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News Release

CORPORATE CHANGES-IN-CONTROL: THE EVOLVING REGULATORY ENVIRONMENT

Remarks to

New York Chapter of the Association for Corporate Growth

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SUMMARY

In this speech, Mr. Goelzer discusses some fundamental changes in the regulatory environment governing changes in corporate control. He notes that, over the last few years, the locus of the regulatory debate has shifted from the federal government to the states and discusses recent state actions that may tilt the balance of corporate power in favor of corporate management and against shareholders. These actions include the Delaware Supreme Court's opinion in the Time-Warner litigation, non-stockholder constituency statutes, and a novel disgorgement provision in a pending Pennsylvania bill.

Mr. Goelzer points out that a reaction to the shift of corporate power from shareholders to management is beginning to appear, notably in the increasing debate over the role of institutional investors in corporate governance. In this regard, Mr. Goelzer describes increasing use of the Commission's Rule 14a-8 mechanism for submission of shareholder proposals to a vote at the corporate issuer's expense, as well as a recent letter suggesting proxy reforms from the California Public Employees' Retirement System to the Director of the Commission's Division of Corporation Finance.

Mr. Goelzer suggests that the history of regulation can be viewed as a series of swings of a pendulum between extremes, with the pendulum now nearing one of those extremes as a result of recent state actions -- threatened insulation of management from accountability to shareholders. Mr. Goelzer concludes that it is likely the pendulum will swing back again in the 1990's, to redress the imbalance between management and shareholders.

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CORPORATE CHANGES-IN-CONTROL: THE EVOLVING REGULATORY ENVIRONMENT

I. Introduction

Good afternoon. I am very pleased to be here today.

A little over a year ago, I spoke to the Detroit Chapter of the Association for Corporate Growth. At that time, I was so bold as to try to predict what federal legislative and regulatory developments might occur during the coming year in the area of tender offers and leveraged buyouts. Among other things, I fearlessly predicted that no major tender offer legislation would be passed -- a prediction which proved to be correct. In fact, over the years I have found that predictions of Congressional inaction on controversial issues are seldom wrong!

When, several weeks ago, I received this invitation from the New York Chapter of the Association for Corporate Growth, I considered whether I should once again take out my crystal ball and attempt to duplicate last year's feat. On reflection, however, I decided to retire with a perfect record for clairvoyance.

Rather than attempt to predict the future, today I have a different goal in mind: to discuss some fundamental changes in the regulatory environment governing changes in corporate control. Over the last few years, in this field the locus of the regulatory debate has shifted away from Washington, D.C., and to the fifty state capitols. And, the states have used their new-found muscle to tilt the balance of corporate power in favor of corporate management and against shareholders. As a result, defensive techniques designed originally to eliminate threats to shareholder decisionmaking now, with the sanction of the state courts and legislatures, may be turned against shareholders.

Even more troubling are current efforts to insulate decisions of boards of directors from effective review by the courts or by shareholders through the exercise of voting rights. Such efforts include

-- lowering poison pill thresholds to prevent the effective conduct of shareholder proxy solicitations,

-- empowering corporations to eliminate the right of shareholders to act by consent or call a special meeting, limiting the voting and economic rights of substantial shareholders, and

-- redefining the fiduciary obligations of directors to authorize them to disregard the interests of shareholders in takeover contests.

Just as institutional investors are beginning to assert their rights as owners, efforts are underway to insulate management from their oversight.

A reaction to that power shift is, however, beginning to appear. In particular, the increasing debate over the role of institutional investors in corporate governance marks the beginning of an effort to restore balance.

I want to amplify a bit on these developments and on the Commission's potential involvement. As always, I come armed with the usual SEC staff disclaimer: The views I will be expressing are solely my own, and not necessarily those of the Securities and Exchange Commission or of others on the staff of the Commission.

II. Yesterday's News

Like Yuppies and the Berlin Wall, many of the high-profile corporate law issues of the 1980's have now receded from public attention. In the world of corporate changes of control, the old cliche is true: Nothing is as stale as yesterday's news. A year and a half ago, following the RJR-Nabisco megadeal, the debate over LBOs and MBOs was nearly deafening. Congressional committees held a spate of hearings, numerous legislative proposals were introduced and considered, and countless op-ed pieces analyzing and weighing the issues were written.

Today, of course, the debate over what to do about LBOs is considerably more muted. In large part, the market has seen to that. The highly-publicized bankruptcy of Campeau, the difficulties other leveraged companies have had in completing asset sales necessary to pay off debt, the general decline of the junk bond market, the provisions of FIRREA 1/ limiting thrifts' investments in junk bonds 2/ -- all of these things have contributed to a much lower level of LBO activity and, consequently, a much lower level of anxiety about what should be done to curtail that activity. The collapse of Drexel Burnham, the driving force behind the high-yield debt market, was the capstone of this trend.

1/ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

2/ Id. § 222.

III. Current Developments -- The Rise of the States

The hostile takeovers and LBOs of the 1980's have, however, left a regulatory legacy -- despite the fact that, after years of debate and countless hearings, Congress, during the past decade, did not change the Williams Act provisions that regulate corporate takeovers. Government, like nature, abhors a vacuum, and while the federal government has not acted, the states have been scrambling to put the brakes on takeovers. As a result, the more controversial issues in this area now involve state law.

A. The Time-Warner Decision

One recent event that clearly may be of major significance is the Delaware Supreme Court's opinion in the Time-Warner litigation, issued just two weeks ago. 3/ Delaware, of course, exercises great influence in the development of corporate law. Throughout the 1980's, the Delaware courts grappled with many significant cases in this area, and issued rulings that shaped the legal environment for changes in corporate control. In general, the Delaware decisions have seemed to strike a balance between the board's ability to defend the corporation against threats and its fundamental obligation to protect shareholder economic interests.

The Time-Warner opinion, however, may signal a new direction. In that case, certain Time shareholders and Paramount Communications, which had made an all-cash tender offer for all of Time's shares at a substantial premium over the market price, sought to enjoin Time's tender offer for 51% of Warner Communications. The Time-Warner transaction, which did not require the approval of Time shareholders, would have precluded the Paramount offer for Time. The Delaware Supreme Court denied the request for a preliminary injunction of the Time-Warner transaction. While its opinion emphasizes the peculiar facts of the case, aspects of the court's reasoning suggest that the Court may be narrowing its previous rulings in this area. For example, the court concluded that by entering into the proposed merger with Warner, Time did not "put itself up for sale" thus triggering the board's duty to obtain the highest value for shareholders. 4/

Moreover, Time's decision to restructure the merger to preclude Paramount's competing offer was found to be a reasonable response to the "threat" that Paramount's offer posed to the

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3/ Paramount Communications, Inc. v. Time Inc., Nos. 284, 1989; 279, 1989; 283, 1989 (Del. Sup. Ct. Feb. 26, 1990).

4/ Id. at 27-31.

"achievement of corporate goals." 5/ The court expressly disapproved recent Delaware Chancery Court decisions "suggest[ing] that an all-cash, all-shares offer, falling within a range of values that a shareholder might reasonably prefer, cannot constitute a legally recognized 'threat' to shareholder interests." 6/ The Delaware Supreme Court held that valid concerns entertained by the board included the fear that shareholders might elect to tender on the basis of an erroneous judgment as to the strategic benefit of the target's anticipated merger with a third company, the degree of uncertainty injected by conditions attached to the hostile bid, and the timing of the bid to follow the target's issuance of a proxy statement, which the board viewed as arguably designed to upset, if not confuse, the shareholder vote. 7/

The Time/Warner decision raises troubling questions concerning whether the board's obligations run ultimately to shareholders or to some more abstract conception of sound corporate policy. Commentators have already suggested that the opinion means that a board of directors can "just say no" to a hostile tender offer, even one that offers an adequate price to shareholders. 8/ One of the key questions in this area will be whether the Delaware courts continue to follow this course in the 90's.

B. Non-stockholder Constituency Statutes

Still more ominous are similar state law developments in the legislative, rather than judicial, forum. One of these developments is the newest form of state takeover statute -- the non-stockholder constituency statute.

Since the passage of the federal Williams Act in 1968, many states have enacted their own takeover statutes. In Edgar v. MITE Corp., 9/ the Supreme Court struck down the Illinois Business Take-Over Act -- a "first generation" state takeover statute -- on the ground that it violated the Commerce Clause. As a result, until 1987, the ability of the states to erect

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5/ Id. at 31-41.

6/ Id. at 33-35.

7/ Id. at 36-37.

8/ See, e.g., "Can Takeover Targets Just Say No to Stockholders?," The Wall Street Journal, March 7, 1990, at A19.

9/ 457 U.S. 624 (1982).

barriers to national tender offers for corporations domiciled or doing business within their borders was limited. In that year, however, in CTS Corp. v. Dynamics Corp. of America, 10/ the Supreme Court upheld the validity of Indiana's "second generation" control share acquisition statute and paved the way for the states to significantly block takeovers, at least so long as they did so only with respect to corporations they had created and in a way that entailed a shareholder vote. CTS spawned the "third generation" statutes -- laws, like one enacted in Delaware, that preclude the hostile acquiror from merging with or selling the assets of its target for a substantial period of time, unless certain preconditions are met. 11/ All of these three generations operate by addressing the procedural responsibilities or voting rights of hostile tender offerors.

By contrast, the latest state law innovations -- non-stockholder constituency statutes -- go to the heart of corporate law by changing the fiduciary duties that a target company's directors owe to the company's shareholders. Over twenty states have adopted statutes that permit or require the board of directors of domestic corporations to consider the interests of non-stockholder groups. 12/ These statutes vary as to the situations in which such consideration is permitted or required -- for example, such consideration may be permitted or required in all situations, or only in control transactions. The Minnesota statute, for example, states that

> a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation. 13/

These non-stockholder constituency statutes may revolutionize corporate law. A basic principle of that law is that a corporation's directors owe fiduciary duties to the

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10/ 481 U.S. 69 (1987).

11/ Del. Code Ann. tit. 8, § 203 (Supp. 1988).

12/ See Hanks, Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come, Insights, Dec. 1989, at 20.

13/ Minn. Stat. § 302A.251, Subd. 5 (1989).

corporation's shareholders. If non-stockholder constituency statutes are construed to permit consideration of non-stockholder groups only when that consideration relates to potential benefits to shareholders, the statutes would appear to add little to existing corporate law. But it seems clear that the constituency statutes are intended to permit directors to consider a takeover bid's impact on non-stockholder constituencies even when such consideration is unrelated or even contrary to potential benefits to shareholders. This represents a significant departure from traditional concepts of the accountability of corporate management to shareholders.

C. Pending Pennsylvania Legislation

The high -- or perhaps low -- water mark -- at least so far -- in this trend to disconnect directors from their traditional obligations to shareholders is a Pennsylvania bill which was passed by the Pennsylvania State Senate last December and is now awaiting action by the Pennsylvania House of Representatives. 14/ This bill combines a non-stockholder constituency provision 15/ and several other provisions that are designed to protect corporations from takeovers, but in a way that may significantly insulate management and erode the rights of shareholders.

The bill also contains a novel disgorgement provision 16/ that generally would apply to any investor who acquires, offers to acquire, or publicly discloses the intention of acquiring at least 20 percent of the voting power of a Pennsylvania corporation. If an investor is subject to the disgorgement provision, generally all profits realized by the investor from disposing of equity securities of the corporation within 18 months after the investor became subject to the provision are recoverable by the corporation. While the stated purposes of the Pennsylvania disgorgement provision indicate that it is designed to protect against "greenmail," it has been suggested that this measure could be construed to extend to proxy solicitations conducted not for the purpose of acquiring control, but to oppose a management-sponsored proposal or even to secure shareholder support for a precatory shareholder proposal. 17/ If this is the case, then merely soliciting revocable proxies from 20% of an issuer's shareholders could lead to compulsory disgorgement of

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14/ Pa. S. 1310 (1989).

15/ Id. §§ 2, 4.

16/ Id. § 6.

17/ Gilson, An Evaluation of Pennsylvania Senate Bill 1310 at 8 (undated).

all profits accruing on sales of an issuer's stock for the next one and a half years. 18/

I should reiterate that this bill has not been enacted yet; I certainly have no way to predict its prospects. I think it does provide, however, a particularly good example of the extremes to which the states are apparently prepared to go -- and of the fact that the most heated issues concerning corporate changes in control today are arising at the state, rather than the federal, level.

IV. Shareholders Fight Back -- Institutional Investors and Federal Proxy Reform

In the wake of the combined effects of changes in the markets that inhibit the financing of takeovers and the changes in state law that may make it feasible for management to "just say no" -- if anyone bothers to ask -- institutional investors appear to be searching for new ways of influencing corporate governance. A recent article in the New York Times summarized this attention by stating that institutional activism "is increasingly seen as one of the few ways of keeping management on its toes." 19/ Thus, in place of the old "Wall Street Rule," under which they would either support management or dispose of their investment, institutions have sought to exert their economic power through proxy voting and other means, to change a disfavored corporate policy or practice. As a result, institutions are seeking to facilitate their access to the proxy mechanism. Let me give three examples of developments in this area.

A. Commission Action

First, the Commission has taken action in its adoption in 1988 of Rule 19c-4. 20/ The Commission's decision to propose Rule 19c-4 followed attempts by the New York Stock Exchange to abandon its 60-year old prohibition against listing common stocks having less than full voting rights, thereby permitting listed

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18/ The Pennsylvania bill also contains a "tin parachute" provision under which severance pay up to 26 times weekly compensation would be required for any employee terminated, other than for willful misconduct, within 24 months of certain control share acquisitions. Pa. S. 1310, § 6 (1989).

19/ Big Funds Pressing for Voice in Management of Companies, New York Times, Feb. 23, 1990, at A1.

20/ 17 C.F.R. § 240.19c-4 (1989).

companies to dilute or rescind voting rights of existing shareholders. Structured to protect public shareholders against disenfranchisement pursuant to disparate voting rights plans, Rule 19c-4 requires that the rules of the national exchanges and associations prohibit listing if the company issues securities or takes other corporate action that would have the effect of nullifying, restricting, or disproportionately reducing the per share voting rights of holders of common stock.

B. Increasing Shareholder Challenges to Defensive Devices

Second, shareholder resistance to antitakeover measures increasingly has been channeled into use of the Commission's Rule 14a-8 21/ mechanism for submission of shareholder proposals to a vote at the corporate issuer's expense. Pursuant to this rule, shareholders may generally submit to the issuer for inclusion in its proxy materials a single proposal and supporting statement of not more than 500 words on voting matters not involving ordinary business operations or the election of directors.

Institutional shareholders first launched an organized offensive against the more common anti-takeover measures in 1987, sponsoring approximately 150 Rule 14a-8 proposals calling upon portfolio companies to rescind or allow a shareholder vote on poison pills, and to eliminate or restrict golden parachutes, greenmail, and disparate voting rights plans. By contrast with the relatively poor showings of prior years, these proposals drew in some cases more than 40 percent of all votes cast at particular companies. 22/ Eschewing reliance solely upon the description of their proposals in the issuer's proxy materials, proponents for the first time mounted independent proxy solicitations in support of these proposals. 23/ Even though majority votes were not obtained, the percentages were sufficiently high to persuade a few companies to conduct a vote on their poison pills. 24/

Shareholder proposals submitted during the 1990 proxy season have encompassed a wide range of corporate governance issues. Resolutions advocating that companies opt out of Delaware's

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21/ 17 C.F.R. § 240.14a-8 (1989).

22/ See Marcil and O'Hara, Voting by Institutional Investors on Corporate Governance Issues in the 1987 Proxy Season, 5-18 (1987).

23/ See Marcil and O'Hara, at 9.

24/ See Marcil and O'Hara, at 16.

takeover statute will be on the ballot at several Fortune 500 companies, as will proposals requesting that issuers subject to a shareholder vote, or curtail, poison pills, and restrict greenmail and golden parachutes. The staff of the Commission's Division of Corporation Finance recently declined to permit issuer exclusions of Rule 14a-8 proposals seeking to bar golden parachutes, reversing prior no-action positions. 25/ With this reversal, it is likely that more proposals challenging these and similar compensation payments contingent upon a change in control will be introduced.

C. CalPERS Letter

A third noteworthy event is a November 1989 letter from the California Public Employees' Retirement System -- CalPERS -- to the Director of the Commission's Division of Corporation Finance suggesting proxy reforms. The letter illustrates that access to the proxy machinery may be the next battleground.

1. Confidential Voting and Independent Tabulation

First, the CalPERS letter proposes that the Commission promulgate rules that would require confidential voting and independent tabulation of proxies. 26/ Similarly, two bills are pending before Congress -- the Investor Equality Act of 1989 27/ introduced by Senator Shelby and the Corporate Takeover Reform Act of 1989 28/ introduced by Senators Armstrong and Metzenbaum -- each of which would direct the Commission either to promulgate rules that would require confidentiality in the granting and voting of proxies, or would provide an alternate means for assuring the integrity of the proxy voting process.

Those supporting confidential voting and independent tabulation argue that it would protect shareholders against coercive pressures to vote in a particular way and eliminate the pro-management bias of the current proxy voting system, pursuant to which management members are able to discover voting results and thereby solicit shareholders either to change or cast their votes. They also argue that confidential voting and independent tabulation protect the privacy of individuals, especially

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25/ Transamerica Corp., SEC No-Action Letter (Jan. 10, 1990).

26/ CalPERS Letter, Proposal A.17, at 14.

27/ S.1658, 101st Cong., 1st Sess. § 8 (1989).

28/ S.1244, 101st Cong., 1st Sess. § 7 (1989).

employee-shareholders, who are especially vulnerable to retaliation. 29/

Those opposing confidential voting and independent tabulation deny the existence of managerial coercion and stress the importance of preserving unrestricted communication between managements and shareholders. Opponents of confidential voting and independent tabulation also argue that secret voting by institutional investors who are fiduciaries, for example, pension fund managers, would be inappropriate, especially in light of the Commission's disclosure mandate. Finally, they argue that wrongful tabulation by in-house personnel has not been demonstrated to be a problem. 30/

Recently, several Fortune 500 companies have adopted confidential voting and independent tabulation procedures. I cannot predict whether legislative or regulatory provisions requiring such procedures will be adopted or whether changes in this area will be left to such private sector initiatives. But, in any event, this should be an area to watch in the near term.

2. Shareholder Access to Issuer Proxy Statements

Another area of concern to CalPERS is shareholder access to issuer proxy statements. 31/ The present proxy rules provide generally that the holder of at least one percent or $1000 of an issuer's voting securities may submit no more than one proposal for inclusion in the issuer's proxy statement. 32/ The CalPERS letter suggests that an investor who holds at least three percent or $1 million of an issuer's voting securities should be permitted to submit multiple proposals -- in essence, this would afford large holders free access to the proxy statement as a vehicle to communicate with other shareholders. The reason given by CalPERS for this proposed change is that it would "allow larger security holders who demonstrate a substantial interest in participating in the governance of the [issuer] to play a more effective role."

29/ See, e.g., Heard, A Secret Ballot Has Merit, Insights, Dec. 1988, at 21.

30/ See, e.g., Norman, It Ain't Broke: A Defense of the Proxy Voting Process, Insights, Dec. 1988, at 20.

31/ CalPERS Letter, Proposal A.13, at 13.

32/ 17 C.F.R. § 240.14a-8 (1989).

The pending bills would also expand access to issuer proxy statements for shareholders representing a threshold percentage of the issuer's voting power. 33/ The threshold percentage is three percent in one bill and ten percent in the other.

Providing increased shareholder access to issuer proxy statements could significantly affect corporate governance. This could be especially true in the case of the legislative proposals that would give large shareholders access to the issuer's proxy statement on matters relating to the election of directors. Currently, only management has the right to include nominees for the board of directors in issuer proxy statements. Large shareholders currently have only the right, at their own expense, to conduct an independent proxy solicitation for the election of directors.

Increased shareholder access to issuer proxy statements would reduce the costs of a proxy challenge to incumbent management and thereby might induce managements to operate corporations more efficiently and maximize stockholder values. Increased access would also, of course, impose costs on the corporate treasury, and thereby on all shareholders. Currently, a shareholder successfully conducting an independent proxy challenge may be reimbursed by the issuer for the expenses of the contest; losers must generally pay their own way. A policy requiring issuers to finance unsuccessful solicitations might encourage frivolous contests and might have the effect of forcing management to give special concessions, akin to "greenmail," to shareholders launching challenges.

3. Communications Between Shareholders

Third, CalPERS has suggested changes to facilitate direct communications between shareholders. For example, CalPERS has proposed that the definitions of the terms "solicit" and "solicitation" -- terms used to describe activities subject to the proxy rules -- are overbroad and subjective and could reach certain communications between shareholders that are not part of a proxy solicitation. CalPERS suggested curing this overbreadth by providing more objective criteria defining a "solicitation," based on the timing and purpose of the communications, the subject matter of the communications, and the parties involved. 34/

33/ S.1658, 101st Cong., 1st Sess. § 9 (1989); S.1244, 101st Cong., 1st Sess. § 8 (1989).

34/ CalPERS Letter, Proposal A.1, at 9-10.

The present proxy rules exempt solicitations by a person other than the issuer where not more than 10 persons are solicited. 35/ CalPERS has suggested that the safe harbor be expanded, perhaps taking into account factors such as sophistication of those solicited to define circumstances where all the protections of the proxy regulatory process are not required. Alternately, CalPERS has suggested a safe harbor that permits an increased number of persons to be solicited for larger companies or companies with greater numbers of shares outstanding. 36/

4. Shareholder Lists

Current proxy rules require an issuer either to mail proxy materials for a requesting shareholder, at the shareholder's expense, or to provide the requesting shareholder a list of record shareholders. 37/ CalPERS suggests that the rules be revised to require disclosure to requesting shareholders of the list of both record and beneficial owners. 38/ CalPERS argued that this would remedy the following two shareholder disadvantages. First, CalPERS stated that if the issuer elects to do the mailing, it has some control over the timing and efficiency with which a shareholder communication is disseminated. Second, CalPERS stated that if the issuer provides a shareholder list, it need only disclose record and not beneficial owners.

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The CalPERS letter contained 48 specific proposals for proxy reform. I have touched on some of the more substantial of these proposals, to give you a sense of the nature of the changes that institutional shareholders seek. Since, as I said at the outset, I have temporarily retired my crystal ball, I cannot predict what changes, if any, will be made by Congress or the Commission in the area of proxy regulation. But the Division of Corporation Finance staff has stated that it will be considering the CalPERS issues, 39/ and it is reasonable to expect that proxy regulation

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35/ 17 C.F.R. § 240.14a-2(b)(1) (1989).

36/ CalPERS Letter, Proposal A.3, at 10.

37/ 17 C.F.R. § 240.14a-7 (1989).

38/ CalPERS Letter, Proposal A.10, at 12.

39/ Remarks of David A. Sirignano, Chief, Office of Tender Offers, The SEC Speaks in 1990, Washington, D.C., March 2,
(continued...)

is an area that will be an active part of the Commission's agenda in the next few years.

V. Conclusion

In conclusion, it seems to me that much of the history of regulation can be viewed as a series of swings of the pendulum between extremes. In my view, the pendulum now is nearing one of these extremes. The states, in reaction to a decade of hostile takeovers and a Supreme Court sensitive to the principles of federalism, have afforded to corporate managements takeover defenses that threaten to insulate them from accountability to shareholders. But, it is unlikely -- and, in my view, certainly undesirable -- that the corporate owners -- the shareholders -- will be permanently deprived of meaningful ability to protect their interests. The CalPERS letter is a first step in what may become the corporate law theme of the 1990's -- redressing the imbalance between management and shareholders. If the type of access CalPERS seeks to the proxy machinery does not prove workable, then, in the long run, Congress is likely to be pressed back into the fray -- not on behalf of management as the antitakeover legislation of the 1980's sought, but to restore the rights of shareholders.

Thank you.

39/(...continued)
1990.

The staff of the Division of Corporation Finance supplied information and material for use in this speech. I appreciate their assistance and contribution, especially with respect to the description of the CalPERS proposal and of current proxy trends.