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POLITICS AND TAKEOVERS: A BRIEF WASHINGTON PERSPECTIVE

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Panel Discussion on
The Economic Effects of
Mergers and Acquisitions

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Commissioner

The remarks initially delivered at the February 19-21, 1987 conference have been updated to include developments as of July 20, 1987. The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those the Commission, other Commissioners or Commission staff.

POLITICS AND TAKEOVERS: A BRIEF WASHINGTON PERSPECTIVE*

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November of 1986 marked a turning point in the politics of the takeover debate. In the space of ten days, the Securities and Exchange Commission announced settlement of the Boesky insider trading case[1] and the Democrats gained control of the Senate. Either event alone would have altered the context of the takeover debate. The combination of the two in such a short period of time, however, added a sense of urgency to the legislative desire to "do something--do anything" about takeovers.

In these remarks, I will: (1) discuss the relationship between takeovers and insider trading, and explain the illogic of the argument that hostile takeovers should be curbed in order to stop insider trading; and (2) criticize recently introduced antitakeover legislation that does nothing to prevent allegedly "egregious" defensive tactics while imposing overbroad burdens on stock acquisitions that could adversely affect many transactions wholly unrelated to hostile takeovers.

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*The remarks initially delivered at the February 19-21, 1987 conference have been updated to include developments as of July 20, 1987.

[1]<u>SEC v. Boesky</u>, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986).

The Link Between Insider Trading and Takeovers

Many takeover critics have tried to link insider trading with hostile takeovers. They argue that hostile takeovers should be curbed so that insider trading can be stopped. This argument is, however, seriously misguided.

Insider trading occurs when someone misappropriates or, through breach of a duty, converts valuable nonpublic information about a pending transaction or disclosure.[2] Thus, insider trading can occur when a friendly merger is pending,[3] when a company has found a substantial mineral deposit,[4] or when unfavorable earnings have not as yet been announced.[5] Hostile takeovers are not uniquely susceptible to insider trading, nor do hostile takeovers cause insider trading in any meaningful sense--just as mineral finds, earnings reports, and friendly takeovers do not cause insider trading in and of

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[2]Generally, there must be a purchase or sale of securities in breach of a fiduciary duty or a relationship of trust or confidence, while in possession of material nonpublic information about an issuer or the trading market for an issuer's securities. See, e.g., Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); United States v. Carpenter, 612 F. Supp. 827 (S.D.N.Y. 1985), aff'd 701 F.2d 1024 (2d Cir. 1986), cert. granted, 55 U.S.L.W. 3424 (U.S. Dec. 15, 1986) (No. 86-422).

[3]See, e.g., SEC v. Siegel, 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987).

[4]SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[5]See, e.g. SEC v. DePalma, 86 Civ. 3541 (D.D.C. Dec. 30, 1986); SEC v. Wahl, 86 Civ. 0568 (D. Neb. Aug. 20, 1986); SEC v. Weksel et al., 86 Civ. 6063 (CSH) (S.D.N.Y. Aug. 6, 1986); SEC v. Moorhead, 85 Civ. 2007 (D. Colo. Dec. 2, 1985).

themselves. Indeed, efforts to prohibit hostile takeovers in order to deter insider trading make as little sense as efforts to stop vote fraud by cancelling all elections, or efforts to stop bank robbery by shutting down all banks.

Unfortunately, recently introduced antitakeover legislation falls prey to easy but illogical arguments that seek to prevent insider trading by stopping takeovers. For example, a statement accompanying S. 1323, the "Tender Offer Disclosure and Fairness Act," attacks the "market manipulating corporate raider" and cites trading by Dennis Levine, Martin Siegel, and Ivan Boesky as examples of the abuses engendered by "manipulative raids."[6] The problem with this attack on insider trading, which makes a great deal of sense as an introduction to a legislative definition of insider trading, is that it makes no sense as a rationale for legislation targeting takeover activity.[7]

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[6]133 Cong. Rec. S7594 (daily ed. June 4, 1987) (statement of Sen. Proxmire).

[7]Not all members of Congress make this error. As Congressman Markey, Chairman of the House Subcommittee on Telecommunications and Finance observed, the incidence of insider trading "does not, of course, mean that we should halt all corporate takeovers in order to root out the insider trading problem. But it does mean that those responsible for these transactions have not developed appropriate mechanisms to contain the flow of information relating to takeovers." Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, "Congressional Study Finds Persistent Run Ups in Target Company Stock, Indicating Possible Pervasive Insider Trading," at 2 (July 15, 1987) (news release quoting Rep. Markey, Subcommittee Chairman).

Insider trading is not caused by hostile takeovers, nor is it uniquely associated with hostile takeovers. To make this point crystal clear, consider the Nestle-Carnation deal, a notorious example of insider trading that involved Messrs. Boesky and Siegel and netted Ivan Boesky profits of $28.3 million.[8] In the Carnation trade, Siegel was Carnation's investment banker and participated in extensive friendly negotiations that both Carnation and Nestle sought to keep secret.[9] There were no hostile bids involved, and no raiders were trying to impose their will on Carnation's management. Nonetheless, Siegel tipped Boesky about the friendly deal and the transaction gave rise to a stunning volume of insider trading.

The Carnation trade demonstrates that friendly deals are every bit as susceptible to insider trading as hostile ones. In fact, a recent study by the Commission's Office of the Chief Economist found substantial evidence of stock price runups prior to the announcement of friendly transactions.[10] It also found that runups prior to friendly deals are more

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[8] SEC v. Siegel, 87 Civ. 0963 (Complaint, ¶ 23).

[9] For a description of these negotiations and Nestle's interest in maintaining confidentiality see In re Carnation Corp., Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,801 (July 8, 1985).

[10] Office of the Chief Economist, SEC, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation? (Feb. 24, 1987).

pronounced than runups prior to hostile transactions.[11] This suggests--but certainly does not establish--that insider trading may be more pronounced in friendly deals than in hostile deals. Friendly deals may be more susceptible to insider trading because more people on both sides of the negotiations are likely to know of the pending deal for a longer period of time. In contrast, a hostile bidder wants to avoid tipping a target that a bid is forthcoming. The hostile bidder is therefore likely to move faster with fewer people knowing of the bid, and is more likely to be able to maintain secrecy.

If friendly deals are more susceptible to insider trading should Congress stop friendly deals in order to stop insider trading? Of course not. Similarly, Congress should not constrain hostile takeovers on the misguided rationale that those deals are particularly susceptible to insider trading.

In fact, even in cases where insider trading is discovered in connection with a hostile takeover, the trading does not necessarily emanate from the bidder camp, nor does it occur with the bidder's approval. For example, the U.S. Attorney's Office has alleged that during Mesa's hostile bid for Unocal one of Unocal's investment bankers tipped

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[11]"Friendly, negotiated takeovers have more pre-bid runup then hostile takeovers (47.1 percent versus 35.3 percent one day before the bid) when foothold acquisitions of the bidder are held constant at zero." Id. at 3.

Mr. Siegel about Unocal's planned defensive maneuvers.[12] Unocal's defensive tactic caused the value of its shares to decline, and Siegel caused his employer to buy put options that increased in value as a result of the Unocal price decrease. But to blame this insider trading on the raider's conduct is obviously wrong and makes about as much sense as blaming pass interference on the quarterback who throws the football.

Strong rules against theft of information in the form of insider trading are sound public policy, and I support vigorous efforts to protect corporations' and stockholders' property rights in confidential market information.[13] However, the link between hostile takeovers and insider trading is largely a public relations device used by opponents of takeovers with little regard to the logic of their arguments. Insider trading cannot and should not serve as a rationale for imposing restraints on takeover activity. Insider trading and takeovers are two different issues that call for distinct analyses and distinct legislative approaches.

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[12]United States v. Siegel, 87 Cr. 118 (RJW) (filed Feb. 13, 1987) (Complaint).

[13]J. Grundfest, To Catch a Thief: Recent Developments in Insider Trading and Enforcement, Address to the National Investor Relations Institute, New York Chapter (June 20, 1986).

Takeover Legislation

On the legislative front, the Senate Democrats' antitakeover proposals introduced in the first six months of 1987 suffer from a disappointing gap between rhetoric and reality. The rhetoric speaks of a need to control both coercive bidder tactics and abusive defensive techniques without foregoing the benefits that result from an active takeover market. The legislative reality, however, is that some of these bills would do essentially nothing to control the allegedly abusive defensive techniques they claim to address. They would also impose substantial burdens on anyone seeking to acquire a significant stockholding position in a publicly traded corporation, even if the share acquisition was wholly unrelated to a hostile takeover.

Whatever the rhetoric, the message of much of the legislative language is clear: the legislation is designed to stifle takeover activity with little regard to costs imposed on a broad range of nontakeover transactions. The legislation also seeks to tilt the balance in takeover contests strongly in favor of incumbent management because the bills contain no meaningful effort to control abusive defensive tactics. Accordingly, even if one is opposed to egregious and abusive takeover tactics and believes federal legislation is appropriate, it would be easy to oppose much of the legislation now pending before the Senate.

For example, S. 1323, the "Tender Offer Disclosure and Fairness Act," is sponsored by Senator Proxmire, and co-sponsored by all eight Democrats on the Securities Subcommittee of the Banking Committee. The statement accompanying S. 1323 explains that "tender offers themselves should be neither encouraged nor discouraged by law; egregious defenses as well as coercive takeover tactics should be limited."[14] Bravo! As a guide for responsible takeover legislation it would be hard to craft a more workable and evenhanded formula.

However, by oversight or calculation, somewhere between the fine rhetoric and the serious work of legislative drafting, something has gone wrong, because the bill: (1) does essentially nothing to limit "egregious defenses;" (2) restricts a broad range of market transactions that have nothing to do with "coercive takeover tactics;" and (3) seeks to discourage by law the very transactions towards which the statement proclaims neutrality.

Toothless Controls on "Egregious Defenses?" The authors of the bill have identified greenmail, golden parachutes, and poison pills as defensive practices that they consider egregious. Assuming for the moment that these practices warrant federal regulation--a conclusion I do not embrace--it would make sense to draft legislation that effectively

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[14]133 Cong. Rec. S7594, 7596 (daily ed. June 4, 1987) (statement of Sen. Proxmire).

addresses the problems caused by such "egregious defenses." The proposed legislation is, however, toothless when it comes to regulating greenmail, golden parachutes, and poison pills. Indeed, the remarkably ineffective nature of the provisions intended to regulate these three practices unfortunately calls into question the willingness of the bill's authors to control takeover defenses that are purportedly "egregious."

Greenmail. In particular, S. 1323 does not prohibit greenmail.[15] Instead, it attempts to control the price at which greenmail can be paid. It does so by establishing a maximum repurchase price equal to the average price over the thirty days preceding the greenmail transaction. This price control provision will be ineffective whenever the average price over a trailing thirty day period is greater than the prevailing market price because, under those circumstances, greenmail can be paid at a price higher than the price prevailing at the time of the repurchase.[16] Thus, the "anti-greenmail" provision of S. 1323 may paradoxically lead to higher greenmail payments. Moreover, because some individuals may have an interest in creating a higher thirty day average price in order to support a larger greenmail payment, a danger exists that some individuals may attempt to manipulate stock

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[15]S. 1323, 100th Cong. 1st Sess. § 8 (1987) (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 78n).

[16]This scenario can occur if there is an intervening bid that is withdrawn or if expectations of such a bid arise and then disappear.

prices to take advantage of such a greenmail price control rule. Under no circumstances would it prevent a large stockholder from selling his shares back to the corporation for a premium price unavailable to other, typically smaller stockholders.

The proposed legislation would therefore do little to deter greenmail. Instead, if enactment of the bill is construed as federal approval of transactions that comply with its toothless price control rule, then passage of the legislation could actually increase the incidence of greenmail transactions. A similar pattern has, in the past, been observed in connection with the tax treatment of golden parachutes: Once Congress established a special tax applicable only to golden parachutes that more than trebled an executive's compensation,[17] a rule of thumb emerged that parachutes that no more than trebled compensation were acceptable.

Golden Parachutes. The golden parachute provision in S.1323 would prohibit a company from adopting a golden parachute only while a tender offer is pending.[18] However, at least 198 of the Fortune 500 already have such plans in

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[17] *See* I.R.C. § 280G, Golden Parachute Payments (West Supp. 1987).

[18] S. 1323, § 8 (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 78n).

place,[19] and the legislation would do nothing to control these existing parachutes. The proposed legislation would also do nothing to deter corporations from adopting parachutes at any point in the future--provided the paperwork was signed before the tender offer begins. Thus, the bill would again be toothless regarding the hundreds of parachutes that have already been strapped on in anticipation of takeover battles.

Poison Pills. The poison pill provision of S. 1323 would prohibit only poison pills adopted while a tender offer is pending.[20] More than 400 publicly traded corporations have already adopted poison pills.[21] The pending legislation would not affect existing pills and would do nothing to prevent adoption of future poison pills before a tender offer is announced. Thus, the legislative proposal is toothless with respect to the hundreds of poison pill plans that have already been put in place.

Leading takeover counsel have advised clients to adopt poison pills now, so that they will be prepared in the event the bill becomes law.[22] Paradoxically, if companies accept

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[19] V. Rosenbaum, Takeover Defenses-Profiles of the Fortune 500 (Jan. 1987).

[20] S. 1323, § 8 (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 79n).

[21] Labaton, More Potency for Poison Pills, N.Y. Times, July 20, 1987, at D2, col. 1.

[22] M. Lipton, "The Proxmire Bill and the Pill," Memorandum to Clients of Wachtell, Lipton, Rosen & Katz (June 6, 1987).

this advice the simple introduction of S. 1323 will have increased the number of "egregious" poison pills in place.

Antitakeover Provisions. The provisions targeting "egregious defenses" are all bark and no bite. Are the provisions aimed at potential hostile bids equally inept? Hardly. The anti-bidder provisions are so broad and over-inclusive that I have neither the time nor space to describe even a fraction of them. Instead, I will describe only one set of provisions with potential consequences that are particularly overbroad. If enacted, these provisions could radically change the structure of the entire stock market and influence thousands of transactions that have nothing to do with hostile takeovers.

S. 1323 would prohibit anyone from acquiring more than 15 percent of a company's shares unless the acquisition was made through a tender offer.[23] Combined with a provision in S. 1324 that prohibits partial tenders by requiring that tender offers for more than 20 percent of a company's shares be for all the company's shares,[24] the legislation would

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[23]S. 1323, § 7 (amending Section 14d of the Securities Exchange Act of 1934, 15 U.S.C. 78n(d)).

[24]S. 1324, 100th Cong., 1st Sess. § 9 (1987) (amending Section 14d of the Securities Exchange Act of 1934, 15 U.S.C. 78n(d)).

effectively prevent anyone from acquiring more than 20 percent of a company unless he tendered for the entire company.[25]

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[25]There are two reasons I analyze these provisions in unison although they are not contained in the same bill. First, proponents of each provision are likely to feel that they need the other to make their provision "effective," i.e., the mandatory tender offer provision will have a far stronger impact if combined with a mandatory "any or all" rule, and vice versa. There is, therefore, sentiment to combine these two provisions in a single piece of legislation, and they have earlier been considered as elements of a common bill. Second, the adverse consequences of each provision are most far-reaching if the two provisions are combined, and I wish to emphasize the perhaps unforeseen consequences of legislation that mandates tender offers for acquisitions above a certain size threshold while simultaneously prohibiting partial tender offers.

This is not to suggest that these provisions are harmless if uncoupled. To the contrary, the mandatory tender offer provision of S. 1323 and the mandatory "any or all" provision of S. 1324 are objectionable standing on their own. The mandatory tender offer provision would substantially increase the cost of acquiring more than 15 percent of a publicly traded corporation's shares, and could also substantially and unnecessarily increase the incidence of partial tender offers by investors seeking to establish large equity positions. In addition, it would prohibit many large block transactions because the purchaser would have to tender for the large block and, pursuant to Commission rules, would have to accept tendered shares on a pro-rata basis from all stockholders, not just the seller of the block. All this would occur without adding any meaningful efficiency or investor protection to the market.

The mandatory "any or all" provision of S. 1324 would prohibit partial tenders and either: (1) inefficiently deter valuable partial acquisitions that facilitate technology sharing, venture capital investments, and legitimate "toehold" investments made by investors who want a careful look at a company before deciding to acquire full control; or (2) inefficiently provide an incentive for investors to purchase substantial blocks in transactions that are carefully structured so as to fall outside the Commission's tender offer rules. This latter consequence could stimulate "street sweeping" activity that Congress and the Commission seek to deter (i.e., efforts to cause the rapid accumulation of blocks that can be "swept up" on the "street" through large, negotiated, private transactions).

The consequences of such legislation could radically restructure large portions of the securities market that are unrelated to hostile takeovers. As an example of the reach of these provisions, consider the following illustrations of transactions that would be forbidden.

Suppose a large pharmaceutical company wants to acquire 30 percent of a smaller biotechnology firm's shares in conjunction with a license or joint venture. It will be prohibited from making that investment unless it tenders for all of the biotech company's shares. Thus, the legislation could force the smaller company out of existence as part of the price of obtaining equity capital.

If a company's founder wants to bequeath or gift his 60 percent holding to an only child he could not do so unless the child tendered for the entire company. If an investor wants to provide additional equity capital to a company in which he already owns 20 percent he would be forbidden from doing so unless he offered to buy the entire firm. Indeed, any investor already holding a 20 percent position who simply wants to increase an existing position would be forbidden from doing so unless a tender offer was made for the entire company.

Viewed from the seller's perspective, the situation is potentially even more far-reaching because any seller who owns 20 percent or more of a company's shares would be unable to dispose of those shares in a single block unless the purchaser

agreed to conduct a tender offer for all the company's shares. The block would therefore have to be broken into smaller positions before it could be sold outside an any-or-all tender.

The reach of such provisions obviously stretches far beyond any rational concern over hostile takeovers. Because such legislation would seriously deter any share acquisition that creates a holding in excess of 20 percent, the legislation would, over time, cause the gradual extinction of stockholder positions above 20 percent. Strong minority shareholders are a valuable monitoring device in corporate governance, even if the minority shareholders never threaten a takeover or proxy contest. The gradual extinction of these minority positions could therefore change the balance of power between stockholders and managers in ways wholly unrelated to hostile takeovers.

In addition, it is no defense of such provisions to observe that the SEC could craft exemptions "consistent with the purposes and policy fairly intended" by the legislation.[26] It is a foolish bill that is so overbroad that its authors would require an administrative agency to construct an armada of exemptions merely to allow garden variety transactions to continue undeterred.

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[26]S. 1323 § 7(b)(3), (amending Section 14(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(d)).

When these constraints are evaluated in conjunction with efforts to: (1) introduce an unworkable extension of the "conscious parallelism" doctrine from antitrust law to the takeover arena; (2) impose on shareholders onerous disclosure requirements unrelated to takeover activity; and (3) create sweeping extensions of private rights of action and theories of liability that invite for extensive litigation and strike suits, it quickly becomes clear that the proposed legislation places far greater burdens on bidders, who may be doing nothing unfair or coercive, than on target companies responding to takeover attempts with allegedly "egregious" defenses.[27]

Is It Balanced?

By no stretch of the imagination does the proposed legislation live up to its promise neither to encourage nor discourage tender offers. Nor does the legislation live up to its promise to limit egregious defenses as well as coercive takeover tactics. The reality, instead, is that the proposed legislation would: (1) seriously deter takeovers without regard to whether the takeover is fair and noncoercive; (2) place impediments in the path of innocent transactions wholly unrelated to hostile deals; and (3) do essentially nothing to deter "egregious defenses."

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[27] See Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, Concerning Corporate Takeover Legislation (June 23, 1987).

Clearly, even if one believes that something should be done about takeover activity, legislation of the sort currently supported by many Senate Democrats is not a reasonable approach to the takeover problem.