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SECURITIES AND EXCHANGE COMMISSION
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FOR RELEASE: 4:00 P.M., EST., THURSDAY, JANUARY 17, 1980

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# TENDER OFFERS AND THE CORPORATE DIRECTOR

An Address by

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Seventh Annual Securities
Regulation Institute
San Diego, California

January 17, 1980

In my two prior appearances before you as Chairman of the Securities and Exchange Commission, I shared with you some thoughts about directors' responsibilities, the composition of corporate boards and the sociology of the board room. Today, I intend to shift the focus somewhat and talk about the current acquisition wave -- particularly unfriendly tenders -- and the role of the board of directors confronted, whether as target or offeror, with a takeover proposal. Tender offers, particularly those which do not enjoy incumbent management's support, have become increasingly important during the past several years. Moreover, tender offers, like other facets of corporate conduct, have the potential to become another area in which business and government find themselves pitted against one another. In contests of that nature government, as the only social institution that can legally enforce its will, must win, if the issue is reduced to one of power. For that reason, I want to suggest to you today what I think the issues are and a framework within which businesses -- whether cast as the targets or the initiators of a takeover -- can respond in a fashion which is consistent with the preservation of the public's trust and confidence in the private sector's ability to engage in decision-making compatible with the welfare of the economy and the society as a whole.

The Dynamics of Corporate Takeovers and Acquisitions

At the outset, I want to explore some of the economic and social facets of the current wave of tender offers and acquisitions -- a phenomenon that can be viewed from two perspectives. The choice of which model to adopt will play a large role in determining how a director responds to a concrete situation.

On the one hand, it can be argued that the possibility of takeover serves as a healthy marketplace check and discipline on management. When the corporation is run in such a way that the earning potential of its assets, resources and market position are not realized, others with more skilled or more imaginative management may seize the opportunity to oust the incumbents. From this viewpoint, the economy as a whole benefits from the takeover process. It is the force which squeezes the most inefficient managers out of the system and replaces them with those who can do better. And, more broadly, takeovers are a means by which successful companies can take advantage of the economies, efficiencies and synergy which flow from properly selected acquisitions.

The other perspective on takeovers treats them as a kind of unfair opportunity created by quirks in the market's valuation of a company or by overall market conditions. Under this theory, the managers who are ousted are not

necessarily less competent than their successors, and the advantages of synergy and improved financial management and controls are rarely obtained. The takeover phenomenon is simply the result of a depressed market for the target's shares coupled with the ambitions of the raider's management to build a larger corporate empire.

My own sense is that much of these two models of the takeover phenomenon contains elements of truth, but that different motivations predominate, depending upon the economic climate. In the '50s and '60s, when the securities markets were far more buoyant than they are today, many of the acquisitions which were effected resulted in net gains to the economy measured in terms of the improved condition of the combined companies. I exclude, of course, the financially-motivated "Chinese money" conglomeration craze of the late '60s in which the only concern was with a favorable impact on earnings-per-share. By the same token, however, unfriendly acquisitions were not common. Indeed, the idea of seizing control of a corporation over the objections of incumbent management probably struck most executives as an ungentlemanly tactic best left to a small group of notorious raiders.

The spate of takeovers which we have experienced during the last several years is different in several respects.

The first, and perhaps most unsettling, aspect of the current wave of mergers and acquisitions is the legitimacy which hostile tender offers have come to enjoy. It has become acceptable to treat corporations as the sum of their properties and to assume that corporate control may change hands with no greater concern about the consequences than accompanies an exchange of property deeds in a game of Monopoly. But, a corporation is more than the aggregate of its tangible assets --and more than the equity of its current shareholders -- it is an institution with a complex of interpersonal and contractual relationships that create legitimate interests in the corporation among employees, suppliers, customers, communities, the economy and society at large.

As I suggested a moment ago, this new crop of corporate takeovers has been fueled -- if not caused -- by low stock market prices. At the present time, I would estimate that at least one-third of New York Stock Exchange-listed companies are selling below their book value. And, in a period of low stock prices and high inflation, managers may see considerable attraction in buying out other corporations at below their current value in the hope of repaying the resulting debt in depreciated dollars. Such a strategy may seem far less risky than the alternative of capital spending for plant and

equipment, particularly because the increasing cost of building new facilities today seems so frequently to outpace the inflation rate. This type of reasoning, coupled with other factors such as a regulatory framework that often seems designed to create obstacles to new projects or products and prompts competitive response which reduces the 1/2 life of new products, serve to encourage the search for takeover targets rather than for capital spending, product development and innovation opportunities.

In short, it is not surprising that as a competitive response, corporate takeovers often are viewed as a better alternative than concentrating the bidder's resources and energies in the existing business of the corporation. Yet, the target may be in the same shape as the bidder or become infected with the same attitude. The immediate results of a takeover are particularly attractive to a corporate executive who seeks the ego satisfaction, prestige and remuneration associated with size and the appearance of growth. In contrast to a takeover, the impact of investment spending on earnings, and the deferred nature of its rewards, may not seem to be of benefit to current managers or fit with their short-term time horizon in office.

In this regard, a recent book by an experienced business consultant makes the point that the compulsion for growth --

especially in conglomerates and in companies where financial objectives are the main criteria for executive advancement -- has been generally damaging to the development of sound business and sound business managers. He concludes, in part, that "[g]rowth strategies and totalitarian managment may actually be significant factors in creating inflation and economic instability." */ In a similar vein, Henry Simons, the late University of Chicago economist, observed that such consolidations can be explained in terms of "promoter profits," that is, the personal ambitions of corporate "Napoleons" and the psychological rewards which they derive from power. In fairness, I should observe that some acquisitions have brought more effective management, commitments of resources and fresh perspective. But, in my judgment, too many have not.

What are the consequences of this type of activity? What public policy isues are raised? Inherent in the overall acquisition wave, exaggerated by the increasing use of hostile tender offers, is a concern about the concentration of this nation's economic power, as well as the appropriate use of corporate resources in a period of increasing international competition and shrinking U.S. domination -- when the United States has the highest percentage of obsolete plant, and the

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*/ R. Wild, Management by Compulsion: The Corporate Urge to Grow (1979).

lowest percentage of capital investment, growth in productivity and in savings of any major industrialized society. In the last five years, I would estimate that $100 billion of corporate cash resources -- resources which could have been devoted to new production and employment opportunities -- have been diverted to rearranging the ownership of existing corporate assets through tenders alone. These are resources that do not flow back as new capacity, improvements in productivity, innovation, new products or new jobs. Rather, particularly because of the dearth of new equity offerings in recent years, at best these dollars remain in the secondary market.

The long-term effect of this type of financial inbreeding is likely to be very troublesome. Resources that should be used to increase this nation's productivity and to generate new products are diverted to create a carousel in which management is replaced by new management which, in turn, may also be replaced. Moreover, businessmen are spending increasing attention and energy looking for companies to acquire -- and in avoiding being themselves acquired. Sometimes this process results in better, more innovative management; but, too often, it does not.

Viewing this phenomenon, it is, of course, important to bear in mind that a society which places as much reliance as

does ours on government as an instrument to check the perceived excesses of business is unlikely to tolerate indefinitely business behavior which the public regards as contrary to its interests. I mentioned a moment ago that hostile takeovers may have serious impact on groups -- such as corporate employees -- outside the world of finance. Similarly, it is not surprising to see some very legitimate questions being raised about the economic and social justifications and implications of the current takeover wave. The concerns which seem presently to be the most prominent are those which fit under the rubric of competition, but deal with power and market domination, and are reflected in the efforts of the Attorney General, the Federal Trade Commission, and various Congressional leaders to put new teeth into antitrust and anti-merger legislation. Indeed these efforts, which do not, in my judgment, focus on the most significant economic consequences of acquisitions and takeovers, may be the most serious challenge to corporate latitude in structuring business combinations since the initial enactment of the Sherman Act almost 100 years ago. Of course, the basic thrust of the acquisition wave should focus not on how to put a lid on it, but on the governmental policies -- monetary, fiscal, tax and regulatory -- which encourage it and discourage the willingness to risk, venture and innovate, as well as on those impairments

of the marketplace where the forces of competition are not able to function effectively.

While I have expressed skepticism about the consequences of some contemporary takeovers, I am not enthusiastic about legislation which would prohibit certain categories of mergers. Legislation, which responds to a wave of mergers and takeovers motivated primarily by a combination of a depressed stock market and regulatory obstacles to other forms of corporate growth, would be just as effective in preventing the consummation of acquisitions which would have real economic and social benefits in terms of efficiency and synergy as it would be in frustrating less rational consolidations.

Role of the Board

For these reasons, I believe the central issue in developing an approach to takeovers is to assure a private sector vehicle which will evaluate acquisitions in terms of the full range of relevant factors -- such as whether they make substantive economic sense and deal appropriately with those groups to which the corporation as an institution has responsibilities. In my view, the independent director is the only actor on the corporate scene equipped to play this role. Unfortunately, however, at professional gatherings, such as this Institute, most discussions of tender offers seem to center on the techniques and mechanics of a takeover contest -- that is, the various devices for complying with, or avoiding

the application of, the federal securities laws and the state anti-takeover requirements. Conversely, there typically is inadequate reflection on the legal and ethical standards that should govern the directors' discharge of their role in these transactions. While the subject is a broader one than I can fully cover in the course of one talk, I want to spend the balance of my time with you today presenting a framework which can, I believe, serve as a foundation for the director -- whether of the would-be acquiror or the target -- who is involved with a takeover.

As I indicated earlier, conventional thinking concerning the corporate response to the threat of a takeover seems to spring from one or the other of two rather simplistic theories. One theory is that the marketplace should enjoy unhampered control over the fate of these transactions. That is, the shareholders at that point in time, the presumed owners of the company and beneficiaries of its endeavors, should have the absolute right to determine whether or not to accept the tender. As a corollary, it is assumed that shareholders will make this decision based solely on an appraisal of the economics of the problem -- is the bidder's proposal sufficiently attractive to justify taking the proffered cash, incurring any tax liability, and reinvesting in a new opportunity? This theory, of course,

effectively means that an offer carrying a substantial premium over market value will -- and should -- always succeed.

The opposing theory emphasizes that a corporation's response to a tender offer should come from its directors, who are expected to bring their knowledge and expertise to bear in representing the corporation as a unique entity rather than simply seeking the best deal for its individual shareholders. In discharging this responsibility, directors generally are protected by the business judgment rule from all but the most extreme deviations from what particular shareholders might view as their interest. This theory's corollary is that directors, if they decide that a takeover is not in the best interests of a corporation, may resort to virtually any weapon in the legal arsenal to defeat it. Indeed, the courts have seldom rejected a director's invocation of the business judgment rule to shield himself from a shareholder's suit concerning resistance to a tender offer.

In my view, neither of these theories is useful in illuminating the responsibilities of the directors of the parties in a contemporary tender offer situation. The notion that a corporate takeover should stand or fall solely on the marketplace's determination of the sufficiency of an offeror's premium is particularly unsatisfying. True, from the bidder's standpoint, it ensures that almost every tender offer -- or at least the highest competing tender offer -- will succeed.

From the target's standpoint, it makes the directors' task simple and avoids litigation. But more fundamentally, this theory precludes other than a market value assessment of the corporation, ignores its responsibiities as an institution and assumes the society would overlook economic decisions which could substantially affect its welfare. This is simply unrealistic.

Emphasis on marketplace acceptability also fails to come to grips with the legal responsibilities which characterize the corporate form of business. For example, is it a complete answer to the duties which managers and directors owe to shareholders to assume that an above-market tender offer is in the shareholders' best interests? One wonders, as a matter of fundamental fairness, whether the interests of speculators and arbitrageurs, who move in and out of large positions with little regard to the strengths and weaknesses of the underlying enterprise, should be the decisive factor in determining a corporation's future. I am not advocating a holding period requirement for the exercise of the corporate franchise, but neither do I want to see the interests of the long-term shareholder, who behaves as a corporate owner -- or of shareholders over time -- subordinated to the interests of speculators, who see profits in betting against the corporation. Although I believe in the essential value of marketplace

discipline as a prophylactic against poor management, the benefits of that discipline are lost when compared to the cost to the prospective target if management must behave as if the corporation is continuously on the block.

For these reasons, the vehicle for balancing the competing concerns which must be weighed in evaluating a tender offer is to be found not in the marketplace but in the corporate board room. Directors of the target should make the decision, as they do all other corporate policy decisions, and do so based on an assessment of the corporation as an institution with responsibilities to discharge, rather than simply seeking the best deal for their shareholders. I do not mean, however, that directors should be free to resort to protective measures and then ritualistically invoke the protection of the business judgment rule. Judges are, naturally, not comfortable second-guessing directors in complex and delicate areas, such as takeovers, particularly when they may suspect that the judicial process is being used as a bargaining chip in a larger game. Nonetheless, in my opinion, the courts -- in recognizing the significance of takeovers to the economy and to groups of individuals to which the corporation has responsibilities -- are beginning to inquire whether, in making such a business judgment, a board of directors has met certain minimum, but increasing, standards to warrant judicial deference. Those

standards relate to the competence of the decision-maker -- namely the directors' objectivity and the processes used to arrive at their judgment. The touchstone is whether proper inquiries were made by unbiased and knowledgeable individuals and whether the results of that process were conscientiously considered and applied.

The Bidder

I want now to explore what this concept means in practice to both the board of the bidding corporation and that of the target.

Most of the scanty literature regarding a board of directors' role in assessing tender offers is directed exclusively at the role of target's board in evaluating the offer. The apparent indifference to the role of a potential bidder's board in determining whether to proceed with an acquisition or tender offer is difficult to interpret. Certainly, one should not overlook the responsibility of the board of directors for the direction of the corporation in a transaction which may be as crucial to the bidding corporation's future as it is to the target company's. At a minimum, the board of directors must be assured that an acquisition is in the best interests of the corporation and its shareholders, and that reasonable procedures have been established to assure the transaction's compliance with applicable laws and regulations.

Directors, and particularly independent directors, must play a major role in evaluating the appropriateness of a proposed acquisition. Without implying a lack of confidence in management, the independent directors must be sensitive to the possibility that management's judgment may be skewed in a particular case. Therefore, to a large extent, it is the independent directors' responsibility to satisfy themselves that such an acquisition makes substantive long-term good sense for the company. They should not merely accept undocumented rhetoric about synergy or the benefits of improved management or financial controls, which may tend to be more illusory than real. The directors should consider management's prior experiences and track record in assessing and acquiring companies, integrating new acquisitions into the corporation, and delivering the anticipated benefit.

In order to fully discharge their responsibilities in considering the offering price, directors should make a determination, based on articulated standards, of the cash worth of a potential acquisition target. The justification for a premium should be considered specifically. Additionally, in the case of a hostile tender offer in which the bidder does not have access to much critical information about the target, directors should also consider whether it has a sufficient basis for determining the value of the target company and

that the company can be successfully integrated into the acquiring corporation.

In this regard, I should note that the large premiums that have been paid in certain recent acquisitions make one wonder how carefully the bidding corporation's board considered the economic justification for the transaction. Particularly, where premiums of as much as 100 percent over the pretender price are offered, the burden of determining that such a premium is indeed justified is not a lightly or easily discharged one.

Moreover, in making such a determination, the board of directors has a responsibility also to consider the available alternatives and whether any such alternative would be more in its <u>own</u> shareholders' interests. For example, boards should not ignore that diversification often results in a lower share price and multiple. An alternative course for the company with excess cash might very well be to consider distributing the cash to its <u>own</u> shareholders, rather than to shareholders of a target company. Until the 1970s, I personally was opposed to a company's buying its own stock. I viewed it as a reflection on management's ability to invest intelligently in building the company, as contrasted to liquidating it, while creating the illusion of growth through an increase in earnings-per-share

brought about by spreading earnings over fewer shares. However, I now believe that this may be an appropriate alternative if a company cannot otherwise absorb the cash in its own business. Such a corporation can give its own shareholders the benefit of the premium to do their own diversifying by reinvesting this distribution after taxes -- possibly even in the same target company -- at the market price rather than at a premium.

Having decided to proceed with an offer, it is the board's responsibility to ascertain that procedures have been established to ensure compliance with laws and regulations which prohibit the misuse of nonpublic information concerning a potential acquisition or tender offer. In addition to being a violation of the law, I believe that the misuse of such nonpublic information contributes significantly to a loss of investors' confidence in the fairness of the marketplace.

The Commission is addressing this problem through both enforcement actions and rulemaking. But boards of directors of bidders -- as well as other parties such as investment bankers -- have the responsibility not only to ensure that procedures are in place to prevent leaks, but also to examine and monitor these procedures and take stringent actions when violations of the procedures are uncovered.

Subject Company

Much more has been written and discussed about the board's role when its corporation is the object of an acquisition proposal or a tender offer. As I have already indicated, it is my opinion that an effective board of directors remains the institution best suited to weigh the oft-conflicting factors that may influence a corporate response to such a situation.

However, I also must emphasize my belief that this role for the board also involves special responsibilities for competence and objectivity. I do not believe that the judicial deference incorporated into the business judgment rule should apply in a takeover situation, absent the board's establishing that it has, *in fact*, satisfied these responsibilities. Therefore, I believe that a board's actions in response to a tender offer should increasingly focus on two important questions.

The first question regards the credentials of the decision-makers. The most important credentials, of course, are competence and objectivity. Obviously, a management director -- whose very livelihood may be affected by the board's decision -- cannot be presumed to be acting solely in the corporation's and shareholders' interests. Nor can other directors who have a substantial economic interest

in the continued separate existence of the corporation, including as suppliers of its goods or services, be necessarily considered objective in these deliberations.

Thus, to satisfy such an inquiry, I would expect to find an increasing number of instances in which a corporation's board delegates to a special committee of independent directors the investigation of an offer and the recommendation to the full board of an appropriate response. This is not to say that management directors and others with economic interests in the outcome should abstain from participating in the board's ultimate decision; but, if they provide the margin in rejecting the tender, they may have a difficult burden in establishing that they, in fact, acted objectively in the corporate and shareholder interest. (Parenthetically, I should add that, when there are conflicting interests between an acquiring corporation's management and its shareholders, the logic of that corporation's forming a special committee of independent directors to monitor the terms of the transaction and its management's conduct would seem equally applicable.)

The second question regards the substance of the process to be followed by the board in determining whether the offer is in the best interests of the corporation and its shareholders. In view of limitations on time, this

subject, which is being increasingly addressed in the literature and otherwise, is one I will only touch on with several observations.

In addition to analyzing the offer's terms, the board, as I have already noted, has an institutional responsibility to consider such concerns as the potential adverse impact on employees, suppliers, and communities; any likely antitrust limitations; whether the offer is for less than all outstanding securities, which raises the spector of a residual minority which may be locked into their investments; and any likely discontinuation of unique goods or services to the public. The key, however, is the substance as contrasted to the window dressing and rhetoric used to dress-up an otherwise unjustified defense.

Assuming a decision to resist, the board must recognize that conflicts may exist when acquisition or tender offers are presented. Therefore, the committee's responsibilities would not be satisfied, absent the committee's continuing examination of management's conduct during the encounter, including its public pronouncements, its communications with any actual or potential bidder, and its representations to the courts -- and the regulatory agencies. This is an on-going function not satisfied by a single meeting -- even the increasingly lengthy meetings which oftentimes represent

the board's sole consideration of an offer before issuing a response.

A few moments ago, I suggested that as part of its consideration of an offer, the offeree's special committee should not limit its analysis to an examination of the offering price -- that it should also consider other factors which potentially could influence the continuing viability of the target corporation or its relationship to certain groups to which it has responsibilities. What should constitute the kind of consideration of these subjects that would warrant judicial or administrative deference?

First, I do not believe that receiving a statement from one's investment banker -- particularly a "quickie" to the effect that an above-market offer nonetheless is inadequate in relation to the true value of the target -- is, in itself, sufficient to satisfy the special committee's responsibilities. At the very least, it should independently verify and accept the factual assumptions upon which the investment banker's valuation is grounded.

Moreover, the basis for any assertion about the corporation's intrinsic worth and future growth prospects should also be examined carefully by the committee. Of course, any documentation which is composed after the bid, particularly if not consistent with current performance,

would be somewhat suspect. Rather, prudence would rely more confidently on bona fide corporate planning documents prepared and considered in normal course and prior to the initiation of any offer. Further, any claim of adverse impact on employees, suppliers, customers or the public should be similarly documented.

It is my view that a court -- in reviewing such a well-monitored, fully-considered and documented special committee determination to reject and resist an acquisition or tender offer bid -- should and would give substantial deference to that decision and to any legal and ethical acts to resist the bid which are reasonably commensurate to the existing threat to the corporation's and its shareholders' interests, provided that the acts themselves are not inconsistent with the corporation's viability. But, I emphasize that does not give the corporation the right to waste corporate assets, by, for example, an otherwise senseless acquisition, or to make vacuous charges against the opposition or engage in other unethical conduct.

While encouraging the board to consider the impact of a takeover on groups to whom the corporation has responsibilities, I do not endorse anti-takeover provisions of this or any other sort, by charter or by-law designed to make the company a less attractive target. While I recognize the desirability

for management to be able to run its company without continually looking over its shoulder, I believe that tenders should be considered on their merits, on a case-by-case basis, and not warded-off by building castles and moats. Indeed, the corporate community cannot have it both ways. It cannot argue against added measures -- legislative or otherwise -- directed to improve corporate accountability by relying on the discipline of the marketplace as a vehicle to depose inadequate management, and then seek to neutralize that discipline, as weak as it already is, by anti-takeover provisions. By doing so, it is inviting a legislative reaction and increased federal presence in dictating corporate structure and accountability.

The Commission's involvement with such amendments heretofore has involved only the issue of appropriate disclosure, and the legitimacy of such amendments has, thus far, remained a matter of state law. I was, therefore, particularly interested in a recent Delaware decision in which the Chancellor approved an anti-takeover amendment that requires an 80 percent shareholder vote to approve a merger, consolidation or similar takeover by any person owning five percent or more of the company's stock prior to

the proposed takeover. 3/ Notably, the amendment also provides that the super-majority provision will not apply if the company's board of directors approves the proposed transaction before acquisition of the five percent interest. In other words, the board has the power to lower the barrier for a friendly acquisition. Whether such apparent flexibility will result in abuses -- such as its use as a bargaining chip to enhance incumbent management's interests at the expense of shareholders -- will be a subject of continuing concern.

The possibility for such abuses that may be associated with such defensive corporate charter and by-law amendments may well lead to legislation. As I have stressed on many previous occasions, I am not in favor of federal legislation which would dictate corporate structure. Nevertheless, legislation dealing with anti-takeover amendments could very well receive a more welcome reception at the Commission and in Congress. And, while limited to a specific problem, such legislation would be a big step toward federal corporation law.

This is not to ignore the need for management to be able to run a company without continually looking over its

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3/ Seibert v. Gulton Industries, Inc., Del. Ct. of Chanceny, Div. Action No. 5631, Memorandum Decision of Vice Chancellor Brown (June 21, 1979); notice of appeal of Del. Sup. Ct. filed Aug. 8, 1979.

shoulder and engaging in defensive activities. Good managements of well-run companies should not have to spend abnormal amounts of time looking at transfer sheets, talking to lawyers and engaging in anti-takeover activities. But, defensive charter or by-law amendments will not be a viable solution in the long-run.

I also recognize that a tender offer for the stock of a company creates a most difficult period for a company's management and its board of directors. Management is perceived as being concerned only with keeping their jobs, and the board of directors is caught between their duty to shareholders and their responsibility to the corporation as a whole and its future as a business enterprise.

But, except for the unusual time constraints, decisions regarding tender offers should be treated no differently by the board than other major corporate decisions. On one hand, it should realize that defensive tactics of incumbent management may be clouded with self-interest and should be subject to the same close scrutiny as other situations involving that dynamic. On the other hand, decisions of independent directors based on an appropriate analysis of an offer should receive the same deference as it would in similar decision-making.

Conclusion

In conclusion, let me return to the principle to which I have referred in a number of my talks across the nation over the past two plus year: Under the American system, anyone who exercises power needs to be held accountable to someone else for his stewardship. Acquisitions and tender offers are perceived correctly to involve the exercise of considerable power -- that is, the ability to influence many persons' lives and futures. Jobs, the welfare of entire communities, and, indeed, the national economy undoubtedly will be affected by these transactions. This nation cannot -- and will not -- allow matters of such vital significance to be unaccountable to rational decision-makers who are acting according to publicly acceptable norms.

Today, I have strongly advocated that this decision-making role for tender offers be filled by vigorious boards of directors composed of persons of independent credentials who effectively meet their responsibilities along the lines which I have discussed here with you. I hope that this analysis generates a discussion among those in business, the government, the bar and academia to evaluate the implications of the current acquisition and takeover wave on the future of the free enterprise system. And, I also hope that this discussion will influence the corporate community in determining that restraint may be a very appropriate business decision.

Thank you.