UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

BUREAU OF COMPETITION

COMMISSION AUTHORIZED
V880015

January 15, 1988

The Honorable Steven H. Amick
House of Representatives
Legislative Hall
Dover, Delaware 19901

Dear Mr. Amick:

The staff of the Federal Trade Commission is pleased to respond to your letter of invitation of January 7, 1988, to comment on House Bill No. 336. */ The bill incorporates the recommendation of the Delaware Bar Association to amend Delaware's General Corporation Law by adding a "business combination" provision as section 203. The proposed legislation, if enacted, would restrict the ability of acquirers to engage in business combinations with target corporations for three years after acquiring ten percent of the target firms' shares.

We believe that enactment of proposed section 203 is likely to deter takeovers that benefit stockholders, employees, consumers, and the economy as a whole. If the legislature nevertheless decides to enact proposed section 203, we urge it to consider making that provision applicable solely to corporations that affirmatively elect to be covered by it through amendments to their certificates of incorporation. An affirmative "opting in" provision would enable the stockholders of each corporation to determine whether restraints on the transfer of corporate control are in the interests of the corporation.

Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive practices in or affecting commerce. 15 U.S.C. § 45. Pursuant to this mandate, the Commission seeks to identify and urge the removal of restrictions that impede competition or increase costs without offering countervailing benefits to consumers. Our efforts have included providing comments to federal, state, and local legislatures and administrative agencies on matters that raise issues of competition or consumer protection policy.

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*/ These comments represent the views of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics, and do not necessarily represent the views of the Commission itself or any individual Commissioner. The Commission has voted, however, with Commissioner Bailey dissenting, to authorize us to submit these comments for your consideration. Commissioner Calvani did not participate in the Commission's vote.

The Commission has substantial experience in the area of mergers and acquisitions. The Commission enforces section 7 of the Clayton Act, 15 U.S.C. § 18, which prohibits acquisitions of corporate assets or securities that may substantially lessen competition or tend to create a monopoly. Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a, the Commission reviews proposed acquisitions of corporate securities, including tender offers, to determine whether they violate the antitrust laws.

The Commission's staff has addressed issues related to the market for corporate control through scholarly studies and comments to state governments. Earlier this year, the Commission's Bureau of Economics published a study on the effects of takeover legislation enacted by New York in 1985. 1/ In the past two years, the Commission's staff provided comments on corporate control legislation to the governor of New York and to the New Jersey legislature.

Effect of Takeovers on Economic Welfare

The corporate takeover is a mechanism for transferring control of corporate assets. The transfer of corporate control can serve a number of desirable economic functions, such as facilitating the redeployment of corporate assets to more efficient uses and improving corporate management. Although not every takeover ultimately produces such benefits, we believe that takeovers in the aggregate are likely to enhance economic efficiency and benefit stockholders, employees, and consumers. As discussed in further detail below, although some critics have questioned the benefits of takeovers, the criticism appears to lack empirical support.

Studies suggest that management-opposed corporate acquisitions are most commonly carried out when outside bidders have an opportunity to improve the performance and thereby increase the value of target corporations. 2/ Such bidders pay substantial

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1/ L. Schumann, State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statutes (Federal Trade Commission, Bureau of Economics, 1987).

2/ See Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy, 11 J. Fin. Econ. 183 (1983); Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981); Easterbrook & Fischel, The Proper Role of a Target's Man-

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premiums over the market value of the shares of target corporations because they believe that the corporations will be worth more under their control. 3/

There are a number of sources for the potential gain in an acquired firm's performance. In some cases, bidders are able to improve the management of the target firm. In other cases, bidders may be able to improve efficiency by combining firms with complementary strengths, integrating production or distribution channels, eliminating duplicative functions, or facilitating mutually beneficial technology transfers. Takeovers may also permit firms to shift corporate assets to more efficient uses by selling or changing the use of underperforming facilities.

The transfer of corporate control in such circumstances is likely to benefit stockholders, employees, and the economy as a whole, as well as the successful bidder. Stockholders, many of whom are employee pension funds, benefit in two ways. First, because bidders for corporate control offer substantial premiums over the pre-offer market price of corporate shares, target company stockholders enjoy rapid appreciation of the value of their shares. Second, the threat of takeovers may motivate incumbent corporate managers to improve corporate performance. Employees benefit from enhanced corporate efficiency and the accompanying gains in corporate competitiveness. 4/ The entire economy can benefit both from the transfer of corporate control to more efficient management and from the incentives that takeovers create for improved managerial performance.

Numerous scholarly studies have concluded that takeovers, on average, lead to an increase in the stock market's valuation of both the acquired and the acquiring firms. 5/ According to a re-

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agement in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981).

3/ There is evidence that share prices of most target companies significantly underperform the market in the pre-offer period. See Gilson, supra note 2, at 852-53, and sources cited therein.

4/ Profitable firms provide the best opportunities for wage growth, new employment, and the fulfillment of pension and other contractual obligations to workers.

5/ These studies measure the stock market performance of the companies involved during short periods of time surrounding takeover bids. Although these studies may be viewed as offering a "snapshot" view of the stock market's valuation of takeovers, and
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cent study, share prices of acquired firms increase by an average of 53.4 percent. 6/ Different studies report that the share prices of acquiring firms increase by smaller amounts, ranging from approximately 2 percent to approximately 7 percent. 7/ These studies suggest that the market values both the acquiring company and the target company more highly than in the absence of a takeover. 8/ In the aggregate, takeovers enhance the welfare of stockholders of both acquiring and target companies.

A substantial body of economic and legal literature supports the view that the increases in the stock market's valuation of firms following a takeover represent efficiency gains -- and the creation of new wealth -- attributable solely to the takeover. 9/ Because participants in the stock market act on the basis of empirical observations, the stock market is unlikely to have systematically revalued upward the prices of equity securities involved in takeovers unless prior takeovers, on average, produced such gains. A smaller group of studies quarrels with these conclusions, but many of these studies contain methodological er-

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thus as only indirect measures of long-term performance, economic scholars largely agree that the increases in company valuations reported by these studies represent efficiency gains. See note 9, infra, and accompanying text.

6/ Securities and Exchange Commission, Office of the Chief Economist, The Economics of Any-or-All, Partial, and Two-Tier Tender Offers, Table 4A (1985).

7/ Those findings are summarized in Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5, 11 (Table 3), 16-22 (1983). See also Jarrell & Bradley, The Economic Effects of Federal and State Regulations of Cash Tender Offers, 23 J. Law Econ. 371, 393-95 (1980); Council of Economic Advisers, Economic Report of the President 197 (1985).

8/ Similarly, share prices of both bidding and target firms usually decline after unsuccessful takeover bids to below the pre-offer level. Bradley, Desai & Kim, supra note 2, at 189-204; Jensen & Ruback, supra note 7, at 8.

9/ The economic and legal literature discussing the benefits of takeovers is vast. See, e.g., Economic Report of the President, supra note 7, at 187-216; Jensen & Ruback, supra note 6; Bradley, Desai & Kim, supra note 2; Gilson, supra note 2; Easterbrook & Fischel, supra note 2; Easterbrook & Jarrell, Do Targets Benefit from Defeating Tender Offers, 59 N.Y.U.L. Rev. 277 (1984); Pound, Lehn & Jarrell, Are Takeovers Hostile to Economic Performance?, Regulation, Sept.-Oct. 1986, 25.

rors. 10/ A major scholarly study that took issue with the conclusions of the stock market studies, relying instead on accounting data, concluded that takeovers neither improved nor degraded the performance of the target firms. 11/

Accordingly, no scholarly consensus on the economic effects of takeovers supports changes in the law to make management-opposed takeovers more costly and difficult. On the contrary, the preponderance of scholarly opinion on the subject supports the conclusion that management-opposed takeovers produce economic benefits. New restrictions on takeovers are likely to undermine

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10/ For example, Weidenbaum & Vogt, Takeovers and Stockholders: Winners and Losers, 19 Cal. Mgmt. Rev. 157 (1987), incorrectly relied on evidence concerning negotiated mergers to conclude that management-opposed takeovers reduce efficiency. When the evidence of management-opposed takeovers reviewed by the authors is examined separately, it supports the conclusion that takeovers enhance efficiency. Similarly, Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979), offered evidence purporting to show that stockholders benefited from management resistance that resulted in the defeat of takeover bids. Lipton's evidence showed that the share prices of some firms that had defeated takeover bids increased above the tender offer price a number of years later. His study did not compare these share price movements to the overall market's movement during the same period. More systematic studies, which examine abnormal returns on shares of takeover targets compared to overall market trends, show that stockholders incur significant losses from the defeat of takeover bids. See generally Easterbrook & Jarrell, supra note 9, at 282-84.

11/ D. Ravenscraft & F. Scherer, Mergers, Sell-Offs, and Economic Efficiency 101-03 (1987). The authors used accounting data to measure economic rates of return. This methodology is controversial because profits revealed by such data are subject to wide variations resulting from the use of divergent accounting conventions by different firms. See generally Benston, The Validity of Profits-Structure Studies with Particular Reference to the FTC's Line of Business Data, 75 Am. Econ. Rev. 37 (1985); Fisher & McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, 73 Am. Econ. Rev. 82 (1983). In addition, because of constraints on the availability of data, the study focuses largely on conglomerate mergers. See Ravenscraft & Scherer, supra note 11, at 22. As the authors observe, however, the incidence of horizontal merger activity has increased markedly in this decade, and "[t]he shift toward large horizontal mergers is more difficult to evaluate solely on the basis of our research." Id. at 219.

economic efficiency by impeding the flow of corporate assets to value-maximizing uses and by entrenching inefficient managers.

<u>Asserted Disadvantages of Takeover Activity</u>

Several purported disadvantages of takeover activity are often cited to justify restraining corporate acquisitions. Although these disadvantages have not been substantiated through empirical research, they are often cited by incumbent managers and other takeover critics in testimony before Congressional committees and in articles in the general press. In the absence of persuasive evidence substantiating these asserted disadvantages, these claims do not support the enactment of curbs on takeover activity.

Some takeover critics claim that acquirers often take over well-managed corporations, oust good management, and reduce corporate efficiency by installing less capable management teams. This, indeed, may happen in some cases. Corporate acquirers, like all other businesspersons, may make mistakes. This possibility, however, does not justify controls on takeover activity any more than the possibility of poor investments in plant or equipment justifies government controls on investment decisions made by corporate managers. In a market economy, investment decisions generally are best left to investors, who stand to profit from correct decisions and lose from poor ones. The critical fact is that takeover activity, in the aggregate, appears to benefit society. Because the benefits of takeovers outweigh their costs, restricting takeovers in the hope of preventing unwise investments is likely to harm societal welfare.

It also has been argued that management-opposed takeovers result disproportionately in facility closings and lay-offs, which impose great social costs on individuals and communities in which plants are located. But factual support for the position that takeovers in fact lead to plant closings and lay-offs that would not have occurred otherwise is, at best, scanty. 12/ Any

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12/ <u>See</u> Jensen, <u>Takeovers: Folklore and Science</u>, Harv. Bus. Rev. Nov.-Dec. 1984, at 114 ; <u>cf</u>. American Enterprise Institute, <u>Proposals Affecting Corporate Takeovers</u> 31 (1985) (citing finding that "very few jobs were affected" by 6,000 corporate acquisitions in 1970s). The AFL-CIO estimates that a total of 80,000 jobs of members of its affiliated unions have been lost as a "result of corporate restructuring" in recent years. <u>Hostile Takeovers</u>, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 262 (1987) (statement of Thomas R. Donahue) (hereinafter "<u>Hearings on Hostile Take-</u>

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closings or lay-offs that are necessary to achieve greater efficiency likely would have been carried out by the target's management in any event if the firm were to remain competitive. Moreover, most economic changes that increase efficiency -- and thereby increase aggregate societal wealth -- create dislocations that reduce the welfare of some individuals. 13/ This is true of virtually every major technological advance, which renders earlier technologies obsolete and may harm firms and individuals dependent on the earlier technologies.

It has been asserted that the financing of corporate acquisitions through high yield (or "junk") bonds saddles acquiring firms with "excessive" debt. Some critics argue that the assertedly high debt burden assumed by corporate acquirers will lead persons who gain control of a target firm, among other things, to close productive plants, terminate expenditures for activities that lead to long-term benefits, such as research and development operations, and "loot" corporate cash accounts and other assets of the firm. Although the focus of the criticism has been acquirers' use of high yield bonds to finance takeovers, relatively little takeover financing is made through high yield bonds. In the first nine months of 1986, a year of significant takeover activity, high yield bonds represented only 7.6 percent of tender offer financing. 14/

12/(...continued)
overs"). Even assuming that this estimate, for which the time frame is unspecified but presumably spans a number of years, is correct, it is difficult to assess how many of those jobs would have been abolished in any event to improve the competitiveness of the affected companies. To put the figure in perspective, a total of 5.1 million workers lost their jobs because of plant closings or efficiency measures in the years 1979-1983. Bureau of Labor Statistics, Monthly Labor Review (June 1985).

13/ It would seem preferable for government to respond to these inevitable economic dislocations by initiating effective remedial measures to assist displaced individuals rather than severely restricting economic activity that benefits society.

14/ H. Sherman & R. Schrager, Junk Bonds and Tender Offer Financing 18 (1987), reprinted in Hearings on Hostile Takeovers, supra note 13, at 627. To put the point in perspective, in 1985, only 600 U.S. companies qualified for investment grade ratings, while 19,000 additional companies with assets of more than $25 million did not qualify. Impact of Corporate Takeovers, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. 699 (1985) (statement of Frederick Joseph). Many of these corporations use high yield bonds to fi-
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It is highly improbable, moreover, that corporate acquirers would undertake obligations they believe likely to render an acquired company unprofitable, because doing so likely would defeat the very purpose of their investment. It is not in the interest of acquirers to shut down profitable operations or eliminate beneficial research and development efforts for the purpose of satisfying debt obligations. Divestiture of corporate assets or reduction in research and development efforts for the sake of satisfying debts, rather than for business reasons, will rob the divesting firm of a source of future earnings to satisfy future debt obligations. 15/ Moreover, the sophisticated institutional investors who buy high yield bonds, which include pension funds, insurance companies, mutual funds, and other financial institutions, are unlikely to lend money for takeovers unless they expect them to be profitable.

Finally, it is argued that takeovers force corporate managers to focus on short term profits and forego long term investments. The evidence shows, however, that foregoing long term investment makes companies more, not less, vulnerable to takeovers. Takeover targets tend to have below-average research and development budgets, showing a lesser commitment to long term investments than the average firm. 16/

14/(...continued)
nance growth because debt securities offer them more flexibility than bank loans or term loans by insurance companies, which until recently had been their only available avenue for debt financing. Thus, in 1985, firms issued a total of $15 billion in high yield bonds. Sherman & Schrager, supra, at 4. During the same year, the total value of debt securities issued to finance tender offers, including investment grade securities, was $4.3 billion. Id. at 17.

15/ Of course, acquirers may sell portions of acquired firms because they do not fit into the firms' business plans, and will shut down inefficient facilities, including inefficient research and development operations, because they are unprofitable in the long run. But this is precisely the sort of redeployment of corporate assets to more efficient uses that results in benefits to society.

16/ This proposition is supported by a recent empirical study of the investment patterns of takeover targets. The study, which examined all 217 takeover targets that were acquired between 1980 and 1984, found that takeover targets had below average ratios of (i) research and development expenditures to total expenditures and (ii) capital investment to earnings. Securities and Exchange
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Effect of "Business Combination" Restrictions

Proposed section 203 governs "business combinations" between "interested stockholders" and takeover target firms. Section 203(c)(5) defines "interested stockholders" as owners of 15 percent or more of the voting shares in Delaware corporations. Under the proposed legislation, such stockholders would be prohibited from merging with or conducting other specified business activities with target corporations for three years after becoming interested stockholders, unless the business combination or the purchase of shares was approved by the target corporation's board of directors before the acquirer became an interested stockholder. 17/

The proposed legislation is likely to deter takeovers whose profitability depends on the ability of the acquirer to merge with the target corporation. The successful bidder for corporate control commonly seeks to consolidate the target into its operations by means of a merger. 18/ A three-year merger prohibition is likely to require many acquirers to maintain inefficient forms of business organization and would thus undercut their ability to improve the efficiency of target corporations. This, in turn, may deter some takeover bids that would benefit the economy.

The bill would also prohibit the sale or other disposition of substantial target company assets, "except proportionately as a stockholder of the corporation," to or with interested stockholders for a period of three years after the stockholder became

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Commission, Office of the Chief Economist, Institutional Ownership, Tender Offers, and Long-Term Investment 8-10 (1985).

17/ Proposed section 203(a) also exempts any stockholder who acquires at least 85 percent of the corporation's shares "upon consummation of the transaction" in which it becomes an interested stockholder, or who, after becoming an interested stockholder, obtains approval for the business combination by the board of directors and secures the authorization therefor by the vote of two-thirds of the outstanding shares of remaining stockholders.

18/ See R. Gilson, The Law and Finance of Corporate Acquisitions 854 (1986).

an interested stockholder. 19/ Many corporate acquisitions are financed through debt securities that may be partially retired through the sale or other disposition of acquired assets. Section 203(c)(3)(ii) of the proposed legislation would prohibit pledging or otherwise transferring substantial assets to or with interested stockholders. 20/ This prohibition would increase the cost of financing, and in many cases may deter, takeovers designed to redeploy assets to more efficient uses.

The proposed legislation would restrict the freedom of stockholders to control and dispose of their property without government scrutiny. Owners of assets should be free to sell property without having the state examine the merits of the transaction, absent a compelling justification. When stockholders determine, for whatever reason, to transfer control of a corporation, the state should not frustrate their will and require them to retain managers they wish to displace.

Empirical Evidence on Effect of Anti-Takeover Legislation

Two recent empirical studies concerning the effect of anti-takeover legislation have concluded that anti-takeover laws harm stockholders and undermine economic efficiency. A recent empirical study by the Commission's Bureau of Economics of a New York statute 21/ similar to section 203 analyzed the extent of the economic harm caused by restrictions on "business combinations." 22/ The study found that the announcement by New York's governor of the proposed legislation that ultimately became the

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19/ The phrase "except proportionately as a stockholder of the corporation" did not appear in an earlier version of the legislation circulated for comment by the Delaware Bar Association and was added by the Association in a later draft. As we understand the modification, the acquired corporation would be free to dispose of substantial assets after an interested stockholder gains control so long as the gains of the transaction are distributed proportionately to all stockholders. Although we welcome this modification, for the reasons set forth in the text below we think that eliminating the prohibition altogether would be preferable.

20/ With the exception of the additional phrase exempting asset transfers made "proportionately as a stockholder of the corporation," the prohibition in section 203(c)(3)(ii) is virtually identical to that set forth in section 912(a)(5)(B) of the New York Business Corporation Law, which has been interpreted to prohibit the transfer of assets whose value exceeds the percentage of total corporate assets set forth therein.

21/ New York Bus. Corp. Law § 912.

22/ Schumann, supra note 1.

New York law resulted in a statistically significant decline in the average value of shares of New York corporations. The decline was equal to approximately one percent of the value of the shares, or $1.2 billion. 23/ As the study noted in conclusion:

> [D]espite the political rhetoric advocating the regulation of takeovers on behalf of shareholders, the evidence . . . indicates that this very strong statute does not protect shareholders; rather, the law protects managers at the expense of shareholders. . . . [In addition, the statute] may promote the inefficient management of society's assets by lessening the ability of capital markets to efficiently reallocate assets. Consequently, the real cost of the goods and services produced by the firms affected by [the statute] may increase, injuring consumers as well as shareholders. 24/

Another study, conducted by the Office of the Chief Economist of the Securities and Exchange Commission, also concludes that anti-takeover legislation is harmful to the interests of stockholders. The study examined the effects of a recent Ohio law that, among other things, authorized corporate directors to consider the interests of persons other than the stockholders in assessing takeover bids. 25/ The SEC study found that the enactment of the Ohio law caused an immediate two percent decline in the equity value of corporations insulated from takeovers by the Ohio law.

Consideration of an "Opting-In" Mechanism

If the legislature decides to enact proposed section 203 in some form despite the concerns discussed above, we request that you consider modifying the bill to make it inapplicable to corporations that do not affirmatively elect to be covered by its provisions through amendments to their certificates of incorporation. In its present form, proposed section 203 applies to all corporations that do not "opt out." To the extent that proposed section 203 is motivated by a concern for stockholders, its purpose would be better served by a requirement that stockholders

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23/ *Id.* at 41, 46-47.

24/ *Id.* at 47.

25/ Securities and Exchange Commission, Office of the Chief Economist, *Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers* (1987). The Ohio law is codified in Ohio Rev. Code Ann. § 1701.01 *et seq.* (Page 1986 supp.).

approve a decision to opt into the proposed legislation. We recommend that a corporation's decision to opt into the statutory scheme be made solely through a stockholder vote amending the certificate of incorporation.

If the legislature decides to retain the proposed opting-out mechanism, we recommend that it consider giving immediate effect to stockholder determinations to opt out of the legislation. Under proposed section 203(b)(3), an amendment to a corporation's certificate of incorporation expressly electing not to be governed by the legislation does not become effective for twelve months. Such amendment, moreover, is made inapplicable to business combinations with any person who became an interested stockholder at the time of or prior to the amendment. This is a serious restraint on the freedom of stockholders to control the corporations they own. The inclusion of an opting-out provision embodies an implicit recognition that the proposed legislation may be harmful to the interests of stockholders. An ineffectual opting-out provision, however, does little to ameliorate that harm.

Conclusion

The case has not been made to date that proposed section 203 is a necessary or desirable response to corporate takeover activity. On the whole, we believe that vigorous takeover activity enhances economic efficiency and thus benefits consumers, workers, and stockholders. We are troubled that proposed section 203 would impede many of the beneficial consequences of takeovers without offering countervailing benefits. We urge you to consider whether the proposed legislation would unduly interfere with the market for corporate control to the detriment of the national economy.

Sincerely,

Jeffrey I. Zuckerman
Director