Stephen M. Bainbridge

Mergers and Acquisitions 3rd Edition

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MERGERS AND ACQUISITIONS

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By

STEPHEN M. BAINBRIDGE
William D. Warren Distinguished Professor of Law
UCLA School of Law

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PREFACE

Perhaps more than any other corporate transaction, mergers and acquisitions implicate a vast array of legal regimes. In any given transaction, issues may arise in such varied areas as corporate governance, securities regulation, tax and accounting, ERISA and other employment laws, successor liability and other tort doctrines, creditor rights, and, of course, antitrust. In deciding what subjects to cover in this text, I have kept in mind my primary target audience—namely, law students taking an advanced business law course such as Mergers & Acquisitions or Corporate Finance. (Of course, I hope the analysis will also prove useful to lawyers and judges seeking a fresh perspective on mergers and acquisitions.) Because most teachers of such courses focus on corporate and securities law issues, as do the several very fine casebooks in this area, I have focused on those subjects herein.

I have tried to produce a readable text, with a style that I hope is simple, direct, and reader-friendly. Even when dealing with complicated economic or financial issues, I tried to make them readily accessible to legal audiences. At the same time, however, I have not shied away from bringing theory to bear on doctrine. While the text has a strong emphasis on the doctrinal issues taught in today's M & A classes, it also places significant emphasis on providing an economic analysis of the major issues in that course. The text thus offers not only an overview of the black letter law, but also a unifying method of thinking about the subject.

I hasten to reassure the potentially worried reader that this text is designed for lawyers and law students—not graduate finance or economics students. Economic analysis is done solely qualitatively—no mathematical models or formal game theory—and kept as intuitive as possible. Even more important, economic analysis is never done for its own sake. In his well-known critique of modern legal scholarship, Judge Harry Edwards remarked: "Theory wholly divorced from cases has been of no use to me in practice."[1] My practice experience confirms that criticism, at least as long as we put strong emphasis on the phrase "wholly divorced." Theory brought to bear on specific legal issues often can be quite illuminat-

1. Harry T. Edwards, The Growing Disjunction Between Legal Education and the Legal Profession, 91 Mich. L. Rev. 34, 46 (1992) (quoting a former law clerk).

ing, as I hope to illustrate in this text. Economic analysis nevertheless is brought into play gradually and only in instances where it adds significant value.

In the interests of full disclosure, I should also note that this book is neither an encyclopedia nor a traditional hornbook. You will find no stultifying discussions of minutiae (I hope) or lengthy string citations of decades-old cases (or, at least, not very many).

A note on citation forms

In general, citations follow standard Blue Book form, but I have kept footnotes to the bare minimum. In particular, I refrained from using "id.," short form citations, and jump cites. Hence, unlike most modern law review articles, not every statement in the book is footnoted. Instead, I typically provide a source citation and allow interested readers to seek out pinpoint citations on their own. I strongly believe that this approach produced a more readable text. Finally, note that frequently referenced statutes and Restatements are cited in abbreviated form without dates, as follows:

ALI PRINCIPLES: American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994).

CAL. CORP. CODE: California General Corporation Law, California Corporations Code § 100 et seq. (West 1998).

DGCL: Delaware General Corporation Law, Delaware Code Annotated tit. 8 (1999).

Exchange Act: Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78a *et seq*. (1999).

MBCA: Model Business Corporation Act (1984 and supp.).

N.Y. Bus. Corp. L.: New York Business Corporation Law (McKinney 1999).

Rule: A rule adopted by the Securities and Exchange Commission under either the Securities Act or the Securities Exchange Act, 17 C.F.R. § 230.100 *et seq*. (1999) and 17 C.F.R. § 240.0–1 *et seq*. (1999), respectively.

Securities Act: Securities Act of 1933, as amended, 15 U.S.C. § 77a *et seq*. (1999).

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Chapter 1

INTRODUCTION

It is difficult to imagine how a modern economy could function without something like our present corporate finance system. The numerous technological changes wrought by the Industrial Revolution, especially the development of modern mass production techniques in the nineteenth century, gave great advantages to firms large enough to achieve economies of scale. In turn, those advantages gave rise to giant industrial corporations. These firms required enormous amounts of capital, far exceeding the resources of any single individual or family. They could be financed only by aggregating many small investments, which was accomplished by selling stock or bonds to many investors—each of whom held only a tiny fraction of the firm's total capital.

Capital markets facilitated this process in at least two respects. First, the primary market gave issuers access to a large and ever growing pool of potential investors. Second, the secondary markets for corporate stocks and bonds gave investors essential liquidity and, accordingly, encouraged investment. In a liquid market, investors can freely sell their securities without involving the firm. Liquidity, in turn, makes it easier and cheaper for the company subsequently to raise capital in the primary market, because investors generally prefer (and will be willing to pay more) for liquid securities.

Few corporate finance transactions, in either the primary or secondary markets, rival corporate takeovers in size, media notoriety, public policy implications, or economic significance. Indeed, mergers and acquisitions are mega-business. Back in 1989, in a case involving the Time–Warner corporation, then-Delaware Chancellor William T. Allen opined that a transaction valued at $30 billion "would be rare" but was at least theoretically possible.[1] In 2000, Time–Warner was acquired by AOL in a transaction valued at over $100 billion. In the subsequent decade, transactions exceeding the $30 billion level became routine.

Merger and acquisition activity tends to be cyclical, usually coinciding with boom periods for the stock market. Economic historians have identified four major "merger waves" in U.S. history: 1897–1904, 1916–1929, 1965–1969, and 1984–1989.[2] Most also agree that a fifth wave

1. Paramount Communications Inc. v. Time Inc., 1989 WL 79880 at 22 (Del.Ch.), aff'd, 571 A.2d 1140 (Del.1989).

2. William J. Carney, Mergers and Acquisitions: Cases and Materials 2–13 (2000); Patrick A. Gaughan, Mergers, Acquisitions, and Corporate Restructurings 23–56 (3d ed.

began in the mid–1990s. That wave was characterized by the prevalence of negotiated over hostile acquisitions, the enormous dollar values involved, and a record-breaking pace both in terms of the number of deals and their aggregate dollar value.[3]

With the economic downturn in the opening years of the new century, and the concomitant stock market decline, the pace slackened somewhat but mergers and acquisitions nonetheless remained a very significant feature of the economic landscape. In 2001, for example, while the number of acquisitions dropped to the lowest level since 1998 and their aggregate dollar value dropped to the lowest level since 1997, there were still 8,265 deals worth an aggregate of more than $700 billion, including more than 100 transactions valued at $1 billion or more.[4]

The rate of M & A activity bottomed out in 2002 but then picked up significantly before peaking in 2007. The economic crisis and recession of 2008 again triggered a drop in the number of acquisition deals. By 2010, however, despite the slow pace of economic recovery, the volume of M & A activity had begun to recover. There were 9,116 acquisitions announced in 2010, a 34% increase over 2009. The total value of those deals was $690 billion, an increase of 24% over 2009. As a result, mergers and acquisitions remain a key part of the practice of corporate finance law.

§ 1.1 The Corporation

Because the asset traded in the market for corporate control is the corporation itself, a review of some basic concepts may be useful for some readers.

A leading legal dictionary defines the corporation as "an artificial person or legal entity created by or under the authority of the laws of a state or nation. . . ."[5] Although technically correct, this definition is not especially enlightening. You may find it more helpful to think of the corporation as a legal fiction characterized by six attributes: formal creation as prescribed by state law;[6] legal personality; separation of

2002); Ronald J. Gilson and Bernard S. Black, The Law and Finance of Corporate Acquisitions 11–61 (2d ed. 1995).

3. William J. Carney, Mergers and Acquisitions: Cases and Materials 7–8 (2000).

4. M & A News and Trends, Mergerstat Rev., Jan. 2002.

5. Black's Law Dictionary 307 (5th ed. 1979).

6. Virtually all U.S. corporations are formed ("incorporated") under the laws of a single state by filing articles of incorporation with the appropriate state official. (A very few exceptions are formed under federal law.) The state in which the articles of incorporation are filed is known as the "state of incorporation." The founders of a company are free to select any state as the state of incorporation; they need not select the state in which the company is currently doing business. Selecting a state of incorporation has important consequences, because corporate law matters usually are governed by the law of the state of incorporation, irrespective of the jurisdiction in which suit is brought or the residence of the other parties to the dispute.

ownership and control; freely alienable ownership interests; indefinite duration; and limited liability.[7] Taken together, these six attributes give the corporate form considerable advantages for large businesses as compared to the other forms of business organizations available under U.S. law.

A. Some Fundamental Distinctions

Corporations come in a wide variety of flavors: business corporations, municipal corporations, and ecclesiastical corporations, to name a few. In this text, we are concerned solely with business corporations. Even with that limitation, however, here are a number of fundamental distinctions to bear in mind:

- *Not-for-profit versus for-profit corporations*. Many charitable organizations are organized as corporations, even though they do not carry on for-profit business activities. Special "non-profit" corporation statutes govern these organizations. Not-for-profit corporations can also qualify for special tax treatment under both state and federal law. As the name implies, the profit motive is what distinguishes business corporations from nonprofit corporations.
- *Public versus private corporations*. The term public corporation is sometimes used to refer to corporations created by the government (be it federal or state) to carry out some public function. In this terminology, private corporations are created by and owned by private individuals to carry out private functions. Almost all business corporations fall into the latter category. Because this text focuses solely on business corporations, we will exclusively use the term "public corporation" in the sense set forth in the next paragraph.
- *Close versus public corporations*. Business corporations generally are divided into two main categories: close corporations (a.k.a. closely held corporations) and public corporations (a.k.a. publicly held corporations). As a general rule of thumb, close corporations tend to be smaller than public corporations, but size is not what distinguishes the two categories. Instead, they are distinguished by the presence or absence of a secondary trading market for their shares of stock. Public corporations are those whose stock is listed for trading on a secondary market, such as the New York Stock Exchange or the NASDAQ system. Close corporations are those whose stock is not listed on such a market. In this text, the term public corporation will be used in this sense.

7. Note that the latter four of these attributes are default rules. Some corporations opt out of one or more of them. In particular, close corporations often unify ownership and control to one degree or another and/or restrict transfer of ownership interests.

Of these three distinguishing characteristics, the last is most salient for our purposes. Corporate securities, like all commodities, are traded in markets. Corporate lawyers distinguish between two basic types of markets in which a corporation's securities (such as stocks or bonds) are traded: the primary market and the secondary market. The primary market is the one in which the corporation sells its shares to investors. An initial public offering (IPO), for example, takes place on the primary market.

The secondary market is a trading market: the one in which investors trade stocks among themselves without any significant participation by the original corporate issuer of the shares. The New York Stock Exchange and the American Stock Exchange are well-known, highly organized, and thoroughly regulated examples of secondary markets. Market professionals working on these exchanges facilitate the trading process by matching buy and sell orders from investors.

Having a corporation's securities listed for trading on a secondary market is significant because it makes the securities liquid. In other words, investors can freely sell their securities without involving the firm. Liquidity, in turn, makes it easier and cheaper for the company subsequently to raise capital in the primary market, because investors generally prefer (and are willing to pay more) for liquid securities. The difference in liquidity of publicly held corporate stock and that of close corporation stock has important theoretical and doctrinal consequences.

B. Sources of Corporation Law

Corporate law differs in two important respects from the common law courses taken by most law students during the first year of law school. First, statutes are far more important in corporate law than is the case in most of the so-called common law courses. When faced with a corporate law issue, the first place one always looks is the corporation statute of the state of incorporation.[8] Second, as far as public corporations are concerned, federal law is much more important in corporate law than is the case in common law subjects. Indeed, publicly held corporations can be said to function in a dual regulatory scheme: federal securities law and state corporate law. This is particularly the case with respect to mergers and other corporate acquisitions, where both state and federal law play very important regulatory roles.

8. Although one must pay careful attention to the applicable state corporation statute, judicial opinions remain quite important in corporate law. Corporation statutes almost never rise to the level of detail found in, say, the federal tax code. Many provisions of corporation statutes are quite vague. Worse yet, corporation statutes often fail to address important issues. Courts have filled the resulting gaps through a process far more closely resembling common law adjudication than statutory interpretation. The fiduciary duties of directors and officers are especially prominent examples of this process, but they are hardly the only ones.

1. State Corporate Law

Virtually all U.S. corporations are formed ("incorporated") under the laws of a single state by filing articles of incorporation with the appropriate state official. (A very few exceptions are formed under federal law.) The state in which the articles of incorporation are filed is known as the "state of incorporation." Selecting a state of incorporation has important consequences, because of the so-called "internal affairs doctrine"—a conflicts of law rule holding that corporate governance matters are controlled by the law of the state of incorporation. Virtually all U.S. jurisdictions follow the internal affairs doctrine, even if the corporation in question has virtually no ties to the state of incorporation other than the mere fact of incorporation.

Suppose, for example, that Acme, Inc., is incorporated in Delaware, but all of Acme's assets are located in Illinois. All of Acme's shareholders, directors, and employees reside in Illinois. Acme's sole place of business is located in Illinois. An Acme shareholder brings suit against the board of directors, alleging that its members violated their fiduciary duty of care. The lawsuit is filed in an Illinois court. Despite all these Illinois ties, the Illinois court nevertheless will apply Delaware law.[9]

The internal affairs doctrine takes on particular transactional significance when considered in conjunction with the constitutional restrictions on a state's ability to exclude foreign corporations.[10] With rare exceptions, states have always allowed foreign and pseudo-foreign corporations to do business within their borders. As early as 1839, for example, the U.S. Supreme Court held that federal courts should presume a state would recognize foreign corporations in the absence of an express statement to the contrary by the legislature.[11] A subsequent Supreme Court decision implied that states could not exclude foreign corporations from doing business within the state provided that the business constituted interstate commerce under the Commerce Clause of the U.S. Constitution.[12] These decisions effectively created a common market for corporate charters. If Illinois, for example, adopts a restrictive corporation law, its businesses are free to incorporate in a less

9. See, e.g., Paulman v. Kritzer, 219 N.E.2d 541, 543 (Ill.App.1966), aff'd, 230 N.E.2d 262 (Ill.1967) (applying Delaware fiduciary duties to the directors of a Delaware corporation).

10. A foreign corporation is one incorporated either by a state or nation other than the state in question. A pseudo-foreign corporation that has most of its ties to the state in question rather than to the state of incorporation. Many Delaware corporations are pseudo-foreign corporations. They are incorporated in Delaware, but most of their operations are located in one or more other states. In most states, there is no significant legal difference between a foreign and a pseudo-foreign corporation, and the internal affairs doctrine will be applied to invoke the law of the state of the incorporation. California and New York are the principal exceptions to this rule. Both states purport to apply parts of their corporate laws to pseudo-foreign corporations formed in other states but having substantial contacts with California or New York. See, e.g., Cal. Corp. Code § 2115; N.Y. Bus. Corp. L. §§ 1317–20.

11. Bank of Augusta v. Earle, 38 U.S. 519, 597 (1839).

12. Paul v. Virginia, 75 U.S. 168 (1868).

restrictive state, such as Delaware, while continuing to conduct business within Illinois.

Throughout the nineteenth century state corporation laws gradually moved in the direction of increased liberality, making the incorporation process simpler on the one hand, while at the same time abandoning any effort to regulate the substantive conduct of corporations through the chartering process. In later years, this process became known as the "race to the bottom."[13] Corporate and social reformers believed that the states competed in granting corporate charters. After all, the more charters (certificates of incorporation) the state grants, the more franchise and other taxes it collects. According to this view, because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes allowing corporate managers to exploit shareholders.

Many legal scholars reject the race to the bottom hypothesis.[14] According to a standard account, investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not make loans to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms thereby become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers therefore have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters thus should deter states from adopting excessively pro-management statutes. The empirical research appears to bear out this view of state competition, suggesting that efficient solutions to corporate law problems win out over time.[15]

13. See generally William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974) (classic statement of race to the bottom hypothesis); see also Lucian Ayre Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1437 (1992).

14. See Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977) (the seminal response to Cary); see also William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. Legal Stud. 303 (1997); Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540, 654–71 (1984); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913 (1982); Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987); cf. Jonathan R. Macey and Geoffrey P. Miller, Toward an Interest Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987) (public choice-based theory of state competition).

15. See Roberta Romano, The Genius of American Corporate Law (1993) (setting forth both an empirical analysis and theoretical arguments challenging race to the bottom hypothesis). As even many advocates of the race to the top hypothesis concede, however, state regulation of corporate takeovers appears to be an exception to the rule that efficient solutions tend to win out. See, e.g., Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L. Rev. 843 (1993); Ralph K. Winter, The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526 (1989); see also