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April 2, 1983

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Re: SEC Advisory Committee

Dear Irwin:

I enclose, at last, some preliminary views on the topic of our subcommittee. Sorry this has taken so long. The views are indeed tentative, so I look foreward to discussing them with you and Ray sometime this coming week (Tuesday to Thursday will be best; I'll be out of town Friday April 8).

I also have Marty Lipton's latest effort (via Kidder, Peabody) to show that defense is really a Great Thing because targets do better after defeating an offer than before. Dan Fischel and I criticized Marty's earlier effort (see our piece in 36 Bus. Law. 1733, 1741-43), and this one is no better. The latest data still fail to take into account the ordinary return to investment that the target's shareholders could have obtained. The data are "discounted" at the rate of inflation, not (as they should be) at the rate of change in the value of other equity investments of similar risk. The Kidder study amounts to saying that someone with a stock selling for $50 on Jan. 1, 1982, was better off if the stock sold for $52 on Dec. 31, 1982 (the 4% gain exceeds the 3.9% rate of inflation), even though every other equity investment rose by 30% or so in the same period. I assume investors care about gains and losses relative to other investments, not about nominal dollars. But more on this when the Economics Subcommittee reports.

Sincerely,

Frank

Frank H. Easterbrook
Professor of Law

cc: Ray J. Groves
Chairman & Chief Executive Officer
Ernst & Whinney
153 East 53d Street
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## TENDER OFFERS, OTHER STATUTES, AND THE STATES

1. I assume that the Subcommittee has resolved affirmatively (or will recommend an affirmative resolution of) the question whether the Advisory Committee should "consider" the relation of tender offer regulation to other schemes. There is often a close relation that is unwise to overlook, even if on reflection the Advisory Committee decides to recommend no change.

2. On the relation between tender offers and tax: It is troubling that tax laws discriminate according to the form of a tender offer. All cash offers produce recognition of gain, while securities offers can be structured to create (or avoid) gain. As a practical matter, structuring the deal to avoid recognition is possible only in friendly offers: there are no hostile offers of securities (only cash), and it is hard to structure even the back end of a two-tier hostile offer to avoid taxation. Thus the tax laws offer considerable shelter to managers, by imposing on hostile bidders a cost not borne by friendly bidders.

There is no very good reason for this discrimination. Surely the usual goal of tax (raising revenue by recognizing gain on occasions when valuation problems are not too severe) is not served by the distinction, and there is no tax reason for attempting to discourage unfriendly offers. Moreover, one of the common justifications for recognizing gain (the shareholder's voluntary conversion of the form of his assets) is not really present in tender offers.

It might be tempting to recommend that taxation be "rationalized" by treating all securities exchanges alike. This would not, however, handle the discrimination against cash offers. I think that it would be preferable to recommend revising the tax laws so that tender offers are treated as nonrecognition events. As with the treatment of owner-occupied houses, the tax law might permit a person taken out in a tender offer to reinvest the proceeds in equities within 21 days and take a basis in the new investment equal to the basis in the old. This would reduce the cost of changes of corporate control, without affecting the government's revenue any more than if there had been no change of control (or it had been friendly enough to be structured as a tax-free exchange).

If subtleties are to remain in the tax treatment of tender offers, then it would make sense to follow Ray Groves's suggestion and require expedited treatment of requests fore rulings. I'm less sure that the SEC or Congress could require the IRS to rule; sometimes time is just too short, and the deal must go foreward on the basis of the opinions of private counsel. Similarly, the Antitrust Division and the FTC cannot always make a final decision on antitrust consequences during the pre-tender period. But surely there could be some sort of honest-efforts requirement.

Finally, I agree with Ray Groves that any form of "minimum merger tax" is exactly the wrong direction in which to move. A merger is a form of capital investment (in a whole firm at a time) that increases productivity. There is no more reason for a special tax on this than on the purchase of new machines (which now bring a tax credit).

3. There are two banking topics that I have heard raised from time to time in connection with tender offers. One is whether banks should lend to bidders that want to take over the banks' customers; the other is whether banks should finance tender offers at all because tender offers "use up credit" that could be employed for better purposes. (Chairman Volker's views, quoted in the Senate Banking Committee's letter, are as unclear to me as they were to Ray Groves. Perhaps he means that banks make tender offer loans that are riskier than other forms of loans for the return involved, but I don't see why they would do that, and I know of no evidence that could support such a view.)

a. The role of banks in financing offers hostile to the managers of the banks' customers seems properly left to the law of contract. In the first place, it is far from clear that a "hostile" offer is deleterious to the bank's customer (as opposed to the customer's managers). If the offer is above market, the customer's shareholders will be delighted. But the dispositive point here is that if banks' customers want protection from such financing, they could arrange for it by contract. Presumably they would have to pay the banks; the limitation would cut off some profitable opportunities for the banks, which would demand compensation. But this is the usual stuff of contract law.

The related point -- that banks have confidential commercial information of the customers -- should be handled the same way. Customers that want their information held in confidence can negotiate for this and compensate the banks accordingly. See Comment, The Responsibilities of Banks in Financing Tender Offer Takeovers of Customers, 48 U. Chi. L. Rev. 439 (1981). I wonder whether many customers would pay much for an increase in confidentiality; after all, the information may be quite valuable to the banks in deciding whether to lend to bidders, and the value of the information ultimately inures to shareholders if it leads to good bids and prevents unwise ones, but this kind of speculation should not be dispositive. We can find out from looking at the market where the real values lie here.

b. On the subject of lending, I think the Advisory Committee should take a strong stand. The arguments advanced by Robert Reich of Harvard, and other Atari Democrats, are feeble.

The argument goes like this. Banks have only so much money to lend. They can lend it to finance new capital investment (as for example the building of a new factory, or R&D on a new invention) or to take over existing assets. If they lend to take over existing assets, then the economy suffers. Pie-slicing is substituted for pie-enlarging conduct. We fall farther and farther behind Japan. Thus banks should be forbidden to loan for tender offers.

The argument is specious, and the Advisory Committee should say so. The economic point is simple. Credit can be used without being used up. A bank that makes a commitment to lend does not restrict its power to make other loans until the commitment is drawn upon. Once it is drawn upon, and money leaves the bank, it goes someplace else (the money is not used up). The new holders of the money (tendering investors) deposit the money in their own banks, or reinvest with those who do, and the banking system then has as much to lend as it did before the offer was made.

Another and stronger way to put it: the Reich argument assumes that money used in tender offers is "lost" and diverted from new investment. Yet it is no more lost and diverted than the money paid to shareholders in dividends, the interest paid on savings accounts, or the cash paid for the 75 million shares of stock that change hands on an average trading day on the N.Y. Stock Exchange. Whoever gets the money thus paid reinvests it. Indeed, the existence of tender offer premia makes investments in stock relatively more attractive than before. Tender offers do not use up real resources or reduce the percentage of GNP invested in capital formation.

4. There is an obvious relation between tender offers and antitrust, and I have written on a small part of that relation. Easterbrook & Fischel, Antitrust Suits by Targets of Tender Offers, 80 Mich. L. Rev. 1155 (1982). I think, though, that this relation is primarily substantive: that is, when do tender offers lead to aggregations of assets that produce anticompetitive results? This question is outside the bounds of the Advisory Committee's charge and should be left to the courts, the Antitrust Division, and the FTC.

The only question colorably within our charge concerns timing. The Hart-Scott-Rodino act of 1976 requires substantial prior notification of antitrust officials concerning impending acquisitions, including acquisitions by tender offer. The time deadlines for prior submission to the FTC and Antitrust Division ought to be made congruent with the time deadlines under the Williams Act, and the SEC's rules, for the securities law aspects of tender offers.

This is of course an impossible dream, because the antitrust and securities deadlines serve different functions. I think, though, that they can be accommodated in the following way. If the Advisory Committee concludes that bidders should be allowed to complete their acquisitions in less time than HSR now requires for antitrust purposes, perhaps because as the Supreme Court held in Edgar v. MITE Corp., 102 S. Ct. 2629 (1982), longer delay unduly tips the scales in favor of targets' managers, then further HSR delay would frustrate the efficient operation of capital markets. HSR could be amended to let the bidder acquire the shares at its own (antitrust) risk, accompanied by an automatic hold-separate obligation. That is, the bidder would have the shares but could not integrate its operations with those of the target until the HSR deadlines had passed. This should sufficiently achieve the purposes of both securities and antitrust laws.

5. The relation between tender offer law and ERISA presumably means: When can a pension fund purchase (or sell) shares of a target company in order to frustrate the accomplishment of an offer? The Advisory Committee should indicate that this requires simply an application of the fiduciary duty of the pension fund's trustees: they should do what is necessary to make the most money for the beneficiaries of the trust. This seems to be the prevailing law, see Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982) (the Grumman-LTV case), and I see no need for either extensive analysis by the Advisory Committee or any recommendation for change.

6. The relation of federal to state law of one of great difficulty. We will need to spend a good deal of time talking this one out. I just want to convey here the rough outlines of a position.

We need to distinguish, I think, between aspects of state law that enforce agreements among shareholders (and other participants in the corporate venture) and aspects of state law that override such agreements and purport to control how people can trade their shares in the aftermarket. This is a different way of putting the interstate commerce point in Edgar v. MITE Corp. that Illinois could not, in the name of the internal affairs doctrine, prohibit out-of-staters from dealing in stock that was not restricted from the start.

There are surely many reasons why firms would want to control trading in the market, and why state laws would properly enforce such agreements. This is easy to see for close corporations, where the identities of the stockholders are important to all of the investors. It is also true that in any competitive market for public corporations, firms would offer investors a variety of choices of organizational form. Some firms would put anti-takeover provisions in the articles, others would throw themselves open to takeover. Investors could choose which they preferred; the forms most favorable to investors would prevail in the market; those who bought stock in anti-takeover firms could hardly complain when the corporate charter provisions were enforced.

Similarly, though, those who bought stock in firms that seemed open to takeovers -- at the time the stock was traded -- have a legitimate gripe when managers begin digging moats and trenches, and when state laws such as the one involved in MITE protect the managers and destroy a form of open market monitoring that the investors thought was among the protections they had from the vicissitudes of life.

Thus I tentatively favor the following sort of preemption rule: all state laws on takeovers that affect trading among out-of-state buyers and sellers of stock, _other than to enforce rules that were in place at the time the shares in question were issued_, are preempted by federal law. When such contractually designed rules, or state laws at the time of issuance that might be treated as implicit terms of the contract, conflict with subsequent federal rules, the contractual or state rules control. Finally, federal rules preempt only to the extent they are procedural. Federal rules should not be deemed to have any substantive content. Thus the Sixth Circuit's Mobil-Marathon decision, which found substantive content in the Williams Act, seems to me unsupportable (and undesirable).

All of this may seem a bit strange, given my writings and my antipathy to defensive tactics. But I'm trying to make a distinction between implementing an original plan, where many people in many states with many plans compete for capital, and subsequent changes in the plan that work to investors' detriment. I think state (enabling) regulation generally preferable to federal precisely because the ability of corporations to move from one state to another puts pressure on states to select the set of legal rules that best serve shareholders, while selection of a uniform federal principle that precludes private contracting removes this competitive pressure. This argument follows directly from Judge Winter's _Government and the Corporation_ (1978), and I have tried to elaborate on it elsewhere. Easterbrook, _Antitrust and the Economics of Federalism_, 26 J. Law & Econ. 42 (1983); Easterbrook & Fischel, _Voting in Corporate Law_, 26 J. Law & Econ. (June 1983). I'll spare you the details here, since we'll surely talk about the subject later.