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RICO and Tender Offers: Public Policy Considerations

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

Good morning. I appreciate very much this opportunity to address the National Association of Manufacturers.

Today I wish to talk about two significant policy issues affecting the jurisdiction of the Securities and Exchange Commission. I believe that these policy issues have a potentially substantial impact on the conduct of business by U. S. corporations. I refer to the urgent need to amend by legislation the Racketeer Influenced Corrupt Organizations Act (RICO) and Congressional consideration of tender offer legislation. Each of these issues has special applicability to the work of the SEC.

RICO

I recall very well the public discussion during the 1950s and 1960s concerning the potential impact of organized crime on legitimate business. My first job out of law school was as a trial lawyer in the organized crime and racketeering section of the Criminal Division of the Justice Department at a time when Robert Kennedy was the Attorney General. My recollection of that time was that at the core there was a fear that large criminal enterprises were earning billions of dollars from illicit activities and that these billions were being invested in legitimate businesses. When syndicate criminals invested such huge sums, business enterprises were corrupted and the competitive climate of the market economy was undermined either by the very fact of the investments or by methods of operations of criminals. As I recall, these concerns eventually gave rise to the passsage of RICO in 1970.

Although the legislative history of RICO makes clear that the statute was intended to provide a treble damage remedy for a racketeering injury by a racketeering enterprise, similar to the award of treble damages for a competitive injury actionable under the antitrust laws, unfortunately, the statute was drafted so broadly that the very legitimate corporations and businesses that were intended to be protected under the RICO statute have now become "racketeer" defendants under the statute. Clearly, this is an instance of a valid public policy thrust gone awry in the execution.

I believe that this is an important issue of corporate governance. We in the Federal public policy formulation level expect much of corporations. In return I believe that we have a duty to structure a system of laws which impact on corporate behavior that may fairly be regarded as rational. I further beleive that RICO fails this test.

RICO makes it unlawful for any person to:

(1) use any income derived from a pattern of racketeering activity to acquire an interest in any enterprise;

(2) employ a pattern of racketeering activity to acquire an interest in any enterprise; and

(3) conduct the affairs of any enterprise through a pattern of racketeering activity.

A "pattern of racketeering activity" is defined as two acts of racketeering activity occuring within ten years of one another. The phrase racketeering activity is defined as any one of over 20 acts indictable under Federal and State law including mail fraud, wire fraud and securities fraud.

Given the litigious predilection of our society it is not surprising that imaginative counsel have exercised their duty and attempted to pursue remedies under RICO against legitimate enterprises having nothing whatsoever to do with criminal behavior, let alone a connection with organized crime.

During the past two and one-half years there has been a virtual explosion of civil RICO litigation. Estimates are that the number of published court opinions dealing with civil RICO increased from thirteen by early 1981 to over one-hundred recently even excluding the many cases that are settled. The reason for this increase in litigation is, of course, the availability of a treble damage provision in RICO not available under the Acts that prohibit the individual acts of racketeering under RICO. The availability of a statutory treble damage action under RICO raises a substantial concern in my mind that carefully crafted structures of express and implied remedies for violations of Federal and State law will be undermined. For example, RICO permits private plaintiffs to recover treble damages in instances where the federal securities laws expressly limit recovery to actual damages. Also, RICO may be used by private plaintiffs to make out claims for securities law violations where they would have no basis for a claim under the federal securities laws.

RICO cases have been filed by export-importers against other corporations alleging claims arising out of fraudulent purchase orders, by jewelers against others alleging fraudulent accounting activities and a whole host of similar alleged claims in the nature of common law fraud or contract breaches.

In my view the implicit unfairness of RICO is that it metamorphosises a laundry list of laws which require indictment by a grand jury and proof beyond a reasonable doubt into civil violations actionable under RICO by lumping them together under the rubrick "pattern of racketeering" activity. Civil actions as we know need only carry the burden of proof of a preponderance of the evidence.

It is one thing for the United States government to bring a criminal charge of mail fraud where the defendant has the bulwark of the grand jury interposed between itself and the government and where a trial by jury is subject to a high standard of proof and quite another to piggyback a Federal civil case on the bare allegation of fraud generally under such a statute with a much lower threshold of proof where the defendant is subjected to treble damages. In my view the state of affairs under RICO stands a long history of statutory and judicially allocated remedies under criminal and civil law on its head.

RICO claims, for example, have been made in a whole variety of securities cases such as tender offer litigation, fraud by securities brokers, and fraud in the sale of securities where no racketeer is even remotely involved.

The existence of a new set of remedies for securities violations is troubling for a number of reasons. The legislative history of RICO furnishes absolutely no indication that Congress intended to provide a broad private remedy for violations of the securities laws. Absent some explicit evidence it seems inappropriate to attribute to Congress an intention to alter significantly the balance of rights and remedies established by the securities laws. As the Second Circuit Court of Appeals said in a recent case "It is hard to believe that in adopting civil RICO Congress intended to permit proof of 'willful' violations by only a preponderance of the evidence. Otherwise two misstatements in a proxy solicitation could subject any director of any national corporation to 'racketeering' charges and the threat of treble damages and attorneys' fees."

RICO was enacted as part of the Organized Crime Control Act of 1970, an act designed "to seek the eradication of organized crime in the United States . . . by providing new remedies to deal with unlawful activities of those engaged in organized crime." The only statement accompanying the introduction of the private cause of action in RICO was that it would enable "those who have been wronged by organized crime [to] at least be given access to a legal remedy."

Moreover, the only types of securities fraud specifically mentioned in the course of RICO's legislative history are the sale of stolen securities and market manipulation resulting from large purchases and sales of securities by organized crime syndicates. Clearly, Congress did not intend RICO to provide an alternate and more attractive remedy for private parties for non-racketeering violations of Federal and State law, especially since those laws referred to in the RICO statute involve decades of statutory and regulatory evolution and commentary and case law development. Certainly Congress, has shown, for example, in recently enacting a cure for securities law insider trading cases, that where it wishes to do so it will provide explicitly a treble damage type remedy.

Allegations of RICO violations against public companies contain a potent smear factor that can compel even a totally innocent defendant to settle a complaint rather than allow itself to be labelled in newspaper headlines as a racketeer.

There is the large possibility that the application of RICO to non-racketeering securities transactions will be abused because of the absence of prosecutorial discretion in civil cases. While the government may exercise prosecutorial discretion to bring RICO claims that are related to organized criminal activity, there is no analogous restraining influence on civil plaintiffs to assure that the statute functions within the bounds intended by Congress.

Given these concerns, and RICO's application in areas far removed from the fight against organized crime, some courts have read various limitations into the Act in order to conform its use to a reasonable interpretation of congressional intent.

Three very recent Second Circuit opinions reflect a very narrow reading of the statute that could greatly reduce the ability of private plaintiffs to bring a RICO action for treble damages. In one case, the court held that a prior criminal conviction is a prerequisite to a civil RICO action. And, in all three cases, the court held that private plaintiffs must allege a "racketeering injury" in order to have standing to sue under RICO. A "racketeering injury" is different in kind from the harm that occurs as a result of the predicate acts themselves. According to the court, it involves the type of systematic harm to competition and markets with consequent injury to investors and competitors that arises from the infiltration of legitimate enterprises by organized crime.

The Second Circuit's restrictive reading of RICO results from a very careful analysis of the congressional purpose in enacting the statute. In the words of that court, we should not "impute to Congress the intention of federalizing a large portion of the common law . . . or of altogether replacing or eliminating much of the need for extensive bodies of federal law specifically directed at extensively considered evils [without] more explicit language from Congress indicative of such intent."

Notwithstanding these judicial attempts to narrow the scope of RICO, private plaintiffs will probably continue to use RICO's civil right of action to alter significantly the balance of rights and remedies established by the securities and other laws.

This is because the Second Circuit's recent cases do not control future rulings by other circuits and indeed are in conflict with other circuit rulings. Thus, RICO claims may continue to be made in situations where Congress has explicitly limited recovery under Federal law to actual damages and in situations where Congress has not provided a right of action.

In my judgment, Congress needs to revisit the RICO statute. It should specifically make clear in the statute that before a civil claim may be filed under RICO the predicate of a criminal charge by the government is a necessity. It should further make clear that a "racketeering" type injury needs to be shown. That is that more than injury arising from the individual violations need be shown. What should be required is an injury which results from a pattern of racketeering to the competitive position of the enterprise alleging the harm. Perhaps the Supreme Court will do the job. But I believe it is the responsibility of the Congress to take RICO off its head and stand it on its feet.

TENDER OFFERS

Much heat has been generated in the past several years in the press, in Congress, at the SEC and in the business and investment community concerning the subject of takeovers and their regulation under Federal law. I hope I can today contribute a few of my own thoughts on some of the major policy issues raised in the ongoing debate. My thought is not to go down the laundry list of specific areas in contention but to convey to you my philosophical approach to the questions raised along with some of the background and intent lying behind the Federal Laws regulating takeovers.

During the 1960's the cash tender offer became an increasingly favored method of acquiring control of publicly held corporations. Since cash, rather than securities, was offered to investors the federal securities laws, as originally enacted, did not cover these transactions. In order to prevent the secrecy with which cash tender offers and open market purchase programs had been conducted, Congress, in 1968, enacted the Williams Act. Under the statute, material information must be disclosed with respect to tender offers at the time the offer is commenced and, in the case of non-tender offer purchase programs resulting in the acquisition of beneficial ownership representing more than 5 percent of the outstanding stock, post-acquisition disclosure.

The Williams Act was carefully drafted to avoid tipping the balance of Federal regulation either in favor of incumbent management or in favor of the person making the takeover bid. The Williams Act, however, left untouched the ability of management of a target to continue to exercise its discretion over the affairs of a company under the business judgment rule of state corporation law. The Williams Act was designed primarily to require full and fair disclosure for the benefit of investors by requiring the offeror to present its proposal to shareholders while at the same time providing management an equal opportunity to fairly present its position on the offer to investors. The Williams Act requires that any person making a tender offer resulting in the ownership of more than 5 percent of the equity securities of certain reporting companies must file a disclosure document with the Commission and distribute that information to shareholders. Any person recommending that shareholders accept or reject the offer must comply with SEC filing and disclosure regulations.

A purpose of the Act was to achieve equal treatment of all holders of the class of security which is the subject of a tender offer. This purpose was noted by former SEC Chairman Cohen in his testimony during Senate hearings: "The bill is designed to eliminate conditions surrounding the offer which discriminate unfairly among those who may desire to tender their shares." In order to ensure equal treatment of all shareholders, the tender offer regulations provide for minimum offering periods, withdrawal rights, proration rights and "best price" protections.

Notwithstanding the regulatory scheme set up under the Williams Act, various practices have developed in the corporate takeover area which have generated a widely shared perception, however rightly or wrongly, that shareholders are not being treated fairly by bidders or raiders and targets' own management. On the bidder side of corporate takeovers, current regulations do not prohibit two techniques that present substantial opportunity for abuse. One, the purchase of additional shares during the ten-day window period between the acquisition of more than 5 percent of the equity securities and the required filing of a Schedule 13D, deprives the market of important information about rapid accumulations of equity securities and potential changes of corporate control. The other tactic, the two-tier bid, is thought by many to be used to coerce shareholders to tender into a first step cash tender offer in order to avoid being forced to accept a lower priced second step exchange. On the defensive side, there has been public criticism of a variety of actions taken by managements which have resulted in frustrated bidders. The actions have included: repurchasing shares at a premium from a shareholder threatening a takeover; acquiring companies in order to create an anti-trust defense; initiating litigation raising issues under the federal or state securities laws and other relevant statutes; authorizing employment termination contracts for executives; the sales of valuable assets; granting options or sales of shares to friendly suitors engaging in a tender offer for the bidder's stock; issuing stock into friendly hands as consideration for an acquisition; and creating a "stock" option plan to dilute the interest of the offeror. The criticism of these actions has been that managements have been more interested in preserving their positions rather than enhancing shareholder gains.

In order to study the fundamental changes that acquisition practices have undergone since the adoption of the Williams Act in 1968, the SEC established an Advisory Committee on Tender Offers. This Advisory Committee was comprised of prominent members of the business and financial communities, academia, and the legal and accounting professions. Their task was to propose solutions to a number of high profile issues raised in the public debate and perception relating to the adequacy of the current regulatory structure to deal with the increasing number and size of corporate struggles for control.

In its report, the Advisory Committee took the position that competitive markets should arbitrate which takeovers take place and that the tender offer rules should be neutral on the question whether takeovers are good or bad. The Advisory Committee suggested that capital allocation would be enhanced, or at least not negatively impacted by such regulatory neutrality. In general, I cannot quarrel with this approach. Hostile takeovers can distract management from long term considerations, forcing concentration on short-term performance to deter takeovers. There is a predatory aspect to some hostile takeovers employing large sums of borrowed funds, not for the purpose of improving the business of the enterprise, or for providing stability to a particular community, but as a form of entrepreneurial speculation which in some cases results in more highly leveraged and therefore less stable business enterprises. On the other hand, hostile offers do sometimes replace inefficient managements, although I frankly suspect that it is the well managed companies that are targeted for takeover. Nevertheless, my view would be that there are certain risks attendant to doing business in a free market economy one of which is that shareholders of a corporation may be offered a higher price for their shares than current market value and that the shareholders may wish to sell their shares. Provided that management retains sufficient discretion under the business judgement rule to consider the long range and other consequences of a proposed hostile offer that are properly within the province of management, hostile offers at least in theory may provide a disincentive for managements to become complacent.

Although I take the view that hostile tender offers should not be outlawed, it nevertheless appears clear to me that there are some potentially serious abuses that need to be addressed. While these practices are not limited to hostile takeover situations, it appears to me that they are most troublesome in the hostile context.

One is the surreptitious acquisitions of large blocks of stock without notice to management or shareholders. The Williams Act requires that when a person acquires more than 5 percent of the equity securities of a corporation, a substantial disclosure document be filed with the SEC and given to management and the public. In addition to information regarding the identity of the acquiror and the number of securities owned, disclosure is also made with respect to other information relating to the transaction including the purpose of the transaction and any plans or proposals that the acquiror has with respect to the target. The Congressional purpose of this provision is to timely apprise managements and shareholders of a potential change in control, so that they may, according to their responsibilities, examine the circumstances of a change in control on the interests of the corporation and on the marketability of shareholder interests.

Unfortunately, the law allows 10 days after the 5 percent threshold has been reached for the required notice to be made. The 10-day window as this period has become known has been used by some to acquire more stock in the corporation.

Thus, at the end of 10 days, management and shareholders may be faced with holdings in a potential acquiror's hands substantially in excess of 5 percent. This frustrates the intent of the law which is to give to managements and shareholders notice of a proposed change in control at a stage early enough for them to exercise their judgments about the merits of the proposal in order to be in a position to make rational alternative choices, such as whether to sell stock or not to sell stock, or in the case of management whether the proposal is in the overall interests of the corporation or not.

There appears to be an emerging consensus that there is a need to close the 10-day window.

There is no such consensus on another potential abuse in takeover situations which involves the price at which shares are to be acquired. I refer to the practice of two-tier pricing in some hostile tender offer situations. In a two-tier priced offering the offeror makes a substantial cash offer for a controlling block of stock sufficient to permit a subsequent merger at its discretion (usually 51 percent of outstanding shares). The offer to the non-controlling merger block, made known at the outset of the offer, is usually for non-cash corporate paper, of less worth and presumably of a riskier nature than cash. In such situations, shareholders may feel coerced into tendering hoping to obtain proration rights for as many shares as possible so that they may avoid being frozen out of the cash tier and forced into the non-cash tier.

Two-tier offers appear at first blush to be fundamentally unfair to shareholders. Not only are they forced to take the risk that they will receive speculative paper for a portion of their shares, but their ability to be treated fairly in the cash tier has been adversely affected by the ability of professionals in the market to obtain an unjust share of the cash tier offering.*/ The arguments surrounding and potential

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*/ Market professionals are able to use their position in the marketplace to appropriate a portion of the tender offer premium from individual shareholders. The Commission and the Advisory Committee have already addressed some of the tactics employed by market professionals to gain an unfair advantage over individual shareholders. The Commission adopted rules prohibiting short tendering and hedged tendering. Short (continued)

solutions to two-tier pricing are complex and I do not wish to prejudge a current Commission study nor to minimize actions already taken to curtail unjust enrichment by market professionals. Nevertheless, it appears to me that the burden is on those who favor two-tier pricing to prove that public policy is best served in this instance by non-compliance with the spirit of the best price rule under the Williams Act. I know that the best price rule does not technically apply to two-tier offers. The Williams Act intended that increased consideration in an offer be available equally to all shareholders. I ask the question whether consistency does not require that the highest price consideration in identical form be made available to all shareholders in multi-step hostile takeover situations.

Two-tier pricing and stock acquisitions which avoid the required notice to managements and shareholders have seemed to tilt the balance of the Williams Act in favor of bidders at the expense of targets, their managements and shareholders.

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*/ (continued) tendering is the practice of tendering shares that the shareholder does not own. Hedged tendering involves the sale of a portion of the securities immediately after they were tendered into a partial offer. Both practices permit arbitrageurs to artificially increase the portion of their securities accepted in the proration pool at the expense of individual shareholders whose interests in the proration pool are commensurately reduced. In May, the Commission proposed a rule change that would extend the prohibition of hedged tendering to cover the writing of certain call options. The proposed rule change would require any shareholder who writes a certain option to deduct it from his ownership interest.

Even with these regulations in place, however, arbitrageurs will still have a trading advantage over individual shareholders with respect to the securities of target companies. This advantage results from the arbitrageur's ability to act more quickly to market developments and his access to information from the marketplace, potential bidders and other arbitrageurs that is not available to individual shareholders. This advantage allows arbitrageurs to receive a disproportionate share of the tender offer premium thereby defeating the purpose of the Williams Act to achieve equal treatment of all holders of a target's stock. The ability of professionals to gain these advantages exacerbates, in my view, the unfair aspects of two-tier pricing and puts investors at an even more severe disadvantage in tender offers having two-tier prices.

The Advisory Committee has made a sincere effort to curtail those abuses. Whether their recommendations go far enough are serious questions with which Congress and the Commission must come to terms.

There has been much public criticism of the role of incumbent management in hostile takeover situations. The implicit assumption in much of this criticism is to the effect that managements are looking out for themselves in tender offer situations rather than for the best interests of the shareholders of the corporation. The response has been varied. The Advisory Committee in its report pays homage to the business judgment rule but would preempt the rule in a number of crucial respects under the rationale that security sales in a national market is of overriding concern. The Commission has proposed legislation which would curtail the ability of management to determine executive compensation and corporate issuances and purchases of its securities in some takeover circumstances. Bills in Congress would outlaw all of these and more, most significantly by a wholesale assault on the business judgment rule to require management to prove the reasonableness of its actions in a hostile tender offer situation and provide the necessity for tender offerors to make community impact statements at the outset of any offer for control of a corporation.

Taken as a whole these recommendations, if adopted, would be tantamount to a substantially wholesale federalization of state corporate law. I believe there have been some abuses. The public reads about the abuses in the press under very colorful and catchy phrases (pac men, white knights, golden parachutes, greenmail). Greenmail is indefensible. Nevertheless, in my view the abuses do not support a wholesale supplanting of state corporate law by federal law.

Corporate managements exercise important responsibilities in a free market economy. They put capital to work producing the goods and services consumers want. In the process, they create jobs, they grapple with plant closings, a competitive international economy, and the long term stability of the industrial base. The business judgment rule has played no small part in management's ability to respond to dynamic changes in domestic and international markets.

For the past 20 years the economy has been wracked by inflation and economic shocks such as the run up in the price of oil. In such circumstances it can come as no surprise that investors and savers want as high a return as they can achieve as fast as they can. Look, for example, at what has happened to the term and rate structure of the deposit base of insured financial institutions.

In the absence of a takeover, the stock market does not reflect as current value premiums on shares premised on a change in control. It is not surprising that in current economic circumstances investors' interest is high in takeover situations in favor of changes that will result in immediate price increases. Does it follow then, that hostile tenders carry so clearly demonstrable public benefits that public policy should alter historical federal-state relationships, thereby establishing a federal policy that favors hostile takeovers by preempting state corporate laws which are viewed as impediments to takeovers?

There is a national market for securities. The existence of such a national market does not demand that public policies be adopted which alter the business judgment rule. No damage is done to the national market for securities by managements scrutinizing offers for changes in control of corporate entities and making decisions based upon a complex of public interest considerations such as long term effects on the corporation, its competitive position in domestic and international markets, and stability of labor and community relations. Short term price appreciation to shareholders is certainly an important factor to be considered in applying the business judgment rule, but I raise the question for discussion as to whether it should be the sole or controlling criterion.

Requiring tender offerors to file a community impact statement at the outset of an offer and altering the business judgment rule by federal law would have the benefit of bringing into public view and discussion matters now committed by the business judgment rule to management discretion. Since the reason for this substantial change in the corporate legal framework is to ensure that shareholders may maximize stock price appreciation in the short term, public policy makers should consider the effects of their actions on the long term implications of U.S. economic performance.

I believe that if public policy goes in such a direction, the consequence would be to curtail management flexibility to respond in a responsible manner to altered economic conditions. Some shareholders and many professionals may prosper but the long run effects on our economic performance and investor confidence may be adverse.

I have set forth my personal observations so that they may be considered in the public policy debate. As consideration of these issues moves forward I shall pay close attention to the views of my colleagues. I hope that together we can move forward to a system of consideration of hostile tender offers that is fair to all shareholders, retains flexibility with management and retains a balance between Federal and State relations.