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May 31, 1983

Irwin Schneiderman, Esq.
Cahill Gordon & Reindel
80 Pine Street
New York, New York 10005

Re: Advisory Committee on Tender Offers

Dear Irwin:

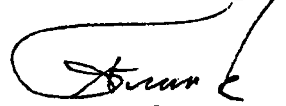
I enclose a draft "final" report of our subcommittee. Since the subcommittee had not discussed fully all of the subjects I raise in the report, it may not reflect full agreement. As best I can recall, however, it reflects agreements on those matters we have covered expressly. For the rest I am on my own.

Perhaps we should set up a conference call once all of us have reviewed the draft. Unfortunately (for convenience of calling, anyway) I'll be hiking in the mountains from June 3-8. You can track me down at the Tamarron resort in Durango, Colorado. I'll miss the June 2 meeting, but I'll be in D.C. on June 10.

I also enclose a detailed set of comments on the report of the joint bidders-targets subcommittee. As you can see, the joint subcommittee did not persuade me. I hope I can persuade you.

Best regards.

Sincerely,



Frank H. Easterbrook
Professor of Law

cc: Jeffrey B. Bartell, Esq.
Ray J. Groves
David B.H. Martin

Enclosures

SEC Advisory Committee on Tender Offers

Report of the Subcommittee on Relationships with Other Systems of Regulation

This Report sets forth the subcommittee's positions on the relation between federal tender offer regulation and other forms of regulation, including both other federal systems and state law.

The members of this subcommittee agree with the positions taken by the subcommittee on basic objectives and the joint subcommittee on the regulation of bidders and targets: regulation should ensure a national market in securities, state laws should not interfere with this national market (but properly may apply to local businesses and to industries traditionally subject to extensive state regulation), and tender offer regulation should not be used to achieve goals other than the protection of investors. Additional and to some extent competing goals -- whether of antitrust, labor, tax, or control of credit -- should be achieved through laws directed expressly to those objectives. Nonetheless, the other regulations impinge on tender offers, and it is desirable to harmonize the systems to the extent possible.

With these principles in mind, we turn to the particular subjects of overlap between federal tender offer regulation and other regulatory systems.

1. Antitrust Law. The subcommittee is strongly of the view that there should continue to be a system of prior review of tender offers by antitrust authorities, so that potentially anti-competitive acquisitions may be halted before they take place. The Department of Justice's comments (May 2, 1983) conclude that a system of prior review is vital to antitrust, and the Chairman and staff of the FTC took the same position in our meeting with them on May 6, 1983.

There is nonetheless an avoidable tension between the system of prior antitrust review established by the Hart-Scott-Rodino Antitrust Improvements Act, 15 U.S.C. §18a (1976), and the system of tender offer regulation contemplated by the Advisory Committee. The Committee tentatively proposes a 30-day minimum offer period for cash and securities bids alike, with the bidder entitled to purchase the shares after that time. The H-S-R Act, on the other hand, distinguishes cash from securities offers and may require a bidder to wait longer than 30 days before acquiring shares. Our discussions with the Chairman and staff of the FTC lead us to conclude that neither of these differences is important to antitrust policy, and that changes in the administration of H-S-R, by legislation or rulemaking, would harmonize the systems.

The provisions of the Act. The H-S-R Act establishes a notification and waiting period of 30 calendar days for securities offers and 15 calendar days for cash offers, the period to begin when the bidding company furnishes extensive information to the Antitrust Division and the FTC. The bidder may not acquire

any shares until this period has expired (unless earlier terminated by administrative discretion, which now occurs in some 24% of all cases). If the Division or Commission lacks sufficient information, it may make an additional request for data. If it makes this additional request, the acquisition may not occur until data satisfactory to the enforcement agency have been furnished and a further 20 days for securities offers (10 days for cash offers) has lapsed after the information has been received. Again, the agency may grant early termination.

Cash versus securities offers. The time differences in the H-S-R Act appear to be based on the assumption that securities offers are friendly bids and that 30 days (plus time to furnish documents, plus 20 days more) is a reasonable time for enforcers to examine offers in the absence of an ongoing contest. The Act cuts the time in half for cash bids on the assumption that these are more likely to be hostile, and time is more likely to be important.

The Advisory Committee's recommendation that securities offers be put on a par with cash offers will change the assumption on which Congress acted. If the Committee's recommendations are adopted, it would be appropriate to distinguish, not between cash and securities offers, but between friendly and hostile offers. For friendly offers the enforcement agencies would take the time now specified for securities bids, and for hostile offers the time now specified for cash bids. The bidder should be required to identify its offer as friendly (that is, having the consent of the target's board) or hostile. An initial period of

15 calendar days in hostile offers would enable antitrust enforcers to act well in advance of the termination of the tender offer waiting period, so that the antitrust news would be disseminated in the securities markets. Even in the rare event of a second request for documents (of which there were only five from January 1982 through April 1983), it should be possible for the bidder to furnish the documents and complete the antitrust review before the tender offer period has expired. The two H-S-R periods (15 plus 10 days), plus the time to reply to the second request, usually will be less than the 30 days contemplated by the Advisory Committee.

Harmonizing the end of the periods. Under H-S-R the bidder cannot purchase the shares until the expiration of the statutory time. If there is a second request, and if the bidder requires more than five days to supply the documents, the H-S-R period will extend beyond the tender offer period, unless earlier terminated. It will disable the bidder from acquiring the shares on the 30th day. In contested auctions, a few days may mean the difference between success and failure.

The purpose of the H-S-R period is to ensure that a merger does not take place before the enforcement agencies have fully evaluated the merits. Once the merger occurs, it is hard to unscramble the eggs. It is possible, however, to harmonize both the antitrust interest in avoiding shotgun mergers and the tender offer interest in permitting the completion of transactions on the 30th day. We recommend that bidders to allowed to take down the shares on the 30th day, no matter what the status of the

H-S-R review, **at their own risk, and subject to a hold-separate order.** Once the H-S-R review periods expire, the bidder would acquire control of the stock, subject -- as is the case now -- to the risk of suit by the enforcement agency, which may seek an interim judicial hold separate order and ultimate divestiture.

This accommodation will not affect antitrust interests, for it gives the antitrust agencies what they need. It does not affect any burdens under the H-S-R Act, because it still requires the antitrust agencies to seek judicial relief to extend the hold-separate period beyond the waiting periods specified in the statute. And it does not change the risks borne by the bidder: any firm that acquires stock before it receives the blessing of the antitrust agency does so at its own risk, whether it acts on the 30th day or the 40th day.

The proposed accommodation could be accomplished by rule-making. Both the FTC and the Antitrust Division might promulgate rules agreeing in advance to "terminations" of the waiting periods under the H-S-R Act on the 30th day, provided the bidders agreed to hold-separate orders of the sort described. The FTC has indicated willingness to consider such a rule if the Advisory Committee so recommends. The accommodation also could be accomplished by statute.

Other changes. The H-S-R Act now requires an acquiring firm to file a notice whenever it obtains either 15% of the stock or $15 million aggregate value of securities in specified firms. If the firms are large, the $15 million trigger may be reached before the 5% trigger under the Williams Act. A question arises

whether the H-S-R filing rule should be changed to make the triggers compatible, especially because an early H-S-R filing may tip off a target's management and change the balance of advantage in a contest for control. The FTC's staff suggested the possibility of allowing a bidder to make a secret filing at the $15 million level, if it so chose, provided that it had not yet acquired 5% of the stock. This seems a satisfactory accommodation, which your subcommittee recommends.

2. **Taxation**. The subcommittee considered ways in which the taxation of cash and stock offers, friendly and hostile offers, might be equalized. This seemed important because hostile offers generally were for cash, triggering taxation, while friendly offers could be arranged to avoid recognition of gain. The proposal to put cash and securities offers on a par greatly alleviates this problem, which, the subcommittee decided, probably could not be addressed in any other way without creating significant new routes of tax avoidance.

The subcommittee also considered proposals to permit mixed cash-securities packages without either (a) triggering taxation of the cash portion at ordinary income rates, or (b) requiring the shareholders to elect all-cash or all-stock consideration. Under current IRS policy, more than 50% cash in such a mixed package is likely to produce taxation at ordinary income rates, as the cash will be assimilated to a dividend. At least in the case of tender offers, calling the cash "boot" a dividend is an implausible and confusing treatment. A representative of the IRS

has offered to review this policy with the staff of the SEC, and as that process of consultation is ongoing the subcommittee withholds any recommendation at this time.

On other tax matters, the subcommittee strongly opposes any special taxation of tender offers, such as a "minimum merger tax" or the disallowance of interest deductions for the financing of tender offers. Such penalty taxes would be justified only if the Advisoty Committee concluded that tender offers are undesirable. Since it has concluded the contrary, there is no reason for penalty taxes.

3. **Regulation of banking and credit.** There are two possible overlaps between banking and tender offer regulation. The first is whether banks should have duties of confidentiality, notice, or abstension in connection with bids for their customers. The second is whether tender offers interfere with credit markets of capital formation in a way that calls for credit regulation. The subcommittee is strongly of the view that neither is an appropriate subject for regulation at this time.

Banks and their customers. The role of banks in financing hostile tender offers of their customers -- and in using information given them by customers -- is very distant from the subjects of the Advisory Committee's charge. To the extent we know anything pertinent, we would leave the subject where it now is -- in the realm of contract law and state-law fiduciary duties. But we have no particular expertise in banking. Consequently we think the Committee should make no recommendation on this subject.

Credit. The subcommittee met with Paul Voelker, Chairman of the Federal Reserve, to explore with him the statement, attributed to him by the Senate Banking Committee, that tender offers distort credit markets. We also sought to explore the argument that is sometimes advanced that tender offers use up credit, and thus divert resources away from new plant and other productive investment. The argument, as we understand it, is that banks have limited credit to make available to borrowers. If they make this credit available for tender offers, it becomes unavailable for investment in new production facilities.

Chairman Voelker indeed made the statement attributed to him, but our discussion revealed that he does not believe that there is any reason for credit controls or other response by the Federal Reserve to tender offers.

The Federal Reserve's staff is of the view that tender offers have no effect on the availability of credit. The staff's argument is that credit can be used without being used up. The money borrowed to finance a tender offer comes into the hands of investors, who reinvest it -- just as they reinvest the proceeds received from selling stock in regular market transactions. Thus the money returns to the banking system and is again available as credit. No real resources are used up; we can have tender offers without diminishing in any way the availability of credit for other forms of investment.

The Chairman does not wholly accept the position of the staff. In the Chairman's view, banks may distort their credit judgments when making tender offer loans. He thinks that the

creation of large loan commitments may have a psychological effect on banks' willingness to make other loans, regardless of the fact that capital flows back to the banking system quickly. Moreover, he is concerned that banks may not adequately investigate the soundness of loans made in contested tender offers, because they lack adequate time to do so. Finally, he expressed concern that large borrowing adversely affects the debt-equity ratios of firms that make tender offers. He emphatically concluded, however, that none of these problems is particularly serious or a cause for regulation, and he expressed the view that these concerns would be substantially alleviated if, as the Committee is inclined to recommend, it becomes possible to use securities more readily in making tender offers.

Your subcommittee believes that it does not matter whether the Advisory Committee agrees with the Federal Reserve's staff or the Chairman. In either event, tender offers present no occasion for any change in the regulation of credit and banking.

4. **Investment managers.** The subcommittee has considered the relation between tender offers and the regulation of pension managers. We conclude that their is no need for the Advisory Committee to make recommendations on this subject, which is now extensively regulated both by ERISA and by the fiduciary duty of the funds' managers. See Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982).

5. **Regulated industries.** A number of industries, including insurance and banking, are now regulated by state and federal agencies in ways that affect tender offers. The acquisition of a bank, for example, requires prior approval by regulatory officials.

The subcommittee concludes that these systems of regulation should be left untouched by the general federal tender offer rules. Whether or not there should be additional freedom to acquire banks, or additional restrictions, depends on the resolution of many other regulatory questions (e.g., the financial responsibility of the acquirors) that the Advisory Committee cannot reexamine. Other systems of regulation are practical and political compromises that cannot be reopened in one respect without general reexamination that is beyond our charge.

6. **Labor relations and plant closings.** Successful tender offers often are followed by reorganizations of the corporations affected by them. These reorganizations may entail the hiring or layoff of employees and the opening or closing of plants.

The subcommittee believes that the Advisory Committee should recommend that these changes be dealt with by means other than tender offer regulation. Labor relations are the stuff of collective bargaining, handled by the National Labor Relations Board and market forces. Plant openings and closings are handled by collective bargaining and state law.

Tender offers may be occasions for labor and plant changes, but they do not "cause" these changes, and they are not the only

occasions for change. Managers usually hire and fire workers, open and close plants, in the ordinary course of business. When such events occur other than in the ordinary course, they usually accompany mergers, spinoffs of corporate divisions, and bankruptcies. Tender offers are such a small part of the phenomena in question that it would be shortsighted to recommend special regulations of labor and plant changes associated with tender offers.

7. *The relation between state and federal law.* There is no doubt that we do and must have a national securities market. There is also no doubt that the states do and must have the principal role in regulating the internal affairs of corporations. Finally, there is no doubt that the corporations themselves do and must have the principal role in designing their own methods of operation and governence, their own relations with their investors. This is as true in designing the terms and preferences of new investment instruments as it is true in designing the relations with existing equity investors. So long as corporations and states remain free to compete with one another in designing different terms and conditions of dealing, they will continue to attempt to improve their offers in order to make them attractive to investors, and thus to sell their securities for the highest prices (both initially and in the aftermarket).

The subcommittee's principal concern is finding principles that harmonize the beneficial competition among firms with the need for a national securities market. There is no one right way to do this, but the subcommittee thinks that the following three principles are a satisfactory way.

1. Federal law should say as little as possible about the provisions corporations put in their articles and bylaws. Firms should be free to offer investors any combination of invitations to, protections against, or treatments of, tender offers, so long as these provisions do not substantially interfere with the freedom of shareholders to dispose of their securities in a liquid national market. Federal restrictions on the content of corporate articles and bylaws can be justified only by the strongest evidence of interference.

2. State prohibitory laws, which override or dictate the provisions corporations place in their articles or bylaws, should be preempted by federal law or constitutional doctrine only when the state laws seriously affect interstate transactions. Thus states may issue prohibitory laws affecting corporations incorporated in the state and having substantially all [or some other number, such as 70%] of the shareholders there. They may also regulate the purely intrastate aspects of any tender offer. They may not, however, use the "internal affairs doctrine" of corporate law to regulate tender offer transactions involving firms the majority of whose shareholders live out of state.

3. The enabling principles stated in (1) and (2) depend on the enforcement of articles, bylaws, and rules that have been adopted. Competition among states and corporations to offer diverse protections to investors can be undermined if either the firms or the states attempt to change the rules once a tender offer has begun or is on the horizon. Thus in order to preserve the integrity of national markets, the SEC should promulgate rules, and federal courts should be available to prevent, last-minute deviations from corporate articles, bylaws, and statutes.

Provision (1) substantially tracks the position underlying the treatment of targets by the joint subcommittee on bidders and targets. It obviously does not deal with the question whether any given provision is sufficiently abusive, or poses a sufficient threat to national markets, to require federal intervention. That question is outside this subcommittee's charge.

Provision (2) substantially tracks the recommendations of the subcommittee on basic objectives, and it is consistent with the decisions of the Supreme Court in Edgar v. Mite Corp., 102 S. Ct. 2629 (1982) (state regulation of tender offers in interstate commerce violates the Constitution), and Shaffer v. Heitner, 433

U.S. 186 (1977) (mere fact that a firm is incorporated in a state is not constitutionally sufficient ground for state jurisdiction over all affairs arising out of that corporation). It tempers these restrictions, however, with the principle of the 1933 and 1934 Acts that state and federal regulation can coexist. By focusing on the degree of effect on interstate transactions, this approach also avoids the usually-insoluble inquiry into whather the local interest in a particular case is "legitimate and substantial".

Provision (3) generalizes the insight that led the Advisory Committee to approve Golden Parachute contaracts if adopted in advance of a tender offer, but not if adopted at the last minute. Similar considerations also underlie the advisory vote recommendations of the joint subcommittee on bidders and targets.

There may already be sufficient authority for the SEC to adopt such rules, on the ground that last-minute changes are manipulative practices in violation of the Williams Act. Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981). The subcommittee recommends, however, that the prohibition against manipulation recognized in Mobil be confined to last-minute changes in the rules. If a corporation places in its articles or bylaws provisions designed to facilitate sales of crown jewels (as in Mobil), and state law permits use of these provisions, their employment should not be deemed manipulative. If, on the other hand, a corporation pledges to hold itself open to tender offers, perhaps by making it difficult for managers to issue new stock, the managers' last-minute attempts to get around these

internal restraints would be deemed manipulative within the meaning of the Williams Act.

Irwin Schneiderman, Chairman
Jeffrey B. Bartell
Frank H. Easterbrook
Ray J. Groves