more than a footnote expressing doubt about the wisdom of negligence-based liability.

In two cases decided in 1977, the Supreme Court continued to restrict the reach of private federal securities litigation. Here, the Court's majority began to make explicit reference to state law as a justification for narrow readings of implicit

[11]421 U.S. 723 (1975).
[12]425 U.S. 185 (1976).

claims under federal securities laws, although its dedication to this analytical principle varies as much in these cases as it does in those attempting to determine whether to permit any implied claim under a particular provision.

In *Piper* v. *Chris-Craft Industries, Inc.*,[13] the Court refused to permit Chris-Craft, a defeated tender offeror, to bring a damages action under Section 14(e), the general anti-fraud provision of the Williams Act. The majority buttressed its reading of the legislative history of the Williams Act by invoking *Cort* v. *Ash* and its four factors. Although the opinion devoted varying degrees of energy to the *Cort* factors, the Court invested only a modest effort to determining whether the claim was one traditionally reserved to state law. The Court noted the Second Circuit's conclusion that Chris-Craft might have a state-law claim for interference with a prospective commercial advantage. Based on the mere possibility of this state-law claim, the majority concluded that it was appropriate to relegate the offeror-bidder and others in that situation to whatever remedy is created by state law. Although the *Piper* Court's ultimate interpretation of the Williams Act is defensible, its federalism analysis supporting that interpretation was particularly weak.

A month after *Piper,* the Court announced its opinion in *Santa Fe Industries* v. *Green,*[14] which presented the most significant federalism situation in the implied claims cases. Plaintiffs had brought a Section 10(b) and Rule 10b-5 claim against Santa Fe Industries and its investment banker, Morgan Stanley & Co., after a "short-form merger" between Santa Fe and Kirby Lumber Corp. Plaintiffs sought to set aside the merger or to obtain the fair value of their shares. Among other allegations, they claimed that the short-form merger itself was unfair and thus violated Rule 10b-5 because it had been accomplished without "any corporate purpose" and without prior notice to shareholders. On intermediate appeal, the Second Circuit treated this as a valid securities claim, holding that Rule 10b-5 reached fiduciary misconduct by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure. In so doing, the court of appeals transformed a relatively ordinary state corporate-law claim of fiduciary breach into a federal securities fraud claim.

The Supreme Court reversed, declaring that a private claim under Section 10(b) and Rule 10b-5 required allegation and proof of deceptive or manipulative conduct. Once again, the Court began its analysis with the language of the federal securities laws, and was able to satisfy itself that, standing alone, the language of federal law clearly indicated the result. Justice Byron White then moved to an extensive discussion of the relationship between the disclosure objectives of the federal securities scheme and traditional state corporate-law concerns. First, he noted the existence of state-law appraisal rights for minority shareholders who feel that their shares are undervalued in a short-form merger. Unlike *Piper*'s reference to the mere possibility of a tortious interference claim for defeated tender offerors, White is unarguably correct in suggesting in *Santa Fe* that a federal law remedy for share valuation would provide no relief not otherwise generally available in a state-law

[13] 430 U.S. 1, 40-41 (1977).
[14] 430 U.S. 462, 474-480 (1977).

appraisal proceeding. However, it does not follow from this that federal courts should begin to treat implied rights under Rule 10b-5 as merely "supplementary to" state-law principles. Hostility to federal implied rights could move the courts to refuse or limit an implied claim any time that a state remedy is provided. On this view, no private claim would exist in many situations where there had been deceptive or manipulative conduct. White avoided this approach by declaring, "Of course, the existence of a particular state-law remedy is not dispositive of the question whether Congress meant to provide a similar federal remedy." He also noted the cases in which an implied federal claim under Rule 10b-5 also constituted a state-law fiduciary breach.

White also was sensitive to the possibility of general displacement of state fiduciary law by Rule 10b-5. Extension of implied claims to all fiduciary breaches involving securities transactions would mean that federal uniformity of interpretation would tend eventually to override "established state policies of corporate regulation." White identified this risk primarily with the possibility that uniform, nationwide interpretations of federal securities law would impose stricter standards than traditional state corporate law for fiduciary behavior in corporate transactions. For White, the issue was not whether the Congress has power under the commerce clause to override state corporate policies as it regulates the national securities markets. Instead, he suggested that because the Congress did not attempt to override these policies (except where deception or manipulation was involved) and expressly refused to preempt state law, the courts should not interpret Section 10(b) and Rule 10b-5 to work a creeping preemption. Two concurring opinions in *Santa Fe* expressed reservations only about this portion of White's opinion, deeming it unnecessary to determining the case.

If the Court's invocation of federalism issues seems more appropriate in *Santa Fe* than in *Piper*, the difference may be that the two cases present dissimilar "threats" to a continued role for state law in corporate regulation. In *Piper,* it is not entirely clear how the states' regulatory powers are particularly threatened by recognizing an implied damages remedy under Section 14(e) for defeated bidders. State authority would be no less "endangered" by a Section 14(e) remedy for a non-bidder shareholder who claims damages resulting from the victors' misleading statements. Indeed, as *Cort* intimated quite clearly, this sort of federalism "threat" is presented by all implied claims under federal law except when federal authority is founded on a constitutional grant of exclusive power to the federal government. *Santa Fe* presents an authentic federalism problem, however. Unrestricted Section 10(b) and Rule 10b-5 claims could very well displace state corporate law because federal remedies are more procedurally attractive to plaintiffs. State enforcement of fiduciary duties thus would wither from disuse, and with it a meaningful state role in corporate fiduciary regulation. State-law displacement would undermine the dual regulatory system that the Congress intended to preserve when enacting the 1933 and 1934 acts.

Express Private Remedies

The division of authority between federal and state spheres also is implicated in defining the scope of remedies expressly provided in federal securities statutes. A recurring problem in these cases has been the threshold issue of whether the investment at issue between the parties is a "security," and thus subject to federal regulation. Federal regulatory authority would be severely restricted if "security" were narrowly defined by statute and rigidly interpreted by judges applying that statute. In fact, the opposite has occurred.

The 1933 and 1934 acts both define "security" by a list of specific investment mechanisms, such as stocks and bonds, and more generally as "any interest or instrument commonly known as a 'security.'" "Investment contracts" are among the mechanisms specifically listed in the securities statutes, and the courts have used this concept to hold a variety of investment schemes to be "securities" within the meaning of federal securities laws.[15] Although many of these schemes closely resemble garden variety fraud traditionally left to state law, the federal courts have not hesitated to invoke federal securities anti-fraud provisions to attack the misconduct. The investment contract cases thus broadened considerably the reach of the federal securities laws by defining an "investment contract" as a contract, transaction, or scheme whereby a person (1) invests money (2) in a common enterprise and (3) is led to expect profits (4) primarily or substantially from the efforts of persons other than the investor.[16] In defining "security," courts also directly consider whether the investment is the sort that demands federal securities investor protection.[17]

The expansionist trend in defining "investment contracts," like other such trends in federal statutory interpretation, slowed considerably in the mid-1970s and early 1980s. Indeed, conservative jurists began to exploit the "investment in common enterprise" element of investment contracts to avoid federal securities jurisdiction over some sales of corporate stock. Although "stock" is expressly included in the statutory definitions of "security," a line of cases known as the "sale of business" doctrine held that the sale of stock in a closely held corporation may not be a "security," especially if the sale, in essence, is a face-to-face transaction that conveys the total or controlling ownership and management of the business' assets. The reasoning in these "sale of business" cases is that these transactions are not within the intended definition of "security" because they do not involve investment in a common enterprise, and so do not require investor protection under federal securities laws. This narrow reading of express statutory language would have left a significant class of corporate transactions almost entirely to traditional state corporate governance and fraud rules.

Ultimately, the sale-of-business doctrine was rejected by the Supreme Court in *Landreth Timber Co.* v. *Landreth.*[18] In reversing the lower courts, the Court reasoned that the statutory definition is satisfied when a business elects the corporate form and offers shares with the traditional indicia of ownership, such as voting for directors, or participation in current earnings or liquidation proceeds.

[15]See generally, Thomas L. Hazen, *The Law of Securities Regulation* (2nd ed.; St. Paul, Minn.: West, 1990), pp. 22-23, 793-795.

[16]See *SEC* v. *W. J. Howey Co.,* 328 U.S. 293, 298-299 (1946).

[17]See generally, *Marine Bank* v. *Weaver,* 455 U.S. 551 (1982); Hazen, *The Law of Securities Regulation,* pp. 24-25.

[18]471 U.S. 681 (1985).

Landreth Timber thereby recognizes the courts' continuing obligation to respect the securities regulatory regime as enacted by Congress. It does not discuss the effect of its interpretation of "security" on the parallel state regulatory regime; this omission is appropriate because the case deals with express congressional language. *Landreth Timber* signals that the Court will not use federalism concerns to overturn clear congressional designs. It offers less certainty in determining whether the Court will return to federalism when next presented with an implied claims issue under the securities laws.

FEDERALISM AND THE LAW OF TAKEOVERS[19]

The conflict over the relative roles of state and federal regulation of corporate governance is starkly presented in cases concerning the validity of state takeover statutes. The friction between regulatory systems also is central to litigation concerning the SEC's attempt to limit the ability of corporations to issue dual-class common stock, a particular takeover defense tactic that is generally permitted under state law. The state takeover statute cases raise issues relating to commerce and supremacy clause jurisprudence, while litigation concerning the SEC's preemptive dual-class common rule turns on the scope of the commission's legislatively delegated authority to affect corporate governance through its power to regulate financial markets. In both categories of cases, courts have given considerable deference to state authority.

State Takeover Statutes

As the hostile takeover phenomenon developed in the mid-1960s, target companies lobbied the Congress for amendments to the Securities Exchange Act of 1934 that would limit such takeovers. The SEC and several commentators, in turn, argued that a vigorous market for corporate control was in the interest of shareholders and the economy as a whole, and that any federal legislation should not unduly restrict takeovers. The result was the Williams Act (amending the 1934 act), which established minimum time periods during which tender offers must remain open, as well as certain other mandatory terms. The Williams Act also mandated the disclosure of particular facts about an offer.

Those favoring substantive regulation limiting hostile tender offers then turned to the states, where their efforts were more successful. Ultimately, thirty-seven states passed the first generation of post-Williams Act state takeover legislation. Two subsequent waves of state statutes have followed. State legislation employs a wide variety of statutory solutions directed at controlling hostile transactions. The general effect of these statutes, regardless of exact pattern, has been to make acquisitions more dependent on the judgment of target management. These statutes also make hostile offers more risky and expensive and therefore operate to deter at least some would-be acquirors.

[19]The legal issues presented by state and federal takeover regulation are more fully discussed in Dennis R. Honabach and Roger J. Dennis, "The Seventh Circuit and the Market for Corporate Control," *Chicago Kent Law Review* 65 (1991): 681.

The resulting dual federal-state legislative regulation of control transactions has sparked a spirited debate about the propriety of competing systems. In particular, while potential targets applaud the new legislation, would-be acquirors maintain that the new state legislation harms shareholders by disarming the market for control. Consequently, they have attempted to invalidate the state acts in a series of challenges to their constitutionality under the supremacy clause and the commerce clause. Two of these challenges have reached the Supreme Court, *Edgar* v. *MITE Corp.*[20] and *CTS Corp.* v. *Dynamics Corp. of America.*[21] *MITE* reviewed the first generation of state statutes, and represents an assertive claim of federal power inconsistent with other securities-regulation cases raising federalism issues. *CTS* involved a second generation statute, and illustrates the more traditional deference to state regulation of corporate governance. To date, cases challenging the third generation of statutes have not reached the Supreme Court. *Amanda Acquisitions Corp.* v. *Universal Foods,*[22] a recent lower court opinion, examines a third generation state takeover statute. It was decided after *CTS,* and aggressively asserts a paramount role for the law of the state of incorporation in the regulation of most aspects of takeovers.

In *MITE,* the Supreme Court declared unconstitutional an Illinois measure typical of the early expansive state statutes. The Court majority invalidated the Illinois statute on a commerce clause basis; a plurality also concluded that the statute was preempted by the Williams Act. The Court's commerce clause doctrinal analysis followed the dormant commerce clause balancing analysis of *Pike* v. *Bruce Church, Inc.*[23] This analysis is used when a state statute has an indirect burden on interstate commerce, and requires that local benefits of regulation be weighed against burdens on interstate commerce and that the burden on interstate commerce not be excessive when weighed against local interests. Justice White's opinion deeply discounts any purported local benefits and discovers substantial burdens on interstate commerce in a determined claim of federal power based on a policy preference for any active market for corporate control. While part of this preference is derived from the 1968 congressional view of tender offers reflected in the Williams Act itself, White's approach in *MITE* epitomizes using the *Pike* balancing model as a method for substituting the Court's substantive view toward a state law for the state legislature's view.

The supremacy clause portion of the case was more clearly a question of federal statutory interpretation; the Court had to determine how far the Williams Act had gone toward preempting state corporate laws that made hostile tender offers difficult to accomplish. Here, White read the Williams Act's legislative history as requiring neutrality between target and raider in both federal and state law, employing in the process a broad, "purposive" method of statutory construction. This purposive approach led the plurality to conclude that both target management

[20]457 U.S. 624 (1982).
[21]481 U.S. 69 (1987).
[22]877 F.2d 496 (7th Cir.), *cert. denied* 493 U.S. 955 (1989).
[23]397 U.S. 137 (1970).

groups and raiders were to be denied any "undue advantage that could frustrate the exercise of an informed choice" by investors. After management exercises its right to opine on whether the offer should be accepted, "the takeover bidder should be free to move forward within the time frame provided by Congress."

MITE represents an extreme federal interference with state corporate law, and conflicts with the style of decisionmaking in the private right of action cases discussed above. Rather than viewing state law as a congressionally preserved, positive basis for limiting the reach of federal law, White's opinion narrowly delineated the interest of states in regulating changes in corporate control through tender offers. Because of the fragmented nature of the opinion and its striking departure from the prior approach to securities regulation, however, *MITE* left a number of questions unanswered. These questions became crucial as state after state passed new takeover legislation intended to circumvent the constitutional difficulties identified in the Illinois statute. The Supreme Court answered some of these questions in *CTS,* which involved a challenge to the Indiana control-share acquisition statute. Unlike the Illinois statute challenged in *MITE,* the Indiana statute applied only to Indiana corporations that had their principal place of business in Indiana as well as a significant number or percentage of shareholders in Indiana.[24]

The *CTS* Court validated the Indiana statute against both commerce and supremacy clause attacks. On the commerce clause issue, Justice Powell's approach differed greatly from White's *MITE* opinion. Powell did not undertake any in-depth *Pike* balancing test. Instead, he focused on the issue of discrimination against interstate commerce as the principal concern of a dormant commerce-clause analysis, and found that the Indiana statute did not significantly discriminate. In the absence of discrimination, no effort was made to measure the concomitant burdens on interstate commerce.

Powell's *CTS* opinion wove its commerce clause analysis from several distinct strands of standard corporate doctrine. It harkened back to the concession view of state corporate law when he stated that corporations are "entities whose very existence and attributes are a product of state law." The opinion then proceeded to treat the Indiana statute as ordinary corporate law, much of which has an extraterritorial impact. Perhaps most significantly, Powell believed that the internal affairs doctrine gave Indiana considerable regulatory authority over its corporations. So viewed, the *CTS* Court would understandably be loath to subject all of corporate law to a commerce-clause balancing test with respect to its impact on takeovers. Powell thought that only in the rarest situation should a federal court invalidate a state's regulatory decisions on intra-corporate rules, even though those rules necessarily affect interstate commerce. Finally, he noted that voting rights are particularly within the core of subjects traditionally regulated by state law.

On the supremacy-clause preemption issue, Powell ostensibly used White's approach in *MITE.* The basic assumption thus was that state laws that violate the Williams Act's neutrality principle are invalid. Powell simply found that the Indiana statute was not preempted because it fostered neutrality and shareholder

[24]See also, Eric S. Rosengren, "State Restrictions of Hostile Takeovers," *Publius: The Journal of Federalism* 18 (Summer 1988): 67-79.

autonomy by allowing shareholders to respond collectively to offers. In reality, however, Powell's opinion on preemption differs from the *MITE* plurality opinion in a fundamental regard, that difference being his attitude toward the continued function and legitimacy of state law as expressly declared in federal securities statutes. Consequently, *CTS'* approach to legislative interpretation of securities statutes is more consistent than *MITE's* with the Court's general, if irregular, method since *Santa Fe.*

A number of other state takeover statutes have been tested since *CTS*. Among them, *Amanda Acquisition Corporation* v. *Universal Foods Corporation* is in many ways the most interesting case because Judge Frank Easterbrook's opinion is a single-minded law-and-economics takeover decision dealing with this topic and is an interesting sequel to White's use of law-and-economics analysis in *MITE* to reach a different result. In *Amanda,* Easterbrook validated the Wisconsin takeover statute against both supremacy and commerce clause attacks. The Wisconsin statute is a very strong version of a business-combination state takeover-statute. By regulating corporate conduct in the "second stages" (*after* a hostile tender offer would have been completed), it virtually precludes a hostile takeover whenever the acquiror needs immediate and unencumbered control over the target's assets. Furthermore, the statute effectively prevents transactions based on asset-backed debt financing and those in which substantial restructuring is contemplated. Its application is mandatory; shareholders are not permitted to vote away Wisconsin's "protections."

Easterbrook's commitment to maintaining a vital market for corporate control is well known, and he restated it in *Amanda* while discussing his policy-based objections to the Wisconsin statute. Nonetheless, he wrote aggressively to uphold Wisconsin's anti-takeover legislation. Easterbrook used two different lines of analysis on the supremacy-clause preemption issue, each of which led him to find that the Wisconsin statute was not preempted. First, and in contrast to *MITE,* Easterbrook adopted a narrow view of the preemptive effect of the Williams Act, noting that after the *CTS* decision, the "weight of precedent" no longer supported a preemptive federal neutrality model, which would command the states to observe neutrality between bidders and target managements. He suggested instead that the Congress intended a neutrality policy only for its statute, the Williams Act. So interpreted, the Williams Act leaves to the states further substantive regulation of the corporate control market if they deem it necessary.

Moreover, Easterbrook concluded that even if the preemptive neutrality model were still good law, the Wisconsin statute was legitimate because the Williams Act only regulates the tender offer process itself. Easterbrook believed that Wisconsin law did not affect either tender offer timing or disclosure, which he considered the exclusive objects of federal regulation. The Wisconsin statute influences tender offers indirectly, but significantly, because second-step transactions in many instances are economically necessary for first-step tenders to proceed. This indirect regulation deters and prevents hostile bids: a rational bidder would decline to offer a hostile bid initially if the second-stage arrangements could not be concluded. Because neither offerors nor shareholders have federally protected rights to make or receive offers, however, the Wisconsin statute's indirect effect is irrelevant for preemption purposes, even though it deters potential offers.

In addressing the commerce-clause claim, Easterbrook emphasized that while the dormant commerce-clause jurisprudence may be directed at discrimination, the Wisconsin statute does not discriminate against nonresidents. Although it may in fact injure mostly investors who live outside the state, offerors from all states are equally affected by the statute. Moreover, he determined that so long as the subject of the statute is a matter of corporate law, the state of incorporation is free to set the rules, as has always been the case with regard to the substantive rules regarding mergers. In sum, Easterbrook's opinion in *Amanda* achieves a thorough deference to state law by its narrow readings of the federal Williams Act's preemptive effect and regulatory scope, and by its recognition of the traditional state authority over corporate control transactions, despite inescapable effects on interstate commerce.

Federal Regulation of Dual-Class Common Stock

The battle between acquirors and targets has also been played out in interpreting the scope of the SEC's rulemaking authority under the proxy and market regulation provisions of the 1934 act. In *The Business Roundtable* v. *SEC*,[25] the United States Court of Appeals for the District of Columbia invalidated SEC Rule 19c-4, a 1934 act rule that barred the securities exchanges and over-the-counter markets from listing for trading a security if a publicly traded corporation had reduced the per-share voting rights of existing common shareholders in creating that security. Such reduced voting power in publicly traded securities reserves a type of super-voting power to another class of securities not subject to public trading; this arrangement is called "dual-class common." In practical terms, super-voting power gives management the ultimate veto over takeover bids. Outside shareholders own a majority of the equity interests, but the shares held by the public shareholders do not have the power to control the firm through the election of directors because of their inferior voting rights. This type of voting structure was traditionally limited to closely held corporations or public corporations with a dominant family investment. As the 1980s takeover era blossomed, corporate actors began to create dual-class common capital structures in recapitalizations as a preemptive defense (a "shark repellant") against hostile takeovers.

Historically, the largest of the stock exchanges, the New York Stock Exchange (the NYSE), forbad the listing for trading of dual-class common. The practice was permitted, however, by other financial markets as well as by state corporate law. Rule 19c-4 was intended to apply the NYSE approach throughout financial markets in the United States. Rule 19c-4 essentially prohibited the creation of dual-class common stock in publicly traded corporations if done after the corporation's initial public offering. The rule thus federalized the issue and prevented competition among states and trading venues over this particular corporate provision.

The *Business Roundtable* decision weaves the federalism themes of *Santa Fe* and *CTS* together in invalidating Rule 19c-4. The statutory basis for the rule cited by the SEC was its dual authority to regulate proxy solicitation and competition among

[25]905 F.2d 406 (D.C. Cir. 1990).

the securities markets. Because the court viewed the rule as directly affecting the substance of corporate governance, it started from the premise that the scope of commission authority was limited. Citing *Santa Fe,* the court declared that a clear congressional statement of intent was needed to override core, state, corporate law. Invoking *CTS,* the court maintained that state-law control of the substantive aspects of shareholder voting was "firmly established." The court narrowly read the congressional concern over corporate suffrage through proxy solicitation regulation as being directed "almost exclusively" at issues of disclosure. Congressional interest in "fair corporate suffrage" did not reach such issues as the relative voting power of shares, a subject traditionally governed by state corporate law. Power to regulate competition among trading venues gave the SEC authority to regulate some subjects, such as the hours of operation, quotation systems, and trading halts, but not voting power structures for listed companies.

Business Roundtable represents a troubling invocation of exclusive state power over corporate governance. It disregards congressional declarations of plenary SEC authority over proxy voting, exchange regulation, and over-the-counter trading. The NYSE's "one share, one vote" rule is more than fifty years old, and arose out of the same concerns and historical setting that led to the 1934 act. A reasonable case can be made that disproportionate voting stock creates the very type of abusive proxy solicitation that the Congress empowered the SEC to prevent under Section 14(a)'s broad grant of regulatory authority. Instead of recognizing this historical context, the *Business Roundtable* Court relies on an uncritical apportionment of federal corporate authority to "disclosure matters" and state authority to everything else, when such an allocation is intellectually unworkable, and is not justified by an unbiased reading of the statutory language or its legislative history.

We recognize that *Business Roundtable* is a hard case. What troubles us and the court about Rule 19c-4 is that it is difficult to find a "fire break" between the "one share, one vote" rule and federal preemption of corporate governance through SEC mandated listing standards. A plausible defense of the rule can be built, however, by acknowledging that the NYSE's "one share, one vote" rule has been a component of the federal regulatory scheme for decades because exchange rules are subject to SEC authority under the 1934 act's self-regulatory organization provisions. Rule 19c-4 simply extends this regulatory device to other exchanges. Had the D.C. Circuit not reflexively declared that corporate governance by voting was a matter of state law, its assessment of Rule 19c-4 would have required a subtler inquiry into whether the rule is an appropriate federal intervention into corporate governance under federal securities laws. *Business Roundtable* reveals the consequences of failing to perceive and honor both federal and state authority under the joint corporate regulation established in the United States.

CONCLUSION

Borak, Santa Fe, and *Landreth Timber* represent the tension in corporate federalism, each recognizing a significant partial truth about the dual system of corporate regulation. *Borak* tells us that private enforcement of the fundamental protections created by the federal securities laws are a significant and useful part of the regulatory scheme, while *Santa Fe* reminds us that judges must be careful not to let systemic biases in favor of attractive federal remedies completely overrun state corporate regulation, which the Congress clearly did not preempt by the 1933 and 1934 acts. *Landreth Timber* recognizes that explicit language can expand as well as contract federal power.

However, the federal courts, and the Supreme Court especially, have not been able to articulate comprehensive standards for discerning when federal interests in securities regulation require encroachment on state corporate regulatory authority. Clearly, federalism is a fundamental value in the United States, and in regulating securities, the Congress expressly left the states with an important role. Some concern for state authority is therefore justifiable when interpreting federal securities laws. This concern occasionally can be overstated, or worse. For example, instead of state-law preservation, a concern for the meaning of statutory language would justify *Blue Chip's* purchaser-seller requirement, or *Piper's* refusal to endow defeated bidders with an additional means to savage their takeover rivals.

Attempting to solve this difficulty by compartmentalizing the complex relationship between state and federal corporate regulation in damages actions is doomed to failure. One particular risk is a false distinction between "substance" and "procedure" that attributes substantive authority over governance doctrine to the states and treats the federal securities provisions as uniform national "procedures" for securities transactions. Most legal commentators have long rejected any pretense that procedural rules lack substantive content. Moreover, this approach is particularly inappropriate for dual corporate regulation. The extensive federal disclosure requirements have both procedural and substantive aspects. The legislative history also reveals a clear congressional design to displace certain aspects of state regulation, particularly where voting proxies are concerned.[26] Federal securities provisions are concerned with corporate governance matters, and their overlap with traditional state rules of corporate governance will remain a continuing source of tension.

Perhaps a better interpretive start could be made by acknowledging at the outset that state corporate law remains important for federal securities regulation because the Congress itself preserved continuing state participation in corporate regulation, even as it enacted significant legislation designed to cure problems the states could not reach, or could reach but had not governed satisfactorily. To say that it is preserved, however, does not mean that traditional state authority has been left entirely unchanged by the development of federal securities law. In interpreting federal law, the courts must acknowledge that the states continue to have primary authority over those corporate matters traditionally regulated by the states. These interpreters also should acknowledge that significant portions of the federal securities regulations were enacted because of dissatisfaction with the results of state regulation. The 1933 and 1934 acts altered the corporate "landscape": after federal intervention, it is impossible to make "state law as it might have been" a

[26]For a legislative history of Section 14(a), see Patrick J. Ryan, "Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy," *Georgia Law Review* 23 (Fall 1988): 123-147.

useful interpretive canon for federal securities law. Judicial interpreters must accept the wisdom of *Santa Fe,* and recognize that overly expansive interpretations of federal law literally might obliterate meaningful state corporate regulation, a result not intended by the Congress. At the same time, they cannot permit an oversolicitous regard for continuing state authority to blind them to Congress' other command, which is to interpret and enforce federal securities provisions to deal with significant national regulatory problems created by the widespread adoption of the corporate form of doing business.