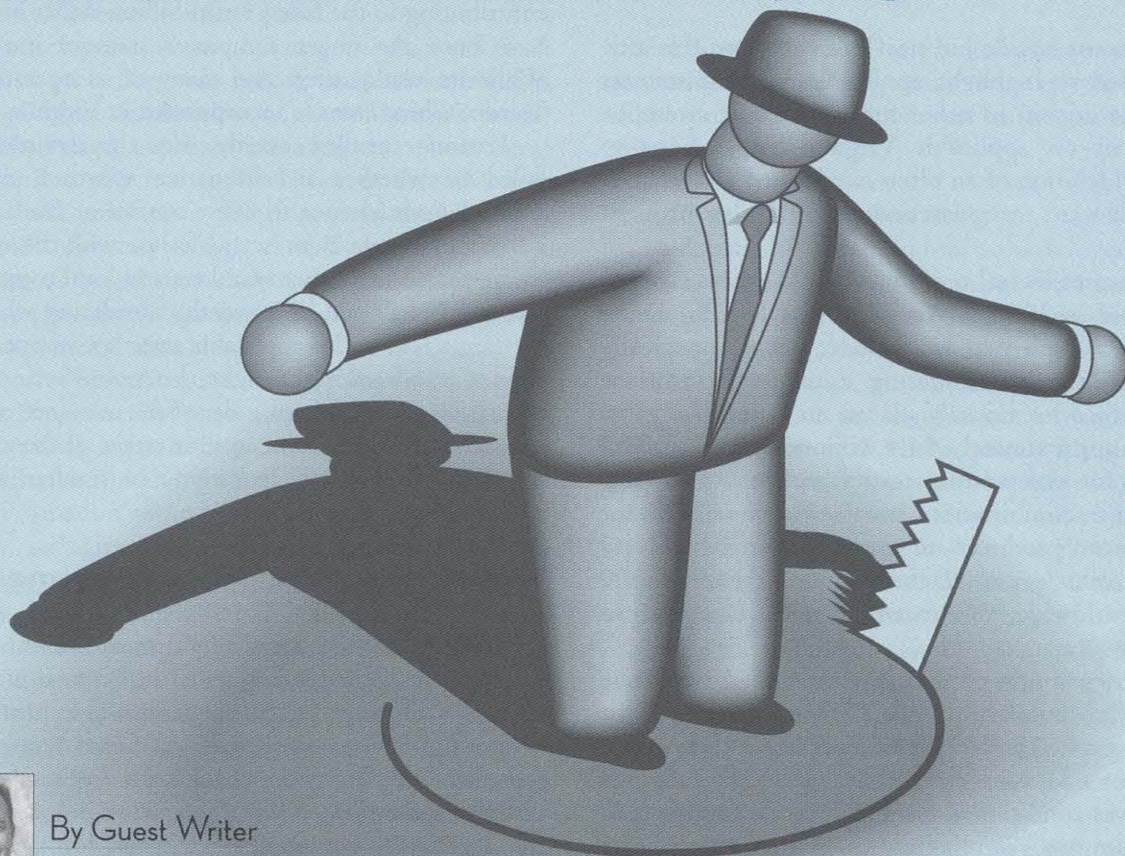
The Booby Traps In State Antitakeover Laws



By Guest Writer
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Most m&a lawyers are quite expert in the standards and requirements of Delaware corporate and federal securities laws, but less conversant with applicable state laws. If trends in the m&a market continue, legal advisers likely will need more expertise in state antitakeover statutes and their implications both for targets and acquirers. It is not safe to assume that the rules and challenges for targets and acquirers are uniform or that state law cannot play a central role in the outcome of a takeover bid.

Virginia statutes point up the formidable legal hurdles facing hostile bidders at the state level.

With a recent hostile bid providing context, this article is intended to highlight applicable Virginia statutes that could be critical to other future takeover attempts. While I focus on applicable Virginia law, I hope to prompt consideration of an often-overlooked area of state law that is relevant to transactions in a number of jurisdictions.

One high-profile deal that hinged on Virginia law was the hostile bid in 2003 by **ArvinMeritor Inc.** for **Dana Corp.**, a transaction that would have been strategically significant in the consolidating auto parts industry. ArvinMeritor's offer initially placed an enterprise value on Dana of approximately $4.4 billion, including $2.2 billion each for outstanding equity and assumed debt. The proposed combination involved two significant North American producers of a variety of products and systems for vehicle manufacturers, more than 90,000 employees worldwide, and an anticipated $17 billion in annual sales.

After a series of non-public expressions of interest were rebuffed, ArvinMeritor, on July 9, 2003, announced that it was launching a hostile bid for Dana, a larger competitor, in the form of a $15-per-share tender offer. The proposed acquisition was conditioned on the absence of restrictions stemming from two Virginia statutes — the Control Share Acquisitions Act and the Affiliated Transactions Act — as well as Dana's shareholder rights plan.

Consistent with its earlier rejection of ArvinMeritor's unsolicited proposals, Dana's directors formally recommended that the shareholders reject the offer and not tender their shares, citing a number of reservations about the bid. After only limited progress with the tender offer during the ensuing months, ArvinMeritor increased its bid by 20% to $18 per share but Dana's board remained steadfastly opposed.

In pressing the bid, ArvinMeritor filed a bill of complaint in Virginia state court seeking injunctive relief for alleged breaches of fiduciary duty by Dana's board of directors and a declaratory judgment that Dana's antitakeover measures were improper.

Ultimately, ArvinMeritor withdrew its takeover bid in November 2003 — after incurring approximately $16 million in banking, legal and other costs. ArvinMeritor also withdrew its lawsuit challenging the actions by Dana's board in opposing the bid.

ArvinMeritor's failure to acquire Dana could be attributed to a variety of factors, such as potential antitrust challenges, financing considerations, inadequate consideration, or differing strategic visions. However, a significant issue contributing to the failed multi-billion-dollar bid may well have been the target company's state of incorporation. While its headquarters and many of its operations are in Toledo, Ohio, Dana is incorporated in Virginia.

I cannot analyze exactly why the ArvinMeritor bid failed or whether an alternative approach might have allowed ArvinMeritor to wrest control of Dana. However, if a corporation such as ArvinMeritor, with the assistance of sophisticated investment bankers and legal counsel, fails in a costly, hostile bid, it is worth considering what leverage the target had under applicable state law in opposing such a bid. Considered in that light, the ArvinMeritor-Dana battle provides a helpful reminder of the relevance of Virginia's antitakeover statutes and an illustration of the challenges a hostile bidder may face in Virginia or in other jurisdictions with similar statutes.

Virginia's Antitakeover Regime

Standing between hostile bidders like ArvinMeritor and their chosen targets incorporated in Virginia is a statutory regime with four major elements. The principal antitakeover provisions are the Control Share Acquisitions Act, the Affiliated Transactions Act, and Virginia's poison pill statute. Additionally, while the business judgment statute is not specifically an antitakeover provision, it does allow directors a great degree of latitude in defending against hostile bids and it will be discussed later in that context.

Virginia's antitakeover regime is particularly daunting for hostile acquirers due to precedent established by the case under Virginia law of *WLR Foods v. Tyson Foods*, [1] when chicken and turkey producer WLR fought off an unsolicited bid by poultry and beef giant Tyson. *WLR-Tyson* is notable as a strong validation of the ability of a state such as Virginia to enact and enforce antitakeover statutes that are in addition to applicable federal securities laws and more restrictive than other states' laws.

Control Share Acquisitions Act

Under Virginia's Control Share Acquisitions Act, once a

hostile bidder acquires beneficial ownership of greater than 20% of a target's stock, the bidder's right to vote its shares — both the stock held before crossing the line and shares subsequently bought — can be extinguished. The voting power can be reinstated only by the affirmative vote of two-thirds of the outstanding shares not held by the bidder. The practical effect of this restriction, absent action by the disinterested shareholders (described below), is to withhold from the acquirer one of the central rights of ownership and the ability to exercise control, even when it acquires a substantial equity position in the target.

A Virginia corporation may opt out of the control share restrictions by providing in its bylaws that such restrictions are not applicable. At the time of ArvinMeritor's tender offer, Dana's bylaws expressly provided that the control share restrictions did not apply. However, ArvinMeritor could take little comfort in that fact given the ease with which Dana's directors could amend those bylaws. A Virginia target's board may skirt a shareholder vote and amend the bylaws by its own resolution to add or restore control share restrictions.

The Control Share Acquisitions Act provides a mechanism for a corporate buyer to ask target shareholders to reinstate its voting rights at a special meeting. This process is initiated by the bidder through a formal request that includes information about the acquirer and the proposed transaction, an agreement to pay the target's costs with respect to the meeting, and other procedural requirements. A majority of all disinterested shares entitled to vote is required to restore voting rights.

In practical terms, this reinstatement option does not appear to be a meaningful opportunity for a hostile acquirer if the target's board and management oppose the offer and have already recommended rejection. ArvinMeritor's need to file a lawsuit in support of its bid so early in the process may provide indirect evidence confirming this practicality.

One potentially important qualification to the Control Share Acquisitions Act arises out of the definition of an "issuing public corporation" incorporated into the definition of a "control share acquisition." An issuing public corporation is a Virginia corporation with 300 or more shareholders. One U.S. District Court has interpreted "shareholder" under Virginia law in the more narrow sense — that beneficial owners holding their shares through brokerages or other agents are not necessarily within the definition for determining whether the threshold is met. This threshold would not have precluded Dana's resort to the Control Share Acquisitions Act in response to the ArvinMeritor bid. However, even if it had

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been unavailable, the Virginia antitakeover provisions are nonexclusive and a corporation may rely on one or more of the provisions in defense of an acquisition bid (discussed below).

Affiliated Transactions Act

Under the Affiliated Transactions Act, certain transactions are prohibited for a period of three years following an acquisition of more than 10% of any class of the target's outstanding shares. The prohibited transactions include mergers with the acquirer or its affiliates, share exchanges in which the acquirer obtains additional stock, asset transactions with the acquirer, dissolution of the target, and reclassification of the target's equity. Such long-term restrictions make it more difficult for a potential buyer to consummate and ultimately to get the benefits of an acquisition, and discourage practices such as two-tier offers and "greenmail."

Like the Control Share Acquisitions Act, the Affiliated Transactions Act affords the buyer an opportunity to remove the restrictive effects through action by the board and/or the shareholders of the target. Prior to an acquisition of shares above the 10% beneficial ownership threshold, the acquirer may get the approval of a majority of the disinterested directors to avoid the statute's impact. Once a buyer has exceeded the ownership threshold, an affirmative vote of two-thirds of the voting shares of the issuer — not including those held by the buyer — is required. Also required for lifting the affiliated transactions prohibitions is approval by a majority of the target's board.

Acquirers may be able to gain additional exemptions from the Affiliated Transactions Act even without board or shareholder approvals if they can meet the terms of the statute's fair price mechanism. In rough terms, the fair price provisions provide objective criteria that indicate circumstances where antitakeover protections are not required — i.e., when there is an objectively fair offer to shareholders. The fair price mechanism could be a meaningful exception

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if the offer represents a premium over the price of the target's securities over the preceding two years and at the time of the acquisition is announced or executed. Another exemption is provided if the target is an investment company registered under the federal Investment Company Act of 1940.

Under Delaware law, there is a comparable statute to the Affiliated Transactions Act — the Business Combination Act. [2] Both were based on statutes enacted after the U.S. Supreme Court upheld the constitutionality of Indiana's antitakeover statutes in *CTS Corp. v. Dynamics Corp. of America* in 1987 [3]. Some important differences between the Delaware and Virginia statutes include the beneficial ownership thresholds triggering their effects on voting rights. For example, the Delaware law exempts an acquirer that obtains 85% of the target's shares at the same time it becomes an interested shareholder.

Poison Pill Statute

The ability of a board to put a poison pill in place is a potent tool available to defend against a hostile bid. Virginia law allows directors to set up a shareholder rights plan or poison pill plan without shareholder approval. Such plans under Virginia law may discriminate permissibly with respect to individual shareholders, subject only to standards for director conduct.

The standard of conduct for boards in Virginia in implementing a shareholder rights plan is expressly tied to the business judgment statute discussed in more detail below. Under that statute, adding or redeeming a pill as a defensive measure need only be done in the directors' "good faith business judgment" absent conflicts of interest. This concept includes the mandate that directors' use of a poison pill must be "in the best interests of the corporation." [4]

One variety of poison pills that is clearly permissible under Virginia law is the so-called "flip in" poison pill that allows existing shareholders to acquire more of the target's shares at extremely discounted prices — thereby substantially diluting the acquirer's ownership interest and the value of its shares. As recognized by the U.S. District Court in one of the *WLR-Tyson* cases, the poison pill "gives management a very strong tool to block a tender offer." [5]

Also apparently permissible under Virginia law is the so-called "dead hand" pill, which requires that a pill can only be redeemed by continuing directors. A "dead hand" pill commonly is understood to be fatal to a hostile bidder's efforts because if the bidder manages, by shareholder vote, to replace directors opposed to the bid, the new directors lack the power to rescind the pill.

Perhaps the most daunting of the defenses facing ArvinMeritor was Dana's poison pill adopted some years prior to the hostile bid. The trigger for Dana's "flip in" pill was basically tied to acquisition of 15% or more of Dana's shares.

Dana's board could redeem the pill if, say, the bid is friendly. However, the difficulty of forcing that redemption in view of the deference given directors under Virginia law makes that effort very difficult. Furthermore, the law allows the board to modify the pill. Although it is unclear whether changing the pill would be consistent with their duties under the business judgment statute, Dana's directors could have modified their existing pill to incorporate a "dead hand" feature.

Business Judgment Statute

According to Virginia's business judgment statute:

> "A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.
>
> "Unless he has knowledge or information concerning the matter in question that makes reliance unwarranted, a director is entitled to rely upon information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by:
>
> ...officers or employees...whom the director believes, in good faith, to be reliable and competent in the matters presented....[or] [l]egal counsel, public accountants...within the person's professional or expert competence...[or] a committee of the board...[that] merits confidence..."

Virginia's good faith business judgment standard is notable in that it differs significantly from most other statutory and common law formulations of the standards of care for directors. Most formulations are premised on what an

ordinarily prudent person would do as a director. However, the Virginia standard is based on a director's subjective judgment of the best interest of the corporation, rather than an objective prudent or reasonable person standard. The analysis basically turns on a determination of whether the director's decision was in good faith. The determination of good faith emphasizes process and procedures over substance.

Further highlighting the differences from prevailing jurisprudence in the antitakeover area, the Supreme Court of Virginia has considered this statutory standard of care and concluded that it requires rejection of the well-known *Revlon* [6] standard under Delaware law. In its *Willard* [7] decision, the Virginia Supreme Court also reaffirmed a process-over-substance approach and stated that the objective reasonableness of a director's decision is not a relevant inquiry under Virginia law. Consistent with this observation, the court refused to allow discovery of the substance of the financial and legal advice directors relied upon in making their decision. Without access to discovery about the substance of what directors consider, potential acquirers will have a difficult time, absent a process flawed enough to constitute bad faith, challenging a board's decision to oppose a takeover bid.

While it seems abundantly clear that direct challenges to Virginia's business judgment statute based on practices and standards in other jurisdictions will fail, the statute and some of its interpretations by the U.S. Court of Appeals for the Fourth Circuit and the Virginia Supreme Court are not without their critics.

Validation of the Antitakeover Regime in Virginia

Virginia's current antitakeover statutes, which are sometimes referred to as second-generation antitakeover statutes, result from a series of refinements to an earlier crop of state antitakeover statutes in Virginia and elsewhere in the country that were enacted in the wake of passage of the federal Williams Act in 1968. The U.S. Fourth Circuit struck down Virginia's prior attempt at state antitakeover statutes as a violation of the U.S. Constitution's Commerce Clause in the early 1980s.

Virginia's second attempt at antitakeover statutes was upheld in the Fourth Circuit's *WLR-Tyson* decision. In that case, the appeals court validated the constitutionality of each of Virginia's antitakeover provisions and affirmed the broad discretion afforded a board faced with a hostile bid. In addition, the *WLR-Tyson* decision observed that the various antitakeover provisions are nonexclusive. Therefore, advisers to potential acquirers must consider and address each of these statutory protections independently when a hostile bid is contemplated.

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The Virginia statutes highlighted here could be relevant again soon. Dana is not the only significant public corporation incorporated in Virginia. And Virginia is not the only state with strong antitakeover statutes.

In an environment in which m&a activity is on the rise, it is more likely that an understanding and appreciation of strict state antitakeover laws will be helpful, if not necessary, to m&a lawyers in Virginia and in a number of other jurisdictions. Well-advised parties should recognize that it's not prudent to rely on an understanding of well-established Delaware law to the exclusion of other state antitakeover statutes. Being aware of, and being proactive with respect to, applicable state antitakeover statutes can avoid costly mistakes and lead to better advice for clients involved in m&a transactions. ■

END NOTES

[1] Virginia Stock Corporation Act ß13.1-725 et seq.

[2] Delaware General Corporation Law ß203.

[3] 481 U.S. 69 (1987).

[4] See WLR Foods, Inc. v. Tyson Foods, Inc., 861 F. Supp. 1277, 1286 (W.D. Va. 1994) (affirmed by WLR/Tyson, supra note 1).

[5] Id. at 1285.

[6] See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[7] Willard v. Moneta Building Supply, Inc., 258 Va. 140, 151 (1999).

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