SEC

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

June 26, 1984

MEMORANDUM FOR ROGER PORTER

FROM: CHRISTOPHER DEMUTH CD

SUBJECT: Administration position on takeover/tender offer bills

Attached is our draft letter opposing the recently introduced bills to regulate corporate takeovers and tender offers. I understand that the subject of this letter is to be considered at this Thursday's meeting of the CCEA.

Attachment

→ Boyden Gray
Fyi / CD

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DRAFT

Honorable Timothy E. Wirth
Chairman, Subcommittee on Telecommunications,
Consumer Protection and Finance
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On May 22, 1984, four proposed bills addressing corporate takeovers and tender offers were introduced in the House:

- H.R. 5693--"Tender Offer Reform Act of 1984;"
- H.R. 5694--A bill to prohibit acquisition of corporate control except by means of tender offers for all outstanding shares;
- H.R. 5695--A bill to permit shareholders and the Securities and Exchange Commission to seek injunctive relief from harmful tactics by management in corporate takeover situations; and
- H.R. 5696--"Shareholder Communications Act of 1984."

The Administration has reviewed these proposals carefully and has strong objections to the first three. I am writing to express our views in detail.

Corporate takeovers perform several important functions in our economy. First, they provide a means--sometimes the only feasible means--of policing management conduct in widely held public corporations. Second, they help identify undervalued assets and permit shareholders to realize the true value of their investments. Third, they can reallocate capital and corporate assets into higher-valued uses; enable merger partners to generate joint operating efficiencies; and provide companies with access to financial, management, and other resources not otherwise available.

Takeovers are generally good for shareholders of both bidder and target corporations. The best available data indicate that the average takeover that leads to a merger results in an appreciation in the value of the combined enterprise equal to about 10.5% of the initial value of the merged companies. Shareholders of the acquired corporation realize a premium for their shares averaging 38% of the pre-acquisition market price of

the target; acquirors enjoy smaller, but significant, gains. The division of gains between bidder and target shareholders does not differ substantially between mergers effected by tender offers for "any and all shares" and "two-tier" offers (tender offers followed by a merger at a lower price). Partial tender offers that do not result in a merger lead to somewhat smaller, but still substantial, gains. And these figures understate the economic gains of corporate takeovers, since the pre-takeover market prices for corporate securities often include some premiums anticipating possible future acquisitions.

Earlier actions to regulate tender offers appear to have noticeably discouraged takeover attempts by increasing their costs. The number of tender offers declined nearly 10 percent following enactment of the Williams Act in 1968 and its amendment in 1970. The number of offers increased steadily from 1970 until 1979, although they did not surpass the 1968 level until 1977. They dropped off sharply again in 1980, the year in which the SEC proposed another elaborate set of rules governing tender offers. At a minimum, these facts suggest that we should proceed cautiously in adopting new laws that could make takeover attempts even more expensive and burdensome. The Administration believes that no systematic abuses have been identified that would justify further restrictions on takeover activity. To the contrary, in view of the overwhelming evidence that takeover activity produces significant economic benefits, we should be seeking ways to minimize government disincentives to takeover bids and tender offers.

The proposals to prohibit or regulate potentially abusive "defensive" techniques by target corporations (such as those proposed in H.R. 5693 and H.R. 5695) raise a different set of concerns. These techniques all may have legitimate business purposes as well as the potential for abuse. It is often a difficult question of judgment whether a given technique, in a given set of circumstances, is in fact an abuse that protects incumbent management at the expense of shareholders. Under our federal system, we have traditionally relied on State law and market competition to discipline corporate managers who act against the interests of their shareholders. This system of diverse and responsive State law has been highly successful in protecting shareholders and promoting efficiency in corporate management and financial markets. The proposals before your Committee to regulate defensive techniques would greatly expand federal regulation of corporate management, and would constitute a major step towards imposition of a substantive federal corporation law.

We believe the Federal government's appropriate role in overseeing corporate management decisions is limited to situations where a broader national purpose is to be served, or where existing market disciplines are failing to work effectively. We see no such broader national purpose that would justify adoption of federal restrictions on management defenses to takeover bids and tender offers. To the extent that the

market has failed to restrain defensive abuses, we believe such failure results from excessive regulatory restrictions on bidders.

We are, moreover, very skeptical of the ability of the Federal government to foreclose defensive abuses by prohibiting certain classes of conduct. The prohibition of specific actions will channel defensive behavior into other actions, some of which may be even less desirable. The predictable result will be more prohibitions, more federal regulation, and more waste of resources from attempts to evade the regulations.

Many of these proposals seek to redistribute the balance of power and, hence, the economic gains and losses among the participants in takeover actions, with the hope of creating "fairer" outcomes. However, "fairness" in this case is impossible to determine. Even the question of who benefits or should benefit is problematic. Investors can move in and out of any given stock freely or avoid the equity markets entirely. The large, sophisticated investors, who most people would agree are in the best position to benefit from takeover attempts, are largely pension and mutual funds--i.e., pools of funds from the smallest and least sophisticated investors. In addition, it is not known in advance who will be bidders and who will be targets. The shareholders of each may overlap substantially. The biggest risk is that the Federal government, in the name of fairness, will create rules that make everyone--bidders, targets, and managers--worse off.

In summary, we generally oppose proposals to subject tender offers and takeover attempts to further federal regulation because they are likely to discourage actions that are beneficial to both bidder and target shareholders. We also oppose the creation of federal corporation law to regulate "defensive" management behavior. No market failure has been demonstrated to support either case, and the likely outcome of new federal regulation would be wasted resources.

Our specific comments on the four proposed bills follow.

<u>H.R. 5693--"TENDER OFFER REFORM ACT OF 1984"</u>

H.R. 5693, proposed by the Securities and Exchange Commission, would restrict a bidder's acquisition of shares prior to public notification of intent. It would also, for the first time, prohibit or restrict several corporate management practices under federal law--compensation agreements, tender offers for its own stock, new stock issues, and stock repurchases.

Sections 2 and 3 would restrict a bidder's ability to accumulate a large block of shares before declaring its intentions. The provision would reduce from 10 days to a maximum of 2 days the time period between a bidder's accumulation of 5% of the stock of a target corporation and the day of required disclosure. This

requirement would make it more difficult and more expensive for bidders to mount takeover attempts, and would reduce the gains to a successful bidder from any appreciation in the value of target company shares. We do not consider the rapid accumulation of shares in the market to be an abuse. The effect of this proposal is undesirable--a reduction in takeover attempts and tender offers.

Section 5 would restrict defensive techniques by corporate managers. New or amended compensation agreements between a target corporation and its officers and directors would be prohibited during a tender offer. Such a prohibition would be an unprecedented, unnecessary, and unwise intrusion by the Federal government into corporate management. The ability to offer key corporate managers revised compensation proposals can be beneficial to shareholders in at least two ways. First, it may be necessary to induce key managers to remain with the company during periods of high uncertainty about the corporate future. Second, it may be a useful tool to minimize the incentive for corporate managers to engage in defensive tactics which could be far more detrimental to shareholder interests. In both cases, such agreements serve an important purpose--to bind the interests of managers and shareholders at a time when outside "threats" to incumbent managers might otherwise induce them to act contrary to the interests of their shareholders.

The prohibitions on purchases by a target company of its own securities and issues of new securities during a tender offer may likewise be disadvantageous to target company shareholders. Purchases by the target by a self-tender offer may give target shareholders an attractive alternative to a low bid by an outsider. Sales of securities to third parties may help prompt a bidding war. Even if these devices are sometimes abused, prohibiting them altogether may simply redirect ever-resourceful managements into other defensive strategies that are even less desirable. A defensive stock issue at least has the virtue of placing a significant block of shares in the hands of a single owner, who may then have the power and incentive to police the target's management. An alternative to defensive stock issues might be sale of the target's premier assets--its "crown jewels"--at a bargain price, which lacks any such virtue.

Repurchases from a significant shareholder at a premium over market--so-called "greenmail"--presents a more difficult case, but even here the technique clearly has some desirable effects. First, the possibility that shares may be resold to the target in the event of an unsuccessful takeover attempt raises the expected value--and hence the likelihood--of takeover activity. Prohibitions on repurchases may thus deter takeover offers to the disadvantage of all market participants. Second, evidence indicates that even when "greenmail" takes place, shareholders' stock appreciates, perhaps because of the disciplining effect on management. This technique may be abused, but policing it should be a straightforward matter of State corporation law, and we note

that many States have been active in this area. Given the present state of our knowledge, we believe it would be unwise to restrict repurchase transactions under Federal law.

H.R. 5694

H.R. 5694 would require anyone seeking to acquire 10% or more of the voting equity securities of a company to make a tender offer for all outstanding shares of the company or to acquire such shares directly from the issuer. If the bidder had acquired any shares within the previous 12 months, it would require the offer be for cash at least equal to the highest price paid in any such acquisition.

The effects of H.R. 5694 would be pernicious. Shareholders of blocks in excess of 10% would suddenly find the value of their holdings greatly depreciated since they would no longer command a control premium and could not dispose of their holdings in block transactions; nor could they purchase any additional shares for investment reasons without incurring an obligation to make a tender offer. Investment decisions would be distorted and small shareholders would lose the substantial economic benefits of tender offers for less than "any and all shares," as well as the gains from the disciplining effect on managements arising from the existence of large blocks.

In large public corporations, the concept of shareholder ownership would be dealt a severe blow. The bill would solidly entrench incumbent management in perpetual control of our largest corporations because there would be few, if any, bidders with sufficient resources to make offers for all their outstanding shares. Serious proxy contests would be virtually abolished. In addition, the bill would introduce a significant--and economically undesirable--asymmetry because incumbent management would retain the right to issue large blocks to members of the control group or sympathetic hands.

Even in smaller corporations, changes of control would be unduly inhibited. In addition to limiting the market for the company to bidders able to acquire "any and all shares," the requirement that the price offered be equal to the highest price paid in the previous 12 months may make a tender offer impracticable in a falling market.

H.R. 5695

H.R. 5695 would allow the Securities and Exchange Commission or any shareholder to bring suit under federal law to stop management from taking any action relating to a change of control. The burden of proof would be placed on corporate management to demonstrate that the action in question would be both prudent and fair to the corporations' stockholders. A shareholder could be awarded both attorney's fees and "equitable relief."

Although the stated purpose of this proposal is to avoid "harmful defensive tactics by management in corporate takeover situations," it is written so broadly that it would be certain to have substantial unintended adverse effects. At a minimum, it would lead to a dramatic increase in legal actions and consequent delays and wasted resources. In addition, it would unnecessarily preempt the State role in regulating corporations and would be a step towards creating a federal corporation law and changing the role of the SEC from overseeing disclosure and the effectiveness of public securities markets to actual oversight of corporate management. It would overturn hundreds of years of case law. We have seen no evidence to suggest that such a drastic proposal is warranted.

A short list of potential problems which this bill raises will illustrate our concerns:

- The bill is aimed at "transaction(s)...effecting or...defending against a change in control...." Although the stated purpose of the bill suggests concern over defensive tactics, the actual language suggests that it also applies to bidders. Tender offers as well as defenses could be delayed by injunction until corporate management proves its case in district court--and wins its appeals. Moreover, this would be a powerful, disruptive tool in the hands of dissident shareholders because the reversal of the normal burden of proof would provide a ready means for shareholders to seek to delay routine corporate actions with which they may disagree.

- The bill provides no definition of what constitutes a "defensive tactic." Many legitimate business activities could make a takeover bid more difficult or expensive for the bidder. Must all of these be litigated? Delays generally work against a bidder as the market changes, as more time is available for defensive maneuvers, and as the cost of maintaining its bid increases.

- Transactions "in contemplation of effecting or defending..." are included. If it is difficult to determine whether a transaction is in fact defensive, it must be still more difficult to determine whether a transaction undertaken without the presence of a takeover bid was done "in contemplation" of such a bid.

- What constitutes a "change in control"? In other regulatory contexts, this concept has proved difficult to define and administer. A bid for 51% of the shares is clear, but effective control of most large, public corporations can be gained with far less than 50% of the voting shares. Moreover, the amount needed for effective control varies widely from company to company.

The opportunities for abuse of these provisions are extensive. Potential bidders could sue to prevent a target from taking any management action which might make the target more expensive or difficult to acquire at some future time. Target managements could engage in a series of defensive transactions with the express purpose of forcing litigation during a tender offer, with the reasonable expectation that such litigation will cause delays in the tender offer closing period until the litigation is settled. Dissident shareholders would be given an extraordinarily powerful tool with which to harass managers. The vague, open-ended standards, coupled with the attorney's fee provision, would encourage litigation.

The likely result of H.R. 5695 would be a dramatic increase in litigation and decrease in takeover activity. The people who would benefit the most would be lawyers; shareholders of both targets and bidders would pay the bills.

H.R. 5696--SHAREHOLDERS COMMUNICATION ACT OF 1984

This bill proposes to treat banks, associations, and other entities that exercise fiduciary powers in the same manner as broker-dealers under Section 14(b) of the Securities Exchange Act of 1934. We do not object to the provisions of this bill as proposed.

Sincerely,

Christopher DeMuth
Administrator for Information
and Regulatory Affairs