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Hidden Trap for Large Investors under the Tennessee Business Combination Act

By Jonathan Stanley

The Tennessee legislature enacted the Tennessee Business Combination Act in the late 1980's in response to a trend of hostile takeovers of public companies. Legislatures in many other states passed similar statutes in the same period. These statutes are remarkable both for their complexity and for their ability to create traps for unwary investors that purchase large stakes in public companies. The TBCA is not unusual in its complexity, but it is unusual in that its restrictions, once tripped, cannot be waived, even if the investor, the board, and the shareholders of the subject company all desire to waive them. This article spotlights some of the TBCA's restrictions, as well as the consequences of tripping them.

TBCA Defined

The TBCA's restrictions arise if a shareholder obtains 10% or greater ownership in a Tennessee corporation without the corporation's board either:

- approving in advance the shareholder's acquisition of 10% or greater ownership; or
- approving in advance a business combination in which the shareholder plans to take the corporation private.

The advance approval requirement is crucial here. It means that a shareholder who obtains 10% ownership in a Tennessee corporation cannot later reach an agreement with the corporation's board to take the company private. Even the approval of the board combined with a supermajority of the corporation's other shareholders will not lift the TBCA's restrictions if the approvals occur after the date that the shareholder obtained 10% or greater ownership.

TBCA's definition of a 10% shareholder is complicated. It includes not only a single person or entity that holds a 10% stake, but also groups of shareholders that are "acting in concert." The courts have not ruled on what constitutes acting in concert, which raises the prospect that two 5% shareholders who hold a meeting to strategize could potentially have their holdings aggregated to invoke the restrictions of the TBCA on both of them.

TBCA Restrictions

Once invoked, the TBCA's restrictions are harsh. For a 5-year holding period after the shareholder obtains 10% or greater ownership, the TBCA bans business combinations between the shareholder and the corporation. This includes mergers and consolidations, share exchanges, sales or mortgages of more than 10% of the assets of the corporation, most transfers of shares or warrants to purchase shares, dissolutions and reincorporations of the corporation, and transactions such as reverse stock splits that increase the proportionate

share of a person in the corporation.

Even after the 5-year holding period has expired, no business combination can occur unless:

- 2/3 of the holders of the voting stock of the corporation approve it; or
- the business passes a series of objective fairness tests.

A 10% shareholder may avoid the restrictions of the TBCA by divesting sufficient stock to fall below the 10% mark. However, if at any point that shareholder again reaches the 10% mark, even with advance board approval, the restrictions will again apply because the shareholder did not have board approval prior to the first time he became a 10% shareholder.

TBCA Exclusions

It is worth noting that there are many situations in which the TBCA does not apply. It does not generally apply to companies that are not publicly traded, and grandfathers investors who held their ownership stake prior to March 11, 1988. In addition, public companies can opt out of the TBCA with a provision in their charter or bylaws, subject to certain delays in effectiveness.

Though it applies in a relatively small set of situations, proper care is essential in negotiating the TBCA because the consequences are so significant and difficult to cure. For further guidance on how the TBCA might affect your business, please contact Jon Stanley (615-251-1092) or Kris Kemp (615-251-1080).