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News Release

Remarks of

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LEVERAGED BUYOUTS

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

LEVERAGED BUYOUTS

INTRODUCTION

The $25 billion leveraged buyout of RJR Nabisco Inc. recently focused public attention on corporate acquisitions to a greater extent than ever before. 1/ It also changed the focus of the public debate concerning corporate takeovers from the pros and cons of hostile tender offers to the economic and other effects of all leveraged transactions. This development has been beneficial, since it involves a recognition by policy makers that shareholder protection and other public policy concerns are present in negotiated as well as hostile transactions.

As one who believes that interference with leveraged buyouts would not be beneficial to the economy, I find that current issues arising from leveraged buyouts and takeover activity provide reasons for optimism. The economic effects of these transactions are being fully examined, and the case has not been made that they are harmful. The markets are providing large premiums for shareholders. The courts are addressing most of the significant shareholder protection issues presented by LBO transactions. The disclosure problems associated with tender offers and LBOs are being identified and addressed by the Commission and its staff. Congress has been holding hearings encouraging extensive public debate but does not seem likely to enact LBO legislation.

There is also cause for concern, primarily because some state legislatures seem to be willing to impose state takeover

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1/ See "$25,000,000,000," Time, Dec. 12, 1988, p.56.

protections for creditors, employees, and communities at the expense of corporate shareholders.

The current system of joint state and federal regulation of the takeover process is flexible and sound. State law addresses abuses of shareholders in management buyouts and takeovers, and federal law provides a sound disclosure system. This regulatory partnership must continue to support the proposition that corporate managers are responsible to their shareholders.

DEFINITION OF LEVERAGED BUYOUT

In addressing issues raised by leveraged buyouts, it is important to note that the phenomenon being addressed is not a particular type of transaction, but a financing technique. The technique involves the use of the subject company's assets as a source of collateral for acquisition or restructuring financing, and then servicing debt through income flows and reducing debt through asset sales. This technique can be employed by management or by third parties, in hostile or friendly transactions. The term "leveraged buyout" therefore should be understood to include management buyouts (MBOs), hostile takeovers, friendly transactions with third parties, and corporate restructurings, and can be accomplished through a negotiated merger, a third-party tender offer, an issuer self-tender offer, a sale of assets, a reverse stock split and repurchase of resulting fractional interests, a payment of a large extraordinary dividend financed by borrowings, or any combination of these transactions.

The debate over LBOs encompasses both economic and investor protection issues, which are often inextricable. What is good for shareholders may not necessarily be good for managers or other corporate constituencies, such as corporate bondholders, other lenders, employees, and the communities in which the corporation operates. These groups may view LBO transactions designed to maximize shareholder values as detrimental to their interests.

ECONOMIC CONCERNS

Even if no legislative or regulatory reforms result from the intense scrutiny provided LBOs over the last year, the study of these transactions has been beneficial, since academics,2/ participants in these transactions, 3/ and

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2/ E.g., Adler and Ribstein, Debt, Leveraged Buyouts and Corporate Performance, Cato Institute Policy Analysis (May 1989); Long and Ravenscraft, The Record of LBO Performance, Conference on Corporate Governance, Restructuring, and the Market for Corporate Control (1989); Kaplan, Sources of Value in Management Buyouts, Conference on Management Buyouts (Paper)(1988); Smith, Corporate Ownership Structure and Performance: The Case of Management Buyouts (Working Paper)(1989); Muscarella and Vetsuypens, Efficiency and Organizational Structure: A Study of Reverse LBOs (Working Paper)(1988).

3/ E.g., Merrill Lynch, Leveraged Buyouts in Perspective, March 1989; Kohlberg, Kravis Roberts & Co., Presentation on Leveraged Buyouts, January 1989.

government regulators, 4/ have stepped back to assess whether these transactions have a detrimental or beneficial effect on the nation's economy.

While many of these studies are ongoing, including those being undertaken by the Commission's staff, preliminary results are available. Generally, although any major corporate restructuring or reorganization will cause certain dislocations and uneven benefits, the studies do not support the conclusion that leveraged buyouts should be characterized as detrimental. While there are problems that need to be addressed, leveraged buyouts appear to have had significant beneficial effects in terms of returns to shareholders, corporate efficiency, and profitability.

To the extent that management of a corporation rests in the owners of the corporation following an LBO, the incentives to run the corporation more efficiently and profitably are increased. Corporate managers who have a direct and significant financial stake in the success or failure of the business are likely to be better managers. Additionally, when LBOs result in the breakup

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4/ E.g., An Assessment of the Impact of Recent Leveraged Buyouts and Other Restructurings on Industrial Research and Development Expenditures, Prepared by the Staff of the National Science Foundation for the Subcomm. on Telecommunications and Finance, House Comm. on Energy and Commerce (1989); Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies, A Report Prepared by the Economics Division of the Congressional Research Service for the House Subcomm. on Oversight and Investigations, House Comm. on Energy and Commerce, Comm. Print No. 100R; 100th Cong., 2d Sess. (Dec. 1987).

of conglomerates, managers may be freed from restraints stemming from the diverse objectives of many separate corporate components. A breakup permits management to concentrate its expertise in fewer lines of business.

One economic concern raised by LBOs is that the increased debt burden being incurred by corporations will make them more susceptible to default if our economy should experience a major recession. This fear is not new. In 1984, Securities and Exchange Commission Chairman John Shad, in a speech entitled "The Leveraging of America," 5/ stated that "[t]he leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates." One recent study has suggested that a major recession might force 10% of the U.S. firms sampled into bankruptcy. 6/ Others have expressed the concern that the banking system may be imperiled if a significant proportion of major U.S. companies cannot meet their obligations. 7/

5/ Shad, John S.R., "The Leveraging of America," Address before the New York Financial Writers Association, June 7, 1984.

6/ Testimony of John J. Creedon, President and Chief Executive Officer, Metropolitan Life Insurance Company, Before the Senate Comm. on Finance, on Leveraged Buyouts and Corporate Debt, January 26, 1989, at 5, citing, Ben S. Bernanke and Joseph Y. Campbell, Brookings Papers on Economic Activity (1988).

7/ E.g., H. Kaufman, Halting the Leverage Binge, Institutional Investor, April 1989, at 23.

Noting that corporate debt as a percentage of GNP is considerably lower in the United States than in other industrialized countries, others have suggested that there may not be significant cause for concern. 8/ While the ratio of corporate debt to GNP is 42% in the United States, it is 100% in Japan, 70% in West Germany, and 65% in Canada. These figures may indicate that corporate debt in the United States is not becoming too high.

A more basic question raised by concern over corporate debt levels is whether the federal government should be in the business of regulating corporate debt to equity ratios. In my view, the concern over excessive leverage is too speculative to justify intrusive financial regulation of U.S. industrial corporations. It is extremely difficult, if not impossible, to predict what corporate debt to equity ratio will be beneficial for our economy. Indeed, inefficiencies could be caused by overly restrictive standards, with resulting negative impact on the ability of U.S. corporations to compete with foreign firms.

Instead of government intrusion, I believe it better to rely on market discipline to ensure that corporate debt to equity ratios do not become too high. Creditors have strong

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8/ E.g., Excess Debt and Unbalanced Investment: The Case for a Cashflow Business Tax, Testimony of Martin Feldstein before the House Comm. on Ways and Means, Jan. 31, 1989.

incentives not to place themselves at undue risk. 9/ Concern that lending standards by financial institutions, such as banks, insurance companies, or pension funds, are not high enough can be addressed by the appropriate financial regulators. Indeed, the banking agencies have already increased their scrutiny of the lending practices in LBOs. 10/ To date, there seems to be little evidence that banking institutions have engaged in imprudent lending or investing practices in connection with LBO financing. 11/

One legislative approach that might slow down the LBO movement relates to the current incentive under the tax laws to finance acquisitions by increasing debt and reducing dividend payments, a technique that reduces taxes because interest payments are deductible, while dividend payments are not. This advantage of debt over equity can be removed by making dividend

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9/ Smith, "RJR Legacy: LBO Lenders Grow Cautious," Wall Street Journal, Nov. 21, 1988, p. C1.

10/ Taylor, "Bank Loans for Buyouts to be Placed Under Tighter Scrutiny by Regulators," Wall Street Journal, Nov. 7, 1988, p. A3; Knight, "Regulators Worry About Risk in Financing of Big Takeovers," Washington Post, Nov. 28, 1988, p. A1.

11/ Statement of Robert L. Clarke, Comptroller of the Currency, Before the House Comm. on Ways and Means, January 31, 1989; Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Senate Comm. on Finance, January 26, 1989; Statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, Before the House Comm. on Ways and Means, Jan. 31, 1989; Statement of Dr. Kathleen P. Utgoff, Executive Director, Pension Benefit Guarantee Corporation, Before the Senate Comm. on Finance, Jan. 26, 1989.

payments tax deductible for the paying corporation. Many major industrialized nations provide some credit to the corporation or shareholder with respect to dividend distributions. 12/

Granting a tax deduction for dividends makes sense, but for reasons unrelated to the LBO debate. I believe that the current double taxation of dividends gives corporations incentive to favor debt over equity as a source of financing. As a result, the flexibility regarding timing of payments inherent in using equity is limited by the tax disadvantage of that financing technique.

Of course, the problem with providing a deduction on dividends is the dramatic effect that change would have on federal tax revenues. According to Treasury estimates, even a 50% reduction of the tax on corporate dividends paid would decrease federal tax revenue by $31 billion annually. 13/ Since it is highly unlikely a major revenue loss would be accepted in today's budget environment, other measures, such as corporate tax increases, would have to be adopted to offset the loss.

A number of avenues have been suggested by which the tax laws could be used to interfere with LBOs. The House Ways and Means Committee recently published a list of the options for

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12/ Federal Income Tax Aspects of Corporate Financial Structures, Prepared by the Staff of the Joint Comm. on Taxation, at 89 (1989).

13/ Report to the President, Office of the Secretary, Dept. of Treasury, on Tax Reform for Fairness, Simplicity and Economic Growth Act (Nov. 1984).

consideration. 14/ These options include disallowing or limiting interest deductions on excess leverage, denying the interest deduction on debt used to finance a hostile takeover, and limiting interest deductions for junk bond financings.15/ These proposals, of course, really are aimed at restricting or eliminating LBOs and, in my view, should be rejected for that reason.

SHAREHOLDER PROTECTION CONCERNS

From the point of view of the Commission, the shareholder protection concerns presented by LBOs are the most important. Two principal inquiries must be posed: 1) Are shareholders being treated fairly in LBOs? and 2) Are shareholders receiving information adequate to allow them to make sound investment decisions? Due primarily to the historical development of corporate law and principles of federalism, questions of management conduct and the fairness of transactions have become the province of state law, while the federal securities laws have regulated disclosure.

14/ Press Release No. 13, House Comm. on Ways and Means, April 12, 1989.

15/ A "hostile" offer would be defined as a takeover disapproved by a majority of the independent directors of the board. Other proposals would disallow interest deductions for acquisitions found by the FTC not to be in the public interest because of job loss or other economic disruptions, or for acquisitions by foreign entities.

State Conflict of Interest Law

Issues concerning substantive fairness to shareholders, are governed by the fiduciary duties owed by management to shareholders. These principles of corporate governance are the traditional province of state law. In the last decade, state law, especially the influential body of Delaware corporate law, has continued to evolve to address issues of fairness and management duties in the changing environment of takeovers and leveraged transactions. 16/

Cases involving change of control transactions have evidenced increasingly vigilant judicial scrutiny of management conduct, even in the absence of management participation in the change of control transaction. For example, in Smith v. Van Gorkom, 17/ the Delaware Supreme Court found directors of a corporation personally liable for a breach of their duty of care, where they approved a cash-out merger without taking adequate time to consider the transaction or receiving adequate information about the sufficiency of the offering price. In these circumstances, the court found that the directors did not "act in an informed and deliberate manner," as required by their

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16/ See generally DeMott, Directors' Duties in Management Buyouts and Leveraged Recapitalizations, Ohio St. L.J. 517 (1988); Gilson & Kraakman, Delaware's Intermediate Standard For Defensive Tactics: Is There Substance to The Proportionality Review?, 44 Bus. Law. 247 (Feb. 1989); Morrissey, Law, Ethics and the Leveraged Buyout, 65 U. Det. L. Rev. 403 (1988).

17/ 488 A.2d 858 (Del. 1985).

fiduciary duty of care, and thus could not invoke the protections of the business judgment rule. 18/

The Delaware Supreme Court has introduced a stricter standard for applying the business judgment rule to actions by directors in a takeover contest. In Unocal Corp. v. Mesa Petroleum Co., 19/ the court noted that, as is the case in the performance of its other duties, when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. Moreover, the court stated that, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." 20/ Therefore, the court determined that the directors must show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and that the defensive

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18/ Id. at 873. See also Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986) (directors failed to exercise due care in approving "lock-up" option, where they acted hastily and on inadequate information, and primarily relied on financial adviser's "conclusory" opinion that option prices were fair).

19/ 493 A.2d 946 (Del. 1985).

20/ Id. at 954.

measure adopted was "reasonable in relation to the threat posed." 21/

Most important, when a transaction -- such as an MBO-- involves the potential for self-dealing, courts have imposed even higher standards on directors' conduct. The Delaware Supreme Court has stated that where directors stand on both sides of a transaction, "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."22/ In such cases, directors of Delaware corporations have the burden of establishing the transaction's "entire fairness"-- that is, the existence of both "fair dealing" and "fair price." 23/

It also has been recognized that, whether or not there is management participation in a change of control transaction, once the directors decide to put a company up for sale or it is clear that sale of the company has become inevitable, they must act as neutral auctioneers, whose primary responsibility is to realize the best sale price for the benefit of stockholders. 24/ To fulfill their duties, directors are prohibited from "playing

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21/ Id. at 955.

22/ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

23/ Id. at 710-711.

24/ Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

favorites" with competing bidders "when [the] bidders make relatively similar offers, or dissolution of the company becomes inevitable...." 25/ Thus, once the "auction process" begins, courts will closely review the reasonableness of tactics that potentially demonstrate favoritism such as lock-up agreements26/ and the exercise of "poison pill" rights. 27/ Moreover, the courts will determine independently whether sale of a company has become inevitable. 28/ The recent MacMillan case 29/ reaffirmed these principles and emphasized the directors' reponsibility to seek the best available price for shareholders. The strong language of that decision makes clear that the Delaware courts

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25/ Id. at 184. See also Edelman v. Fruehauf Corp., 798 F.2d 882, 887 (6th Cir. 1986) (relying on Revlon in enjoining target corporation's directors from using corporate funds and preempting bidding in order to assist corporation's management in effecting a leveraged buyout).

26/ See Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

27/ See City Capital Associates Ltd. Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988).

28/ See, e.g., Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772, 780 (D. Del. 1988); Robert M. Bass Group, Inc. v. Evans, [1988-1989] Fed. Sec. L. Rep. (CCH) ¶93,924 (Del. Ch. July 14, 1988).

29/ Mills Acquisition Co. v. MacMillan, Nos. 415 & 416, Del. Sup. Ct. (May 3, 1989).

will not tolerate efforts by management to skew the auction process towards a favored party to the detriment of shareholders.

Federal Regulation of Disclosure

Federal securities laws have addressed the disclosure issues raised by takeovers and have set procedural and substantive requirements on tender offers to allow for unhurried and informed decision making by shareholders and the equal treatment of all shareholders. In adopting regulations in this area, the SEC has been guided by the principles of neutrality mandated by Congress in the Williams Act, the federal legislation regulating takeovers. 30/ The Williams Act neutrality goal has important market implications because it carries the implicit assumption that a competitive, honest market is the best arbiter of the many complex and intricate issues inevitably raised by takeover activity.

The Commission has been ready to respond by rulemaking when judicial and market responses were not adequate to provide investors with the time to make an unhurried investment decision. For example, it has extended proration and withdrawal rights throughout the term of a tender offer in order to

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30/ The Williams Act, enacted in 1968 and amended in 1970, added Sections 13(d), 13(e), 14(d), 14(e), and 14(f) to the Securities Exchange Act of 1934 of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454; Act of Dec. 22, 1970, Pub. L. No. 91-567, 82 Stat. 1497 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f) (1970)).

eliminate pressures on shareholders to tender immediately. 31/ Similarly, when state courts permitted discriminatory tender offers as a defensive tactic and raised the prospect of targeted tender offers, 32/ the Commission reacted by adopting the All Holders Rule 33/ requiring tender offers to be made to all shareholders.

The Commission has long been aware of the significant investor protection questions raised by MBOs. On August 2, 1979, the Commission adopted Rule 13e-3. 34/ Although actively considered in earlier versions of the rule, the Commission determined not to incorporate a substantive fairness requirement into the rule. The Commission instead decided that it would leave the question of substantive fairness of management buyouts to the states and instead would seek to protect shareholders by requiring certain disclosures. 35/

31/ Rules 14d-7 and 14d-8, 17 C.F.R. 240.14d-7, 14d-8. These pressures are created by two-tier offers and multiple proration pools.

32/ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

33/ Rules 13e-4(f)(8) and 14d-10, 17 C.F.R. 240.13e-4(f)(8), 14d-10.

34/ 17 C.F.R. 240.13e-3.

35/ Securities Exchange Act Release No. 16075 (August 2, 1979) [44 FR 46748].

Rule 13e-3 seeks to provide shareholders with the information they need to assess the fairness of a transaction and to pursue remedies under state law. It requires reasonably detailed disclosure of the process under which the terms were arrived at, including alternatives considered and the factors upon which the assessment of fairness by the company or its affiliate is based. These requirements are designed to provide necessary information to shareholders who are asked to sell their corporation to its management.

Rule 13e-3 applies only to transactions engaged in between issuers and their affiliates -- that is, transactions by officers, directors, or other control persons. At the time the rule was adopted, transactions by third parties did not appear to present the same concerns as MBOs because of the apparent lack of a conflict of interest and potential informational advantages. Since then, LBO practice has blurred the distinction between third-party LBOs and MBOs. Where management and the acquiring party agree in advance to the terms of management's participation, and that participation is substantial, there is little difficulty in establishing that the transaction is being conducted by an affiliate and thus subject to Rule 13e-3.

In many transactions, however, third party purchasers have desired to have existing management remain with the company, but have avoided the application of Rule 13e-3 by timing their offers to management so that management members will not become affiliates of the purchaser for purposes of the transaction. No

firm agreement or formal understandings with respect to the nature and extent of management's participation are reached prior to the completion of the transaction. Nonetheless, based upon prior transactions by the LBO firm and sometimes because of informal discussions, management may fully expect to participate in the surviving entity, even though the transaction technically falls outside the rule because it is being conducted solely by a third party. The staff has been examining the issues raised by these circumstances and is considering whether to recommend that Rule 13e-3 be revised to obtain the same level of disclosure with respect to all negotiated transactions.

Eliminating the distinction between affiliated and nonaffiliated transactions makes sense. State law principles demonstrate that courts will hold directors to a high level of responsibility in ensuring that shareholders receive the highest available price, even in transactions not conducted by affiliates. Shareholders should be entitled to disclosures in both affiliated and nonaffiliated transactions that are sufficiently broad enough to allow them to judge the fairness of the transaction and the adequacy of the board's efforts to bring them the best available offer for the corporation.

The Commission's staff also will be examining ways to improve disclosures concerning the fairness of the transaction. One approach would be a requirement that management demonstrate a reasonable basis for its opinion. Another would be a requirement to disclose limitations or analyses in fairness opinions

received from an investment banking firm. For example, a fairness opinion may be suspect if the investment banking firm has been instructed not to consider liquidation value. Even if management has no intention of liquidating the company, the liquidation value might provide the highest value to shareholders and probably should be disclosed. As another example, if the investment banker is told not to shop the company, an important market test for the fairness of the management's proposal may be missing.

The Commission's concern is not solely with protecting shareholders. The staff is also exploring whether improved disclosure is necessary to assist bond purchasers in evaluating the risks of future leveraged transactions by the issuer.

THE PROSPECTS FOR PREEMPTION

What I have described so far is an informal division of responsibility between state and federal regulation, both of which leave ample room for market innovation and development. At present, the law appears to prevent abusive tactics by management and bidders, provides substantial protections to shareholders in management buyouts, and allows shareholders to make informed, uncoerced decisions regarding takeovers.

The state and federal partnership governing acquisitions, is, however, presently undergoing a severe test. The source of concern is a movement at the state level to provide state control over the takeover process through restrictive state statutes. Concern for preserving the existing balance between state and

federal law does not necessarily mean that actions by individual states that interfere with a free national market for the sale of shares should be unfettered. In the aftermath of the Supreme Court's decision in CTS Corp. v. Dynamics Corp. of America,36/ some states have adopted statutes clearly designed to provide for state control over the takeover process in a manner that interferes with the free transferability of shares. Changes in control that occur through the vehicle of the nation's securities markets are matters of both state and federal interest. Each state has certain interests in the corporations it charters, especially those located within its boundaries. When a state's legislation primarily affects the transfer of shares in companies that are locally owned, the state clearly has a legitimate interest in regulating changes of control. On the other hand, Congress has determined that "transactions in securities...are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions...in order to protect interstate commerce...and to insure maintenance of fair and honest markets in such transactions." 37/ This statement sets forth a federal securities law policy that favors preservation of viable markets for the sale of securities. The existence of liquid secondary

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36/ 107 S.Ct. 1637 (1987).

37/ Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

securities markets is extremely important for capital formation in our country, and Congress clearly supports this proposition.

Limitations on the free transferability of securities of corporations that are owned by shareholders nationwide diminish the efficiency, depth, and liquidity of the nation's securities markets. Accordingly, federal law should control in this area by preempting state statutes that unduly interfere with the free transferability of securities. 38/

One state law development in the tender offer area deserves special mention, because it treats modern corporations in a manner inconsistent with a well developed body of law identifying shareholders as the owners of the corporation exclusively entitled to the fiduciary obligations of management. Indiana recently expressly rejected the guidance of the Delaware courts that the interests of shareholders are paramount. It has enacted a statute allowing corporate boards to consider the interests of other constituencies equally with those of

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38/ The Commission has filed briefs in Salant Acquisition Corp. v. Manhattan Industries, Inc. 682 F. Supp. 199 (S.D.N.Y. 1988) and RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988), arguing that the New York and Delaware State antitakeover statutes are unconstitutional. In Salant, the court did not reach the constitutional issue. In Staley, the court denied a motion for a preliminary injunction stating that there were insufficient facts to support a determination that the Delaware Statute "is most likely unconstitutional." 686 F. Supp. at 477. Also, the Commission filed a brief successfully challenging the constitutionality of the Wisconsin statute. RTE Corp. v. Mark IV Industries, Inc., [1987-1988] Fed. Sec. L. Rep. (CCH) ¶93,789 (E.D. Wisc. 1988), vacated per stip. June 22, 1988.

shareholders when dealing with change of control transactions, including tender offers. 39/ With regard to "corporate governance rules" the statute states that:

> In making such determination, directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor.

Other states are considering or have adopted similar legislation. 40/

The Indiana statute is misguided. By failing to consider the shareholder as paramount, the statute removes accountability for corporate management. 41/ It is ironic that, at a time when institutional shareholders are beginning to exercise their influence over corporations and when LBOs are resulting in management ownership of corporations, thus beginning to solve the classic Berle-Means problem of separation of management from ownership, 42/ a movement is now underway to disregard the interest of shareholders. Concerns over the disruption caused by

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39/ Indiana Senate Enrolled Act No. 255, amending ICC 23-1-35-1. The relevant portions of the statute are set forth in Appendix "A."

40/ See e.g., Ohio General Corporation Law §1701.59(E).

41/ See Ruder, David S., Public Obligations of Private Corporations, 114 U. Pa. L. Rev. 209, 225-227 (1965).

42/ A. Berle & G. Means, The Modern Corporation and Private Property (1932).

takeovers should be addressed directly, for example through plant closing laws such as that recently enacted by Congress,43/ rather than by diluting management's accountability to its shareholders.

CONCLUSION

Developments in the coming year will determine whether state law moves towards removal of obstacles between shareholders and noncoercive purchase offers or towards further state efforts to prevent takeovers. Although I have long subscribed to the view that the federal government should not interfere in internal corporate affairs, I also believe that the federal government has a fundamental interest in those corporations owned primarily by shareholders located outside of the state of incorporation. If states continue to adopt statutes and permit defensive tactics that interfere with the free national market for the sale of securities and take steps to prevent imposition of substantive and procedural fairness protection for shareholders in LBO transactions, a federal reaction will be desirable and perhaps likely.

43/ See Worker Adjustment and Retraining Notification Act, Pub. L. No. 100-379, 102 Stat. 894 (August 4, 1988).

APPENDIX A

ICC 23-1-35-1, as amended by the Indiana Senate Enrolled Act No. 255, provides, in pertinent part:

* * *

(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.

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(f) In enacting this article, the general assembly established corporate governance rules for Indiana corporations, including in this chapter, the standards of conduct applicable to directors of Indiana corporations, and the corporate constituent groups and interests that a director may take into account in exercising the director's business judgment. The general assembly intends to reaffirm certain of these corporate governnance rules to ensure that the directors of Indiana corporations, in exercising their business judgment, are not required to approve a proposed corporate action if the directors in good faith determine, after considering and weighing as they deem appropriate the effects of such action on the corporation's constituents, that such action is not in the best interests of the corporation. In making such determination, directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor.

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Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by

directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends:

(1) to reaffirm that this section allows directors the full discretion to weigh the factors enumerated in subsection (d) as they deem appropriate; and

(2) to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.

(g) In taking or declining to take any action, or in making or declining to make any recommendation to the shareholders of the corporation with respect to any matter, a board of directors may, in its discretion, consider both the short term and long term best interests of the corporation, taking into account, and weighing as the directors deem appropriate, the effects thereof on the corporation's shareholders and the other corporate constituent groups and interests listed or described in subsection (d), as well as any other factors deemed pertinent by the directors under subsection (d). If a determination is made with respect to the foregoing with the approval of a majority of the disinterested directors of the board of directors, that determination shall conclusively be presumed to be valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation.

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