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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

6/19/84
FILE, per MDT

June 14, 1984

The Honorable James A. Baker III
Chief of Staff
The White House
Washington, D.C. 20500

Dear Jim:

The attached paper on "The Leveraging of America" discusses three aspects of corporate takeovers and buyouts that will significantly impact American enterprise next year and beyond.

Any comments or suggestions concerning what we should do, if anything, concerning the issues discussed, would be sincerely appreciated.

Very truly yours,

John S.R. Shad

Attachment

The Leveraging of America

John S.R. Shad

Three aspects of corporate takeovers and buyouts that will significantly impact American enterprise next year and beyond are: the increasing tendency of institutional investors to oppose anti-takeover proposals by corporate managements; acquisition related bankruptcies and other consequences of leveraging-up major corporations; and the consequences of a significant increase in exchange offers, if pending proposals are adopted.

The purpose of this paper is not to sound a note of alarm, but to ventilate some of the major issues that should be weighed by the business and financial community, the Congress and the Securities and Exchange Commission, in conjunction with ongoing discussions of the laws and regulations that govern changes in corporate control.

More Institutional Dissents

Until last year, institutional investors' opposition to management proposals has been negligible. However, last year they and other investors defeated anti-takeover proposals by a number of companies, including Castle and Cook, Data General, International Paper and Sherwin-Williams.

Despite management opposition, Superior Oil's shareholders forced recision of a defensive preferred stock dividend, and created a committee of independent directors to evaluate future tender offers.

In a 1983 Kidder Peabody & Co. and Morrow & Co. survey of 2,500 institutions, 75% opposed requirements that mergers be approved by supermajorities (typically 80%) of the shareholders, and half opposed staggered boards (i.e., the election of less than all the directors annually).

In an Investor Responsibility Research Center survey last year, a "wide margin" of institutions opposed both supermajority and staggered board provisions, and favored requiring shareholder ratification of "golden parachutes" (i.e., high termination compensation for executives, following a change in effective control).

In a D.F. King study, 75 of 100 major institutions were generally opposed to increasing management protective provisions.

Based on a June 7, 1984 speech by Securities and Exchange Commission Chairman Shad before the New York Financial Writers Association.

The repurchases of blocks of their stocks at premium prices from possible bidders have subjected Walt Disney, Texaco, Warner Communications, St. Regis, Gulf & Western and many other companies to significant shareholder criticism. The SEC has proposed pending legislation that would proscribe so called "greenmail" transactions.

Following a case-by-case review, Citicorp's $36 billion Investment Management division is reported to have voted against all anti-takeover proposals by 64 companies in which it holds stock.

The $11 billion Batterymarch Financial Management has adopted a policy of voting against all anti-takeover proposals and of announcing publicly its votes on specific issues.

With only a 1% interest in the TWA holding company, Odyssey Partners obtained a 30% vote in favor of breaking-up the company, based on the proposition that the parts were worth more than the whole.

A projection of these trends suggests that a rising number of institutions will not only oppose future anti-takeover proposals by managements, but also begin to support corporate break-ups and mergers, with a view to enhancing the value of their investments.

The Rising Tide of Leveraged Takeovers and Buyouts

These trends lead into the second topic - the consequences of the rising tide of leveraged takeovers and buyouts of major American corporations.

In such transactions, shareholders have received 50% to 100% premiums over the current market prices of their shares. However, the longer term consequences to shareholders and the nation cannot be ignored.

Corporate takeovers and buyouts are financed through large loans. The net effect is that debt is being used to retire equity, which is known as leveraging-up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers and others.

Common Characteristics of Targets

Companies that are being takenover by other companies or boughtout by their managements and others generally have one or more of the three following common characteristics: significant untapped borrowing capacity; shares trading at discounts from the current market value of their net assets, and at low multiples of their cash flows (i.e., their net incomes plus depreciation, depletion and other non-cash charges).

The foregoing - untapped borrowing capacity, undervalued assets and low cash flow multiples - are also common characteristics of many of America's largest and soundest corporations.

Under such circumstances, buyers are able to finance-out a major portion of the purchase price against such companies' own assets and cash flows. When they do so, it is usually necessary to dedicate such cash flows to future debt service, rather than the replacement of aging plant and equipment and declining oil or other reserves. Companies that do not replace aging facilities and declining reserves, become increasingly inefficient.

Also, under current economic conditions, conservatively capitalized companies - those with low debt-equity ratios - have incentives to borrow funds and reacquire their own shares or those of other companies, rather than suffer the consequences of such tactics by others.

In today's corporate world, Darwin's "survival of the fittest", has become - acquire or be acquired.

Management Leveraged Buyouts

Leveraged buyouts by managements have been a fraction of leveraged takeovers of one company by another. In my opinion, shareholders would generally prefer to have managements place their companies on the block at premium prices, rather than use their companies' resources to buyout or fight off bidders. Management buyouts that have attracted higher bids from others include City Investing, Northwest Energy, Norton Simon and Stokely-Van Camp.

Optimum Economic Environment

The past 24 months have been an optimum economic environment in which to effect leveraged takeovers and buyouts.

Corporations' tax deductible depreciation and depletion allowances are based on historical costs. Such allowances have long been inadequate to replace plant, equipment and reserves at current inflated prices. The Economic Recovery Tax Act of 1981 increased such allowances, which has in turn increased corporations' cash flows and liquidity. In addition, the past 24 months have witnessed relatively low interest and inflation rates, and a vigorous economic recovery. This combination of events has facilitated the rising tide of leveraged takeovers and buyouts.

More Bankruptcies in Prospect

However, major bankruptcies have resulted from the heavy debt incurred by companies that have engaged in aggressive acquisition programs (e.g., Baldwin-United, Charter Corp., Lionel, Saxon Industries, Wickes and many others).

When a company highly leverages its capitalization, the consequences of even modest business problems, economic recessions or rising interest rates, are greatly magnified. Shareholders, creditors and others have sustained billion dollar losses - in addition to the serious impact of bankruptcies on employees, communities, suppliers, customers and others.

The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition related bankruptcies. The premiums come first, the consequences later. The leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates.

Marketplace Disciplines

The theory that contested takeovers discipline incompetent managements is of limited veracity. Corporations have momentum. Today's corporate performance and stock prices are in large measure a function of yesterday's decisions, by prior managements - whether good or bad.

Companies that borrowed at the low interest rates 12 years ago to buy oil reserves at the low prices then, and subsequently retired such debt with inflated dollars, are reaping the rewards today of prior management decisions.

When able executives turn around ailing enterprises, the market prices of such companies' shares often lag their improving prospects. They become attractive takeover candidates, because of the competence - not the incompetence - of their managements.

Also, contrary to a discipline, the increasing threat of being takenover is an inducement to curtail or defer research and development, plant rehabilitation and expansion, oil exploration and development, and other programs - which entail current costs for long-term benefits.

More Exchange Offers in Prospect

The third topic concerns offers to exchange one company's securities for those of another. Contested takeovers through exchange offers have been negligible. However, if proposed regulatory changes are adopted by the SEC, next year can be expected to witness a significant increase in both friendly and contested takeovers through exchange offers - and through combinations of open market accumulation, securities exchange offers, cash tender offers and statutory mergers.

Last year, the SEC Advisory Committee on Tender Offers recommended that exchange offer regulations be simplified and accelerated. In view of the billion dollar benefits to corporations and shareholders of the SEC's recent simplification and acceleration of public offerings and private placements of securities, similar improvements in tender offers seems a worthy effort.

The Commission is currently soliciting public comments on proposals that would significantly reduce the paperwork for business combinations and exchange offers. The SEC will also release for public comment shortly, proposals that would permit exchange offers to be done as rapidly as cash tender offers.

Advantages of Exchange Offers

There are many advantages to exchange offers:

- Stock-for-stock exchange offers do not increase the leverage in corporate capitalizations.

- Exchange offers of debt and equity securities can eliminate the necessity to borrow the large sums required to do cash tender offers.

- Multiple transactions can be telescoped into a single transaction. There is no need to refinance the short-term debt incurred to effect cash tender offers.

- Cash tender offers are taxable transactions. Exchange offers of voting equity securities are not - and such acquisitions can be accounted for as poolings of interest, rather than as purchases. In poolings, the premiums over book value paid for target companies do not have to be amortized.

- And finally, the fairness of partial and two-tier tender offers have been questioned. Exchange offers facilitate offers for all of a company's shares, rather than for only a portion of them.

Exchange Offer Consequences

Therefore, why shouldn't exchange offers be streamlined and accelerated? They probably should, but not without assessing and responding to the consequences.

One consequence is that a small company can do an exchange offer for the shares of a large corporation on a basis under which it is simply recapitalizing the larger corporation. The larger corporation's assets and earning power become the credit behind the new securities.

Subject to tax and other considerations, such an exchange offer might consist of a package of common and preferred shares, warrants, zero coupon bonds or other exotic financial instruments, designed to accommodate such an offer. It will be successful if arbitrageurs, institutional investors and others conclude - or if the when-issued market value of the package of securities clearly demonstrates - that the securities offered are worth significantly more than the market price of the target's common shares, before the offer.

Through combinations of exchange and tender offers, target corporations' capitalizations might thus be leveraged-up, and their managements succeeded by those of smaller companies, that may have limited knowledge of the targets' operations.

In order to do cash tender offers, bidders typically have to seek lines of credit from banks and other institutions. Thus, cash tender offers generally require the support and concurrence of institutional lenders. Such support or concurrence is not generally required to do exchange offers. Bidders simply create their own "corporate currencies" (i.e., packages of securities) and offer them in exchange for targets' securities.

The longer time periods and more detailed registration requirements for exchange offers have permitted target companies to block or delay them through legal actions, often based on deficiencies in the registration documents or other contentions. Targets have also used the longer time to seek higher bids from others. For these reasons, there have been relatively few contested exchange offers. However, there will be more if they are streamlined and accelerated, and the consequences are likely to include greater leverage in corporate capitalizations and less experienced managements.

In the open meetings that preceded the Advisory Committee's recommendation to accelerate exchange offers, these implications were not discussed. These and related issues should be factually addressed by those who respond to the Commission's releases on streamlining and accelerating exchange offers.

One of many possibilities would be to limit accelerated exchange offers to the largest and most creditworthy companies - as in the case of accelerated public offerings of securities under the shelf registration rule. They might also be limited to actively traded security issues of such corporations. Exchange offers of exotic securities (so called "Chinese paper") and offers by companies that do not enjoy broad active public markets in their securities, might continue to be subject to the more detailed and time consuming conventional exchange offer requirements.

It should be noted in this regard that the SEC is charged with the implementation and enforcement of the laws passed by Congress, principally through full disclosure. The SEC does not have or desire the authority to pass on the merits of corporate financings, mergers or acquisitions. Congress has wisely concluded that such judgments are better left to the marketplace.

Conclusion

In conclusion, as mentioned at the outset, these are some of the issues that should be weighed in conjunction with ongoing discussions of the laws and regulations which govern changes in corporate control.

It would be as wrong to overreact to these issues, as it would be to ignore them.

Notwithstanding concerns to the contrary, multi-billion dollar leveraged takeovers and buyouts have not had a disruptive effect on the credit markets. As bank loans have been drawn down by bidders and paid to target companies' shareholders, the funds have been instantly recycled - redeposited or reinvested by the shareholders. And bidders' short term bank loans have generally been reduced within a year or two through long term debt and other refinancings or through asset liquidations.

Corporate consolidations are subject to the antitrust and other laws. Their major operational, financial and other benefits should not be inadvertently foreclosed or inhibited in an attempt to address ancillary issues. The evolutionary response of the marketplace to changing business conditions has been much more effective than less flexible laws and regulations.