



UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
CLEVELAND REGIONAL OFFICE

520-A Atrium Office Plaza
668 Euclid Avenue
Cleveland, Ohio 44114
(216) 522-4210
Facsimile: 522-7239

Mark D. Kindt
Regional Director

COMMISSION AUTHORIZED

February 23, 1990

The Honorable Vincent J. Fumo
Senate of Pennsylvania
Senate Post Office
The State Capitol
Harrisburg, Pennsylvania 17120-0030

Dear Senator Fumo:

The staff of the Federal Trade Commission is pleased to respond to your letter requesting comments on Senate Bill 1310.¹ The bill, if enacted, would amend Title 15 of the Pennsylvania Consolidated Statutes governing corporations and unincorporated associations to regulate "hostile" takeovers of certain companies incorporated in Pennsylvania. Specifically, the bill would prohibit bidders for corporate control from voting "control shares" unless a majority of shareholders, including incumbent management, has voted to authorize the exercise of that right. The proposed legislation would also prohibit potential and actual corporate acquirers from retaining any increase in value of corporate securities sold within 18 months of attaining "controlling person or group" status, and require the payment of severance compensation to employees terminated within two years of a successful acquisition.

We believe that enactment of the proposed legislation is likely to deter takeovers that may increase economic welfare. Further, the proposed legislation's disgorgement provisions would appear to impede shareholders' legitimate rights to control the assets they own. If the legislature nevertheless decides to enact the bill, we suggest that it consider making subchapter G and subchapter H of the

¹ These comments are the views of the staff of the Cleveland Regional Office and the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

legislation applicable solely to corporations that affirmatively elect to be covered by them through amendments to their articles of incorporation. An affirmative "opting in" provision would enable the shareholders of each corporation to determine whether such restraints on the transfer of corporate control are in the interests of the corporation.

**I. INTEREST AND EXPERIENCE OF THE STAFF
OF THE FEDERAL TRADE COMMISSION.**

The Federal Trade Commission ("FTC") is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. Pursuant to this mandate, the staff of the FTC seeks to identify 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.

The staff of the FTC has substantial experience in the area of mergers and acquisitions. The FTC 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 FTC reviews proposed acquisitions of corporate assets or securities, including tender offers, to determine whether they violate the antitrust laws.

The FTC's staff has addressed issues related to the market for corporate control through scholarly studies and comments to state governments. The FTC's Bureau of Economics has published a study on the effects of takeover legislation enacted by New York in 1985.² In the past three years, the FTC's staff has provided comments on the corporate control legislation of several states.³

² 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).

³ *E.g.*, Letter to Hon. Lois Pines, Massachusetts State Senate, June 23, 1989; Letter to Hon. Steven D. Wolens, Texas House of Representatives, May 10, 1989; Letter to Hon. Barbara Flynn Currie, Illinois House of Representatives, May 4, 1989.

II. 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 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.

Some 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.⁴ Such bidders pay substantial premiums over the pre-offer market price of the shares of target corporations because they believe that the corporations will be worth more under their control.⁵

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 combine 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 shareholders, employees, and the economy as a whole, as well as the successful bidder. Shareholders benefit in two ways. First, because bidders for corporate control offer substantial premiums over the pre-offer market price of corporate shares, target company shareholders 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

⁴ 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 Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

⁵ There is evidence that share prices of most target companies significantly underperform the market in the pre-offer period. See Gilson, *supra* note 4, at 852-53, and sources cited herein.

corporate efficiency and the accompanying gains in corporate competitiveness.⁶ The 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. For example, the Office of the Chief Economist of the SEC found that share prices of acquired firms increase by an average of 53.4 percent.⁷ Similarly, share prices of some acquiring firms have increased, albeit by smaller amounts. Various studies of share prices of acquiring firms have reported increases that ranged from 2 percent to approximately 7 percent in the past,⁸ although other studies have found no gains for acquirers in this decade.⁹ Even if the acquiring company's shares experience no gains, these studies suggest that the

⁶ Profitable firms provide the best opportunities for wage growth, new employment, and the fulfillment of pension and other contractual obligations to workers.

⁷ OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, *ECONOMICS OF ANY-OR-ALL, PARTIAL, AND TWO-TIER TENDER OFFERS* Table 4A (1985).

⁸ 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).

⁹ See Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988). A recent study of acquiring firms in 78 management resisted takeovers between 1976 and 1981 concluded that those firms lost 42 percent of the value of their stock prices over the three years following their acquisitions. Magenheim & Mueller, *Are Acquiring-Firm Shareholders Better Off After An Acquisition?*, in *KNIGHTS, RAIDERS, AND TARGETS* 171 (J. Coffee, L. Lowenstein & S. Rose-Ackerman ed. 1988). That study has been criticized for using methodology that significantly overstates the losses of the acquiring firms' value. See Bradley & Jarrell, *Comment, id.* at 254. Bradley and Jarrell, using the data from the Magenheim-Mueller study and a different methodology, concluded that the acquiring firms' three year losses were actually statistically insignificant. Moreover, they note that even when "acquiring firms suffer capital losses, the gains to targets outweigh these losses, and the net effect is a significant increase in the value of the combined assets." *Id.* at 256.

market values the combination of the acquirer and the target company more highly than the individual firms absent a takeover.¹⁰

These studies measure the stock market performance of the companies involved during short periods of time surrounding takeover bids. They may be viewed as offering the stock market's valuation of the long-term effects of takeovers based on the information available at the time the takeover is announced. These valuations may change over time as more information is gained. Thus, these studies serve only as indirect estimates of long-term performance. Economic scholars largely agree, however, that the increases in company valuations reported by these studies represent efficiency gains. See note 11, *infra*. Of course, sharp fluctuations in market values, such as those experienced in the October 1987 stock market, may require a cautious approach to long-term conclusions.

A substantial body of economic and legal literature supports the view that these 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.¹¹ Participants in the stock market are not likely to bid up the price of equity securities involved in takeovers unless prior takeovers, on average, produced such gains. Other studies quarrel with these conclusions, but many of these studies contain methodological errors.¹² Some scholars have also questioned

¹⁰ 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 4, at 189-204; Jensen & Ruback, *supra* note 8, at 8.

¹¹ See, e.g., ECONOMIC REPORT OF THE PRESIDENT, *supra* note 8, at 187-216; Jensen & Ruback, *supra* note 8; Jarrell, Brickley & Netter, *supra* note 9; Bradley, Desai & Kim, *supra* note 4; Gilson, *supra* note 4; Easterbrook & Fischel, *supra* note 4; 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.

¹² 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

the overall effects of mergers and unsolicited takeovers on economic efficiency.¹³ Another major scholarly study that relied on accounting data took issue with the conclusions of the stock market studies and concluded that takeovers neither improved nor degraded the performance of the target firms.¹⁴

Using Census Bureau data on more than 18,000 individual plants, Lichtenberg and Siegel recently analyzed the relationship between productivity and changes in plant ownership.¹⁵ Their study, which extended over a 10-year

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 11, at 282-84.

¹³ See Ravenscraft & Scherer, *The Long-Run Performance of Mergers and Takeovers*, in PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 34 (M. Weidenbaum & K. Chilton ed. 1988); Herman & Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in KNIGHTS, RAIDERS, AND TARGETS, *supra* note 9, at 211; Shleifer & Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (A. Auerbach ed. 1988).

¹⁴ 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, and not management-opposed takeovers. See Ravenscraft & Scherer, *supra*, 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.

¹⁵ Lichtenberg & Siegel, *Productivity and Changes in Ownership of Manufacturing Plants*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY (1987). Since Lichtenberg and Siegel study productivity changes directly, they avoid the controversy associated with other studies that have utilized stock prices or accounting profits.

period, found that changes in corporate ownership were accompanied by significant increases in productivity. They concluded:

Our findings concerning the determinants and effects of plant turnover imply that ownership change plays an important role in redeeming inefficient plants. . . . Our evidence is consistent with the view that ownership change or asset redeployment is an important mechanism for correcting lapses from [efficient] producer behavior. The gains realized by both target and acquiring shareholders appear to be social gains, not merely private ones.¹⁶

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, we believe that the preponderance of scholarly opinion on the subject supports the conclusion that management-opposed takeovers produce economic benefits, and that new restrictions on takeovers are likely to undermine economic efficiency.

III. ASSERTED DISADVANTAGES OF TAKEOVER ACTIVITY.

Purported disadvantages of takeover activity are often asserted to justify restraining corporate acquisitions. Although we know of no empirical research to substantiate these disadvantages, 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 substantiating evidence, these claims do not support the enactment of curbs on takeover activity.

Some takeover critics claim, for example, that acquirers often take over well-managed corporations, oust good management, and reduce corporate efficiency by installing less capable management teams. This may happen in some

¹⁶ *Id.* at 667. Lichtenberg and Siegel's empirical finding that ownership changes tend to improve economic efficiency tends to refute the theoretical conjecture of Shleifer and Summers, *supra* note 13, that the private gains from takeovers in the form of higher stock prices may be more than offset by social costs due to the breach of implicit contracts. A conclusion similar to Lichtenberg and Siegel's was reached in a study that looked only at management buyouts. See S. Kaplan, *The Effects of Management Buyouts on Operations and Value* (1989) (accepted for publication 24 J. FIN. ECON.).

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, has not been demonstrated to have adverse effects and in fact appears to benefit society. Because the evidence suggests that 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 lead to plant closings and lay-offs that would not have occurred otherwise is, at best, scanty.¹⁷ Indeed, it is difficult to assess

¹⁷ See Jensen, *Takeovers: Folklore and Science*, HARV. BUS. REV. NOV.-DEC. 1984, at 114; cf. AMERICAN ENTERPRISE INSTITUTE, PROPOSALS AFFECTING CORPORATE TAKEOVERS 31 (1985) (citing finding that "very few jobs were affected" by 6,000 corporate acquisitions in 1970's). See also Lichtenberg & Siegel, *supra* note 15, which concluded that employment declines were more pronounced during the years immediately preceding the ownership change than after the change. The authors concluded that "our analysis indicates that changes in ownership are more likely to stem employment reductions than trigger mass layoffs." Lichtenberg and Siegel, *supra* note 15, at 665. More recent work by the same authors suggests that any employment declines are more likely to occur in the central administrative office than in production facilities. F. Lichtenberg & D. Siegel, *The Effect of Takeovers on the Employment and Wages of Central-Office and Other Personnel* (National Bureau of Economic Research Working Paper No. 2895, March 1989). The authors conclude that "these findings are consistent with the view that reduction of administrative overhead is an important motive for changes in ownership." *Id.* at i. 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. *Hostile Takeovers: Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 262 (1987) (statement of Thomas R. Donahue). 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 51 million workers lost their jobs because of plant closings or efficiency measures in the years 1979-83. BUREAU OF LABOR STATISTICS MONTHLY LABOR REVIEW (June 1985).

whether or not closings or lay-offs that occur after takeovers would have been carried out by the target's management in any event to keep the firm competitive.¹⁸

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.¹⁹ Further, recent studies refute the notion that firms that have been recently acquired devote fewer resources to research and development than firms that have not undergone an ownership change.²⁰

IV. EMPIRICAL EVIDENCE ON EFFECTS OF ANTI-TAKEOVER LEGISLATION.

Four empirical studies concerning the effects of anti-takeover legislation have concluded that anti-takeover laws harm shareholders and undermine economic efficiency. A 1987 empirical study by the FTC's Bureau of Economics analyzed the extent of the economic harm caused by a New York statute²¹

¹⁸ It would seem preferable for government to respond to economic dislocations by initiating effective remedial measures to assist displaced individuals rather than severely restricting economic activity that benefits society. Such measures may include, for example, programs to retrain workers displaced from declining industries.

¹⁹ 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. OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENT 8-10 (1985).

²⁰ See Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, *supra* note 14; F. Lichtenberg & D. Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior* (June 1989)(unpublished manuscript).

²¹ N.Y. Bus. Corp. Law § 912.

restricting "business combinations."²² The study found that the announcement by New York's governor of the proposed legislation that ultimately became the 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 shareholders. 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 shareholders in assessing takeover

²² L. SCHUMANN, *supra* note 2. "Business combination" statutes restrict the ability of acquiring firms to merge or engage in other specified business activity with unsolicited takeover targets for a specified period of time following the acquisition of target company shares.

²³ *Id.* at 41, 46-47. Continuing research by the same author suggests that the decline in the value of New York corporations caused by the enactment of the legislation may have been significantly greater than reported in this study. Measured over the entire 205-day course of the legislative process, the decline was 9.7 percent, net of market. Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York's 1985 Takeover Statutes*, 19 RAND J. ECON. 557 (Winter 1988).

²⁴ L. SCHUMANN, *supra* note 2, at 47.

bids.²⁵ The SEC study found that enactment of the Ohio law caused an immediate 2 percent decline in the equity value of corporations insulated from takeovers. A 1987 study on the effects of Indiana's anti-takeover statute, which contains a "control share" provision similar to that in the proposed legislation, found that the enactment of Indiana's law caused a 4.2 to 6.1 percent decline in the value of shares of Indiana corporations.²⁶ Finally, a recent study examined the stock market effects of all state anti-takeover laws introduced from 1982-87. The study concluded that public announcement of state anti-takeover laws was associated with an immediate 2.4 percent decrease in stock prices of firms incorporated in those states.²⁷

V. EFFECTS OF RESTRICTIONS ON "CONTROL-SHARE ACQUISITIONS."

Subchapter G of the proposed legislation would regulate "control-share acquisitions." A "control-share acquisition" is defined as the acquisition of voting power over shares that, but for the subchapter's requirements, when added to the acquiring person's voting power over other shares, would entitle the acquirer to cast or direct the casting of votes within one of three ranges: one-fifth to one-third, one-third to one-half, or 50 percent or more of all voting power.²⁸ Section 2563(a) of proposed subchapter G provides that "control shares" do not have voting rights unless voting rights are approved in two separate elections. In one vote, the acquirer must secure the support of holders of a majority of the corporation's shares; in the other it must gain the support of holders of a majority of all "disinterested shares" of the corporation. "Disinterested shares" are those

²⁵ OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, 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.). Similar provisions are found in 15 PA. CONST. STAT. §§ 511, 1721 (Purdon 1989), and proposed amendments to those provisions contained in S.B. 1310.

²⁶ J. Sidak & S. Woodward, Corporate Takeovers, The Commerce Clause, and the Efficient Anonymity of Shareholders (March 1987) (unpublished manuscript). The 4.2 percent decline represents a portfolio in which equal weight is given to all Indiana firms. The 6.1 decline represents a value-weighted portfolio.

²⁷ J. Karpoff & P. Maletesta, The Wealth Effects of Second Generation Takeover Legislation (August 1989) (unpublished manuscript).

²⁸ In practical terms, for most purposes of proposed subchapter G, the acquisition of voting rights over shares that would give the acquirer more than 20 percent of the corporation's voting power are "control shares."

shares not owned by the acquiring person, the corporation's officers, or employee stock plans in which employees do not have the right to determine whether plan shares will be tendered in a tender or exchange offer. Shares owned by directors who are not officers of the corporation qualify to vote as "disinterested shares," even though those directors are usually allied with incumbent management.

Under the provisions of Section 2564(a) of proposed subchapter G, an acquirer of "control shares" may request a special shareholders meeting "for the purpose of considering the voting rights to be accorded to the control shares." If the request is accompanied by a written undertaking "to pay or reimburse the corporation for the expenses of a special meeting," the corporation must hold such a meeting within 50 days of the request and undertaking. If no such request is made, voting rights of control shares must be considered at the next annual or special meeting of the corporation.

Proposed subchapter G, if enacted, would impose a number of restrictions on the ability of potential acquirers to obtain control of target companies. First, a potential acquirer who has purchased a majority of a corporation's voting shares would not be assured of obtaining actual control of the firm. Rather, the acquirer would be required to wager that the so-called "disinterested" shareholders will agree to grant it the voting power that ordinarily passes with the ownership of shares. In the event that the "disinterested" shareholders do not so agree, the value of the acquired shares is likely to decline significantly. This restriction may discourage many potential acquirers from even attempting takeover bids. Moreover, the proposed legislation is likely to exact from acquirers a penalty that increases directly with the size of their investment in the target firm; the larger the acquirer's investment in a firm, the less likely it would be to gain control since the remaining "disinterested" shares may be in the hands of entities friendly to management, such as outside directors.

Second, although an acquirer may request a special shareholders meeting to consider the voting rights to be accorded "control shares," the special meeting can be delayed for as much as 50 days after it is requested. At a minimum, this requirement will add three weeks to the 20-business-day minimum tender offer period that bidders now face under federal law. *See* 17 C.F.R. § 240.14(e)(1). During that additional period, potential acquirers must bear a significant financial burden. To avoid the risk of paying a premium price for what ultimately will be nonvoting shares, bidders will have to extend the duration of tender offers to at least the 50-day waiting period imposed by the statute. During that period, they must bear the cost of capital for financing the acquisition, though they have no

assurance that the acquisition will ultimately be made. By so increasing the costs of acquisition efforts, the legislation is likely to reduce their frequency.²⁹

Third, the revocation of voting rights is not limited to shares purchased by the acquirer. Voting rights are also denied to all shares which the acquirer may vote by proxy or agreement. A potential corporate acquirer who has gained substantial shareholder approval is denied the benefit of shareholder support that may be critical to the success of the takeover attempt. The denial of voting rights to shares pledged to a bidder for corporate control is likely to discourage takeover attempts. Further, the provision seriously impairs the freedom of shareholders to exercise ownership rights in their corporations.

VI. EFFECTS OF THE DISGORGEMENT PROVISIONS OF THE PROPOSED LEGISLATION.

Subchapter H of the proposed legislation provides that any profit realized by a "controlling person or group" from most sales of corporate securities acquired up to 2 years before and sold within 18 months after acquiring controlling status are recoverable by the corporation. The term "controlling person or group" is defined in proposed Section 2573, and includes any person or group who has acquired or offered to acquire 20 percent of all voting power, or who has publicly disclosed directly or indirectly the intent to acquire such voting power. The definition also encompasses any person or group who has publicly disclosed directly or indirectly that control of the corporation may be sought by any other means, such as a proxy contest, without regard to voting power held.

The stated purposes of subchapter H are to prohibit "greenmail," to promote stable relationships among the parties involved in corporations and prevent the erosion of public confidence in the future of corporations, and to prevent

²⁹ Alternatively, bidders could make conditional tender offers, pursuant to which acceptance of tendered shares is contingent on the subsequent approval of voting rights for those shares. Because the 50-day waiting period in the proposed legislation exceeds the minimum offering period under federal law by three weeks, however, incumbent management would gain an additional three week period between the conditional acceptance and the shareholder vote in which to adopt defensive measures to thwart the tender offer, such as the sale of corporate assets to another firm. Under the "business judgement rule," such actions may be insulated from judicial scrutiny. In addition, a conditional offer is less likely to be successful than an unconditional one, since some shareholders will not wish to tie up their shares for the period during which the voting right issue remains unsettled.

speculators from misappropriating corporate values or putting corporations "in play" to reap short-term profits. In order to thwart a takeover attempt, incumbent management may repurchase the potential acquirer's stock at a premium price, so-called "greenmail." The payment of "greenmail" enables current management to retain corporate control to the possible detriment of shareholders, who cannot avail themselves of the offer to sell their shares at a premium and whose investments may have increased in value to a greater extent if the takeover attempt was successful. The proposed legislation does not, however, impose direct curbs on the payment of "greenmail." Rather, the disgorgement provisions of subchapter H deny sellers any profit realized on the disposition of stock acquired up to 2 years before and sold within 18 months after a takeover attempt.

Subchapter H, if enacted, would deprive potential acquirers of any increase in stock value, even though the activities of potential acquirers may have caused or contributed to the stock's increased value. For instance, stock value increases may be attributable to changes instituted by incumbent management to frustrate the takeover attempt, or to a successful takeover by a third party that values the firm even more highly than the first bidder for corporate control. By requiring disgorgement of any profit realized on the sale of stock within 18 months of a takeover attempt, the proposed legislation is likely to discourage legitimate bids for corporate control with the potential for enhanced economic efficiency.

Subchapter H is particularly deleterious because it applies not only to hostile tender offers, but also to any means of affecting control of a firm, including proxy contests. Dissident shareholders who may wish to change current management policies are confronted by the same disincentives as hostile bidders under proposed subchapter H. If management were to "win" a proxy contest by merely agreeing to adopt some or all of a dissident shareholder's program, the losing dissident shareholder would be required to disgorge any profits realized within 18 months on stock acquired up to 2 years prior to the proxy challenge.

Moreover, the proposed legislation requires disgorgement if shareholders have as much as "publicly disclosed," directly or indirectly, that they may seek control.³⁰ It is possible that a shareholder could be liable for disgorgement if he merely communicates dissatisfaction with management to other shareholders, since

³⁰ The term "publicly disclosed or caused to be disclosed" is defined in Section 2562 of the proposed legislation. The term includes any disclosure that becomes public which is made with the expectation that it become public or which is made to another who is not under an obligation to refrain from making the disclosure public. When a disclosure "becomes public" is not addressed by the definition.

management could claim that such communication constituted an attempt to seek the other shareholders' votes.

The ability to vote one's shares in order to affect the management of a firm is a cornerstone of the corporate structure of business. The inclusion of proxy contests within the disgorgement provisions of subchapter H may substantially limit the ownership rights of shareholders, and undermines the proposed goal of protecting the interests of shareholders.

VII. CONSIDERATION OF AN "OPTING IN" MECHANISM.

If the legislature decides to enact the "control-share" acquisition restrictions of proposed subchapter G and the disgorgement provisions of proposed subchapter H despite the concerns discussed above, we suggest that the bill be modified to make these provisions applicable only to corporations whose shareholders affirmatively elect to be covered by them through amendments to their articles of incorporation. In their present form, these provisions, if enacted, would apply to all corporations that do not "opt out" by an amendment to their bylaws or articles of incorporation.³¹ To the extent that the proposed legislation is motivated by a concern for shareholders, we think its purpose would be better served by a requirement that shareholders approve a decision to opt into the legislation. We recommend that a corporation's decision to opt into the statutory scheme be made solely through a shareholder vote amending the articles of incorporation.³²

If the legislature decides to retain the proposed "opting out" mechanism, we suggest that decisions to opt out be implemented by a majority vote of all shareholders. The proposed legislation would require an affirmative vote of 80 percent of all shares, unless the amendment has been approved by the board of directors of the corporation. This requirement imposes a serious restraint on the freedom of shareholders to control the corporations they own.

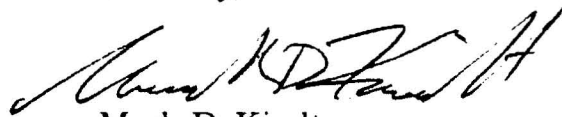
³¹ The "opt out" provisions are found in Sections 2561 and 2571 of S.B. 1310.

³² Corporate bylaws generally may be amended without the approval of the shareholders. *See* 15 PA. CONS. STAT. § 1504 (Purdon 1989). Consequently, we believe that the legislation should require decisions to opt in to be made in the form of amendments to the articles of incorporation.

VIII. CONCLUSION.

We believe that takeover activity most often enhances economic efficiency and thus benefits consumers, workers and shareholders. We believe that Senate Bill 1310 is likely to impede many of the potential beneficial consequences of takeovers without offering countervailing benefits. In addition, some of the provisions may significantly reduce the rights of shareholders (including those not seeking control) to vote their shares and participate in the governance of the corporations they own. The legislature, therefore, may wish to consider whether this legislation unduly interferes with the market for corporate control to the detriment of the economy and consumer welfare generally.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark D. Kindt". The signature is fluid and cursive, with a large, stylized initial "M" and "K".

Mark D. Kindt
Regional Director
Cleveland Regional Office