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TENDER OFFERS: A CONTRADICTION IN TERMS

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

TENDER OFFERS -- A CONTRADICTION IN TERMS

Introduction

When the National Association of Manufacturers asked me to speak about tender offers, they told me I should discuss -- in 25 minutes or so -- the social, economic, legal and regulatory implications of tender offers -- a fairly narrow field to plow. They suggested that I entitle my comments "Tender Offers - A Contradiction In Terms." I suppose that's as good a title as any, since some feel there's nothing tender about the whole process and that both the present system of regulation and the Tender Offer Advisory Committee's proposed revisions could be called "regulation by schizophrenia." Undeniably there is some element of schizophrenia in the present regulatory scheme, the most significant of which is the fact that bidders are regulated principally by federal law and targets primarily by state law. That's a classic conflict and will be the main focus of my comments today. But let's first reflect a bit on how we got to the present state of affairs.

Tender offers are constantly discussed, but rarely in calm tones. Some feel that the only good thing tender offers have generated is a colorful vocabulary: "golden parachutes," "white knights," "crown jewels," "Pac-Man," "poison pills," and "scorched earth." I often have wondered why these terms are so colorful. My best explanation is that they describe the incredibly strong gamut of human emotions generated by tender offers, as much as they describe legal maneuvers.

Most by now are familiar with the Advisory Committee on Tender Offers. Convened a year ago, the Committee lasted four months and issued its report in July, 1983. Given the breadth of the issues examined and a compressed timetable, the Committee did a remarkable job. You may disagree with specific proposals, but we all owe thanks to the Committee for crystallizing the issues and giving us a focus for reexamining tender offer regulation. Although I start with nice comments, my remarks today nonetheless will suggest that I find several of the Committee's proposals quite radical.

The Commission is scheduled to meet publicly on March 13 to consider the Report, in anticipation of Chairman Shad's testimony before Congress on March 28-29. So, without prejudging anything that may happen on March 13, let's reflect upon some specific recommendations and some larger questions which the Report poses.

The Debate and the Players

As I said, the Report has sharpened the debate. At one extreme, some argue that tender offers are an affirmative good. In the long run, all benefit from them -- bidders, targets that are taken over, targets that successfully ward off takeovers, and the shareholders of all. Any interference with takeovers -- whether in the form of regulation or targets' defensive measures -- introduces uncertainty and cost for bidders and therefore discourages that socially beneficial event called a hostile tender offer.*

This camp offers vast economic data which purports to show that even modest regulatory restraints adversely and dramatically impact the market value of securities of bidders, with no offsetting benefit. Some go so far as to suggest that the first bidder should have some form of option to acquire a target because it invested the time and effort necessary to make the bid. They liken this to the exclusive protection enjoyed by an innovator who creates a new product and obtains patent protection. This camp views tender offers purely as economic events, with no issues of fairness.

At the other extreme, some believe that tender offers have become, or always have been, a perverse way to intimidate good corporate managers and that tender offers disrupt our economy and capital formation system. They frequently point to the words of one well-known Chief Executive Officer, also a member of the Advisory Committee, who said:

> Maybe there's something wrong with our system when...companies line up large amounts of money in order to purchase stock when it doesn't help build one new factory, buy one more piece of equipment, or provide even one more job.

Both sides, however, agree on one thing: they want the federal government to be a reformer. Of course, reform is much like beauty; it all depends on the eyes of the beholder. Of particular moment in this debate about reform is an issue as old as our Constitution -- the federal-state relationship. What is done to reform tender offers may well alter the traditional federal-state relationship, and that is a serious matter indeed. Perhaps we should start by questioning whether tender offers are so significant that they should be the driving force causing a realignment of the federal-state relationship, or should it be the other way around -- that the federal-state relationship is too important an issue to be decided in the midst of a heated debate about tender offers.

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* Despite the arguments about the adverse effects of takeover regulation, it is worth noting that in 1966 -- before any federal regulatory scheme -- cash tender offers amounted to less than $1 billion; in 1982 total takeover activity was almost $83 billion.

The Advisory Committee Report - The Conflicting Philosophies

In my view, three hypotheses surface in the Report. Individually, each could command wide respect in our society. Collectively, they are in deep conflict. Let me try to identify the three hypotheses:

First Hypothesis: Shareholders should be free to sell their shares to a willing buyer at the highest price possible in an unfettered market.

Second Hypothesis: The federal government should be a "neutral" referee, doing nothing more than ensuring that no bidder operates with such speed or secrecy that the target or its shareholders are disadvantaged and that no target unfairly interferes with shareholders' rights to realize maximum value for their shares.

Third Hypothesis: Tender offers should not be encouraged unless they have a broad, beneficent effect on a general constituency.

Standing alone each hypothesis sounds good, and in casual discussion all might nod in agreement with each. But let's be more critical. Under a pure application of the first hypothesis, the tender offer should be the free market in its rawest form. We are told that premiums paid to targets do not diminish the assets of bidders, because there is a net gain when the units are valued as a whole. Any regulation of bids or freedom of targets to take defensive steps makes tender offers more costly. That reduces their number and therefore denies society a benefit.

Concepts such as "fairness" and "protecting the small investor" only confuse the analysis. In particular, whether one individual or company is treated "fairly" in a given transaction is irrelevant. The best of all worlds would be the elimination of all federal regulation of tender offers, the preemption of state anti-takeover statutes, and the elimination of defensive tactics by targets. In this world, there is absolutely nothing wrong if a raider appears on Monday morning and tells you he owns 35% of your company's shares which he acquired secretly over an extended period. The irony is that these "free-marketeers" -- no great lovers of the federal government generally -- actually want the federal government to swing a big club and eliminate targets' defensive tactics permitted by state law.

If you happen to reject the logic of the first hypothesis, then we have some latitude to discuss "fairness" and the rules of the game. That brings us to the second hypothesis:

> The federal government should be a "neutral" referee and ensure that no bidder operates with such speed or secrecy that the target or its shareholders are disadvantaged and that no target unfairly interferes with shareholders' rights to realize maximum value for their shares.

But this hypothesis also may be faulty. After all, is neutrality really anything more than what people view as "fair"? Isn't "neutral regulation" really an effort to impose a "fairness" standard, a particularly difficult task since concepts of "fairness" change from time to time.

Be that as it may, neutrality, or even claimed neutrality, has broad appeal. The Securities Act of 1933 is a classic example of claimed neutrality. It claims to be nothing more than a disclosure statute, not a law involving merit regulation. Predictably perhaps, the stated objective of the Williams Act is neutrality. Bidders should operate in the light of day, and targets should have a reasonable time to respond. It all sounds so neutral, or if you will, fair.

The Advisory Committee restated its support of neutrality:

> The purpose of the regulatory scheme should be neither to promote nor to deter takeovers...so long as they are conducted in accordance with laws deemed necessary to protect the interests of shareholders...

and

> Takeover regulation should not favor either the acquiror or the target company, but should aim to achieve a reasonable balance...

The fact that the Committee felt it necessary to identify neutrality as a goal is interesting, since they then went on to call for some significant regulatory changes. That suggests three possibilities:

1. The Williams Act is not neutral.
2. Concepts of neutrality-fairness have changed since the enactment of the Williams Act.
3. The present law and rules may be neutral, but have been abused or circumvented to the point of being ineffective.

You be the judge.

That brings us to a third hypothesis:

> Tender offers should not be encouraged unless they have a broad, beneficent effect on a general constituency.

In a separate statement filed in the Advisory Committee's Report, former Supreme Court Justice Goldberg voiced disgust with the excesses on all sides, labelling them "bizarre abuses." Justice Goldberg would prohibit most of the common offensive and defensive tactics and require that the federal government determine whether tender offers are "fair to shareholders of both the offeror and target company and whether, in economic terms, the public interest is protected" and that shareholders of both bidder and target vote on the tender offer. Since requiring a stockholder vote on both sides makes any combination of entities consensual, this, of course, simply turns tender offers into negotiated mergers. Yet, in negotiated mergers, no federal finding of fairness is required.*

Specific Proposals

While the Committee persistently champions neutrality, in my view many of its proposals amount to a significant preemption of state law and a subsystem of federal corporate law. The articulated justification is that tender offers "take place in a national securities market"; therefore in certain instances -- but not all -- state corporate law, primarily the business judgment rule -- must give way to a federal standard. Someone has said that this amounts to the Committee having said, "We love state law except where we don't love state law." With all due respect for the Committee, that, I suggest, is a call for a radical alteration of the traditional federal-state relationship. After all, if the fact that tender offers take place in a national securities market (a concept nowhere elaborated on by the Committee) is a basis for preempting state law, where does that take us? For example, if the federal government can prescribe the terms of an employment contract, even for the popular goal of eliminating golden parachutes, is that not federal preemption of the classic area governed solely by state law? Golden parachutes set up the dilemma nicely. We are frustrated by the excesses, but should we preempt state law? Are golden parachutes really that bad?

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* Last July Congressman Rodino introduced a bill (H.R. 3561, 98th Cong., 1st Sess.) that would establish a public interest test for acquisitions resulting in the acquiror's having more than $5 billion in assets and 25,000 employees.

That brief example probably has already given away my reservations about federal preemption on any broad basis. So let's review some specific Advisory Committee recommendations which I find most troubling in terms of the federal-state relationship.

In Recommendation No. 33, the Advisory Committee supported a "system of state corporation law and the business judgment rule" and stated: "No reform should undermine that system. Broadly speaking, the Committee believes that the business judgment rule should be the principal governor of business decisions made by corporate management including decisions that may alter the likelihood of a takeover." Yet, several specific recommendations clearly undermine state law.

One of the most dramatic is Recommendation 14. The Committee proposes that no person be allowed to acquire the voting securities of an issuer if, immediately following such acquisition, such person would own more than 20% of the voting power of the outstanding voting securities of the issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer. This recommendation is based on the Committee's belief that "control is essentially a corporate asset" and that "shareholders should have an equal opportunity to share in any premium paid for that asset." Yet, case law in almost every state holds that the control premium belongs to the selling control shareholder. Furthermore, there is little evidence that such a provision will actually halt "creeping" tender offers. Whatever you may think about the merits of Recommendation 14, it cannot be denied that it is at odds with state law.

In Recommendation 35 the Committee sought to deal with "shark repellents":

> Congress and the SEC should adopt appropriate legislation and/or regulations to prohibit the use of charter and by-law provisions that erect high barriers to change of control and thus operate against the interest of shareholders in the national marketplace.

This proposal squarely and acutely poses the issue of federalization of state corporate law. What is more intrinsically a matter of state law than what goes into a company's charter and bylaws? Furthermore, where is the hard evidence that shark repellants operate against the vaguely articulated concept of "interests of shareholders in the national marketplace"? Should targets be rendered utterly defenseless without absolutely definitive proof that tender offers have all the desirable qualities that the no-regulation proponents claim? Is it not logical to conclude that, at least under some circumstances, allowing a target to take defensive

measures benefits its shareholders, either because they ultimately receive a more favorable price or because the company remains independent and increases in value.*

Recommendation 37 would require that certain change of control policies be disclosed and submitted annually to a non-binding "advisory vote" of shareholders. The policies covered would include tactical defenses adopted by targets in the midst of a hostile tender offer -- super-majority provisions; charter provisions that alter the one-share, one-vote concept (for example, formulas diluting voting strength of 10% shareholders, and majority of the disinterested shareholder's approval requirements); stand-still agreements with remaining lives longer than one year that restrict or prohibit purchases or sales of the company's stock by a party to the agreement; and change of control compensation or "golden parachute" contracts, which, when made during the course of a tender offer would be prohibited altogether.

How can the advisory vote be squared with state law? I'm not sure it can. It could have a chilling effect on the best judgment of a Board of Directors; it would call into question state law doctrines of the finality of corporate action; and it would invite litigation. Such a policy must be based on an apparent belief that state law is not sufficient to control improper corporate behavior, yet, where is the proof? If the proof exists, why go halfway? As some have argued: If the vote is non-binding, it's nonsense. If it's binding, it's federal preemption.

I mentioned golden parachutes earlier, and few would argue that "golden parachutes" have a good name. Even though they are permissible under state law, and can be tested on their merits under the business judgment rule, the Committee proposed that golden parachutes be prohibited once a tender offer commences. Without further elaboration, the Committee cited a "perception" problem as a basis for federal preemption of state law. In addition, the Committee's finding precludes a case-by-case evaluation of compensation arrangements. Under its proposal, <u>not one</u> such arrangement could be justified once a tender offer commences. If merely a perception is a sufficient basis to preempt state law, then the Committee's approach is indeed radical.

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* <u>See, e.g.</u>, Lipton, "Takeover Bids in the Targets' Boardroom," <u>Business Lawyer</u>, Vol. 35, November, 1979; and Lipton, "Takeover Bids in the Target's Boardroom; An Update After One Year," <u>Business Lawyer</u>, Vol. 36, April, 1981. Lipton analyzes various defeated takeover bids and concluded that in a majority of instances shareholders of the targets benefited from remaining independent. Professors Easterbrook and Fischel take issue with Lipton's conclusions. See "Takeover Bids, Defensive Tactics, and Shareholders' Welfare," <u>Business Lawyer</u>, Vol. 36, July, 1981.

Similar logic appears in Recommendation 40, which would prohibit counter tender offers -- Pac-Man -- when bidder makes a cash tender offer for 100% of a target's stock. The Committee determined that counter tender offers are permissible under state law, tested by the business judgment rule, and that they may be "necessary to protect the interests of target company shareholders who will remain shareholders in the combined enterprise." But federal preemption is justified for 100% cash tenders on the theory that there will be no remaining shareholders of the target. In the first place, even in a 100% cash tender offer, not all shares necessarily are tendered. Even more worrisome is the conclusion that, in a 100% cash tender offer, Pac-Man cannot be justified under any circumstances and that a quirk of timing -- who bids first -- should determine which group of corporate managers should administer the combined assets.

Likewise, in Recommendation 41 the Committee stated that contracts for the sale of stock or assets to preferred acquirors should continue to be tested against the business judgment rule. According to the Committee, those "leg-ups" or "lock-ups" are frequently necessary to induce a second bidder into a takeover contest, enhancing the potential for an auction. But the Committee applied its own "public interest" standard to find that above a certain level, such contracts are not supportable. It therefore recommended that, during a tender offer, an increase in outstanding stock by more than 15% should be subject to shareholder approval. The Committee pays homage to the business judgment rule, under which each contract could be tested on its merits, but without articulating why, says that past a certain point, these contracts cannot be supported. Again, we love state law up to the point where we don't love state law.

This is followed by the recommendation that the sale of significant assets -- scorched earth tactics -- should continue to be tested against the business judgment rule, without the need for federal regulation. I find that to be astounding. In each of the instances I have discussed, the Committee found that the defensive tactics are necessary to protect the interests of shareholders, then elected to override the business judgment rule. But with regard to the one tactic that arguably can harm shareholders most -- the absolute destruction of the target by company management, corporate suicide if you will -- the Committee defers entirely to state law. If any federal restriction of the business judgment rule is justified, "scorched earth" would seem the place to start. Such are the contradictions of the Report.

Conclusion

What conclusions can we draw? I would not dare assert that abuses do not occur under the present regulatory system. Yet, does the use of a vague notion of the "interests of shareholders in a national market" to usurp state law make all the problems go away? I doubt that also. Golden parachutes and scorched earth tactics seem to offend everyone and to be prime candidates for federal regulation. Yet, once we start down the road of federal preemption, where do we stop?

The Advisory Committee has posed the issues nicely for all of us. That's why I said at the outset that we owe them thanks for crystallizing the issues. Now it's the Commission's turn to react on March 13. I invite each of you to what promises to be an interesting meeting and perhaps the first step toward an alteration of the traditional federal-state relationship.

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