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BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

MAY 5 1988

The Honorable Steven D. Wolens
Chairman
Committee on Business and Commerce
Texas House of Representatives
15th and Congress Streets, Room 231
Austin, Texas 78711

COMMISSION AUTHORIZED

Dear Mr. Wolens:

The staff of the Federal Trade Commission is pleased to respond to your letter of invitation of April 27, 1988, to comment on "An Act Relating to Control Share Acquisitions, Certain Business Combinations and Amending the Texas Business Corporation Act." */ The bill, if enacted, would amend the Texas Business Corporation Act to regulate "control share" acquisitions and certain "business combinations" involving both Texas corporations and certain nonresident corporations. 1/ Specifically, the bill would prohibit bidders for corporate control from voting "control shares" unless a majority of "disinterested" shareholders has voted to authorize the exercise of that right, and it would restrict the ability of acquirers to engage in business combinations with target corporations for a period of five years after acquiring twenty percent of their shares.

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*/ These comments represent the views of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics, and do not necessarily represent the views of the Commission itself or any individual Commissioner. The Commission has voted, however, to authorize us to submit these comments for your consideration.

1/ Article 13.03 of the bill is similar to an Indiana "control share" statute whose constitutionality was recently upheld by the Supreme Court in CTS Corp. v. Dynamics Corp., 107 S. Ct. 1637 (1987). The Court held that the Indiana law was not preempted by the federal Williams Act, 15 U.S.C. § 78m(d)-(e), 78n(d)-(f), or Securities and Exchange Commission regulations promulgated thereunder, and did not unconstitutionally interfere with interstate commerce. Article 13.03, however, differs from the Indiana statute in that it also applies to nonresident corporations. We do not address here the constitutional issues raised by that feature of the proposed legislation. <u>See</u> 107 S.Ct. at 1651-52; Edgar v. Mite, 457 U.S. 624, 645-46 (1982).

We believe that enactment of the proposed legislation is likely to deter takeovers that benefit shareholders, employees, consumers, and the economy as a whole. If the legislature nevertheless decides to enact the bill, we recommend that it consider making the legislation applicable solely to corporations that affirmatively elect to be covered by it through amendments to their articles of incorporation. 2/ An affirmative "opting in" provision would enable the shareholders of each corporation to determine whether restraints on the transfer of corporate control are in the interests of the corporation.

A. Interest and Experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive practices in or affecting commerce. 15 U.S.C. § 45. Pursuant to this mandate, the Commission 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 Commission has substantial experience in the area of mergers and acquisitions. The Commission 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 Commission reviews proposed acquisitions of corporate securities, including tender offers, to determine whether they violate the antitrust laws.

The Commission's staff has addressed issues related to the market for corporate control through scholarly studies and comments to state governments. Last year, the Commission's Bureau of Economics published a study on the effects of takeover legislation enacted by New York in 1985. 3/ In the past two years, the Commission's staff provided comments on corporate control legislation to the governor of New York and to the New Jersey and Delaware legislatures.

2/ Article 13.03 of the bill, which governs "control share" acquisitions, contains an opt-in provision.

3/ 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).

B. 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 desirable 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 and benefit shareholders, employees, and consumers. As discussed in further detail below, although some critics have questioned the benefits of takeovers, the criticism appears to lack empirical support.

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 market value 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 increase efficiency by combining 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, many of whom are employee pension funds, benefit in two ways. First,

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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 therein.

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 corporate efficiency and the accompanying gains in corporate competitiveness. 6/ The entire 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. 7/ According to a recent study, share prices of acquired firms increase by an average of 53.4 percent. 8/ Different studies report that the share prices of acquiring firms have tended in the past to increase by smaller amounts, ranging from 2 percent to approximately 7 percent, 9/ although in this decade acquirers may

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

7/ These studies measure the stock market performance of the companies involved during short periods of time surrounding takeover bids. Although these studies may be viewed as offering a "snapshot" view of the stock market's valuation of takeovers, and thus as only indirect measures of long-term performance, economic scholars largely agree that the increases in company valuations reported by these studies represent efficiency gains. <u>See</u> note 12, <u>infra</u>, and accompanying text. Of course, sharp fluctuations in market values, such as those experienced during last year's stock market crash, may require a cautious approach to long term conclusions. Some scholars have also questioned the overall effects of mergers on economic efficiency. <u>See</u> Ravenscraft & Scherer, <u>The Long-Run Performance of Mergers and Takeovers</u>, in M. Weidenbaum & K. Chilton, <u>Public Policy Toward Corporate Takeovers</u> 34 (1988).

8/ Securities and Exchange Commission, Office of the Chief Economist, <u>The Economics of Any-or-All, Partial, and Two-Tier Tender Offers</u>, Table 4A (1985).

9/ Those findings are summarized in Jensen & Ruback, <u>The Market for Corporate Control: The Scientific Evidence</u>, 11 J. Fin. Econ. 5, 11 (Table 3), 16-22 (1983). <u>See also</u> Jarrell & Bradley, <u>The Economic Effects of Federal and State Regulations of Cash Tender Offers</u>, 23 J. Law Econ. 371, 393-95 (1980); Council of Economic Advisers, <u>Economic Report of the President</u> 197 (1985).

have experienced no gains at all. 10/ These studies suggest that the market values the combination of the acquiring company and the target company more highly than the individual firms that would exist in the absence of a takeover. 11/

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. 12/ 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. A smaller group of studies quarrels with these conclusions, but many of these studies contain methodological errors. 13/ A major scholarly

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10/ See Jarrell, Brickley & Netter, The Market for Corporate Control: The Empirical Evidence Since 1980, 2 J. Econ. Persp. 49 (1988).

11/ 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 9, at 8.

12/ The economic and legal literature discussing the benefits of takeovers is vast. See, e.g., Economic Report of the President, supra note 9, at 187-216; Jensen & Ruback, supra note 8; Jarrell, Brickley & Netter, supra note 10; 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.

13/ 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 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 (continued...)

study that took issue with the conclusions of the stock market studies, relying instead on accounting data, concluded that takeovers neither improved nor degraded the performance of the target firms. 14/

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, the preponderance of scholarly opinion on the subject supports the conclusion that management-opposed takeovers produce economic benefits. New restrictions on takeovers are likely to undermine economic efficiency by impeding the flow of corporate assets to value-maximizing uses and by entrenching inefficient managers.

C. Asserted Disadvantages of Takeover Activity

Several purported disadvantages of takeover activity are often cited to justify restraining corporate acquisitions. Although these disadvantages have not been substantiated through empirical research, 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 evidence substantiating these asserted disadvantages, these claims do not support the enactment of curbs on takeover activity.

13/(...continued)
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.

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. *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.

Some takeover critics claim that acquirers often take over well-managed corporations, oust good management, and reduce corporate efficiency by installing less capable management teams. This, indeed, may happen in some 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, 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 in fact lead to plant closings and lay-offs that would not have occurred otherwise is, at best, scanty. 15/ Any closings or lay-offs that are necessary to achieve greater efficiency likely would have been carried out by the target's management in any event if the firm were to remain competitive. Moreover, most economic changes that increase efficiency -- and thereby increase aggregate societal wealth -- create dislocations

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15/ 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 1970s). 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) (hereinafter "Hearings on Hostile Takeovers"). 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 5.1 million workers lost their jobs because of plant closings or efficiency measures in the years 1979-1983. Bureau of Labor Statistics, Monthly Labor Review (June 1985).

that reduce the welfare of some individuals. 16/ Virtually every major technological advance renders an earlier technology obsolete and thus may harm firms and individuals dependent on the earlier technologies.

It has been asserted that the financing of corporate acquisitions through high yield (or "junk") bonds saddles acquiring firms with "excessive" debt. Some critics argue that the assertedly high debt burden assumed by corporate acquirers will lead persons who gain control of a target firm, among other things, to close productive plants, terminate expenditures for activities that lead to long-term benefits, such as research and development operations, and "loot" corporate cash accounts and other assets of the firm. Although the focus of the criticism has been acquirers' use of high yield bonds to finance takeovers, relatively little takeover financing is made through high yield bonds. In the first nine months of 1986, a year of significant takeover activity, high yield bonds represented only 7.6 percent of tender offer financing. 17/

It is highly improbable, moreover, that corporate acquirers would undertake debt obligations they believe likely to render an acquired company unprofitable, because doing so would tend to defeat the very purpose of their investment. It is not in the interest of acquirers to shut down profitable operations or

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16/ It would seem preferable for government to respond to these inevitable 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.

17/ H. Sherman & R. Schrager, Junk Bonds and Tender Offer Financing 18 (1987), reprinted in Hearings on Hostile Takeovers, supra note 15, at 627. To put the point in perspective, in 1985, only 600 U.S. companies qualified for investment grade ratings, while 19,000 additional companies with assets of more than $25 million did not qualify. Impact of Corporate Takeovers, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. 699 (1985) (statement of Frederick Joseph). Many of these corporations use high yield bonds to finance internal growth because debt securities offer them more flexibility than bank loans or term loans by insurance companies, which until recently had been their only available avenue for debt financing. Thus, in 1985, firms issued a total of $15 billion in high yield bonds. Sherman & Schrager, supra, at 4. During the same year, the total value of debt securities issued to finance tender offers, including investment grade securities, was $4.3 billion. Id. at 17.

eliminate beneficial research and development efforts for the purpose of satisfying debt obligations. Divestiture of corporate assets or reduction in research and development efforts for the sake of satisfying debts, rather than for business reasons, will rob the divesting firm of a source of future earnings to satisfy future debt obligations. 18/ Moreover, the principal purchasers of high yield bonds are sophisticated institutional investors such as pension funds, insurance companies, and mutual funds, who are unlikely to lend money for takeovers unless they expect them to be profitable.

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/

D. Effects of "Control Share" Restrictions

Article 13.03 of the proposed legislation concerns "control share acquisitions." The bill would create a new category of corporate securities under Texas law, labeled "control shares." Article 13.03(A)(1) defines "control shares" as newly-acquired shares that, but for the bill's requirements, when added to the acquiring person's preexisting shares, would entitle the acquirer to exercise voting power within one of three ranges: one-fifth to one-third, one-third to one-half, or a majority of all voting

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18/ Of course, acquirers may sell portions of acquired firms because they do not fit into the firms' business plans, and will shut down inefficient facilities, including inefficient research and development operations, because they are unprofitable in the long run. But this is precisely the sort of redeployment of corporate assets to more efficient uses that results in benefits to society.

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. Securities and Exchange Commission, Office of the Chief Economist, Institutional Ownership, Tender Offers, and Long-Term Investment 8-10 (1985).

power. 20/ Article 13.03(G) provides that a person who acquires "control shares" may exercise the right to vote those shares only if the holders of a majority of the corporation's shares and of each class thereof, other than "interested shares," vote to grant the acquirer that right. The term "interested shares" is defined in Article 13.03(A)(3) as shares owned or controlled by the acquirer, by the corporation's officers, or by the corporation's inside directors (corporate directors who are employed by the corporation). Shares owned by outside directors are not considered "interested."

Under Article 13.03(E)(1), an acquirer of "control shares" may demand a special shareholder meeting "for the purpose of considering whether the shares acquired or to be acquired in the control share acquisitions shall be accorded voting rights. If the request is accompanied by "an undertaking to pay the corporation's expenses reasonably incurred in . . . any special meeting," Article 13.03(E)(5), the corporation must hold such a meeting within 50 days of the date of the demand and undertaking, Article 13.03(E)(2). If no such demand is made, voting rights of control shares must be considered at the next annual meeting of the corporation. Article 13.03(E)(4). If "disinterested" shareholders vote to confer voting rights upon "control shares," dissenting shareholders gain the right to receive for their shares "the highest price paid per share by the acquiring person in the control share acquisition." Article 13.03(H)(2).

If enacted, Article 13.03 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 would 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 would likely be in the hands of entities friendly to management, such as outside directors and employee stock ownership plans.

20/ In practical terms, for most purposes of the bill, any shares whose acquisition would give the acquirer more than 20 percent of the corporation's voting power are "control shares."

Second, although an acquirer may demand a special shareholder 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 non-voting 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. 21/

Finally, the legislation would grant shareholders who vote against giving the right to vote to control shares the right to receive for their shares the highest price paid by the acquirer in a control share acquisition. This guarantee may create an incentive for shareholders to vote against granting the right to vote to control shares. This incentive, in turn, is likely to increase the bidders' uncertainty concerning the likelihood of securing the right to vote, which ordinarily is a normal attribute of share ownership.

The overall effect of legislation that increases both the cost and uncertainty of takeover bids is likely to be a reduction in the number of tender offers and the diminution of the ability of shareholders to exercise their rights as owners to transfer control of corporations. 22/

21/ 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 judgment 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.

22/ See generally Easterbrook & Fischel, supra note 4.

E. Effect of "Business Combination" Restrictions

Proposed Article 13.04 governs "business combinations" between "affiliated shareholders" and takeover target firms. Article 13.04(a)(2) defines "affiliated shareholders" as owners of 20 percent or more of the voting shares in corporations. The proposed legislation would prohibit such shareholders from merging with or conducting other specified business activities with target corporations for five years after becoming affiliated shareholders, unless one of two conditions is met. The business combination may be carried out if the target corporation's board of directors approved the business combination or the purchase of shares before the acquirer became an affiliated shareholder. Alternatively, the business combination may be carried out if is approved by a vote of 66 2/3 percent of the shares not owned by the affiliated shareholder. See Articles 13.04(B); 13.04(A)(6)

The proposed legislation is likely to deter takeovers whose profitability depends on the ability of the acquirer to merge with the target corporation. The successful bidder for corporate control commonly seeks to consolidate the target into its operations by means of a merger. 23/ A five-year merger prohibition will likely require many acquirers to maintain inefficient forms of business organization and thus would undercut their ability to improve the efficiency of target corporations. This, in turn, may deter some takeover bids that would benefit the economy.

The bill would also prohibit the sale or other disposition of substantial target company assets to or with an affiliated shareholder for five years after the shareholder becomes an affiliated shareholder. Articles 13.04(B); 13.04(A)(6)(b). This prohibition would increase the cost of financing, and in many cases may deter, takeovers designed to redeploy assets to more efficient uses.

The proposed legislation would restrict the freedom of shareholders to control and dispose of their property without government scrutiny. Owners of assets should be free to sell property without having the state examine the merits of the transaction, absent a compelling justification. When shareholders determine, for whatever reason, to transfer control of a corporation, the state should not frustrate their will and require them to retain managers they wish to displace.

23/ See R. Gilson, The Law and Finance of Corporate Acquisitions 854 (1986).

F. Empirical Evidence on Effect of Anti-Takeover Legislation

Three recent empirical studies concerning the effect of anti-takeover legislation have concluded that anti-takeover laws harm shareholders and undermine economic efficiency. A recent empirical study by the Commission's Bureau of Economics of a New York statute 24/ similar to proposed Article 13.04 analyzed the extent of the economic harm caused by restrictions on "business combinations." 25/ 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. 26/ 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. 27/

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

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24/ New York Bus. Corp. Law § 912.

25/ Schumann, *supra* note 3.

26/ *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 his original paper. Measured over the entire 205-day course of the legislative process, the decline was 9.7 percent, net of market. L. Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York's 1985 Takeover Statutes* (mimeo April 1988).

27/ Schumann, *supra* note 3, at 47.

directors to consider the interests of persons other than the shareholders in assessing takeover bids. 28/ The SEC study found that the enactment of the Ohio law caused an immediate two percent decline in the equity value of corporations insulated from takeovers by the Ohio law. Finally, a recent study on the effects of Indiana's anti-takeover statute, which contains both a "control share" and a business combination provision similar to those in this 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. 29/

G. Consideration of an "Opting-In" Mechanism

If the legislature decides to enact the proposed legislation in some form despite the concerns discussed above, we suggest that the bill be modified to make it inapplicable to corporations that do not affirmatively elect to be covered by its provisions through amendments to their articles of incorporation. In its present form, Article 13.03, which governs "control share" acquisitions, applies only to corporations that do not opt in through amendments to either their articles of incorporation or their bylaws. Article 13.03(C)(1). Article 13.04, which governs "business combinations," applies to all corporations that do not "opt out" by an amendment to their articles of incorporation or bylaws by a yet-unspecified date in 1988, or, thereafter, by a two-thirds vote of the shareholders, excluding "affiliated" shareholders. Article 13.04(D). To the extent that the proposed legislation is motivated by a concern for shareholders, 30/ its purpose would be better served by a requirement that shareholders approve a decision to opt into any aspect of the legislation. We recommend that a corporation's decision to opt into the statutory

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28/ Securities and Exchange Commission, Office of the Chief Economist, 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.).

29/ Sidak & Woodward, Corporate Takeovers, The Commerce Clause, and the Efficient Anonymity of Shareholders (mimeo March 1987). 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.

30/ If enacted, the bill would be entitled the Texas Shareholder Rights Law. Article 13.01.

scheme be made solely through a shareholder vote amending the articles of incorporation. 31/

If the legislature decides to retain the proposed opting-out mechanism of Article 13.04, we recommend that shareholder determinations to opt out be given immediate effect. Under proposed Article 13.04(D), an amendment to a corporation's articles of incorporation or bylaws expressly electing not to be governed by the legislation does not become effective for eighteen months if it is made after a yet-unspecified date in 1988. We also suggest that decisions to opt out be implemented by a majority vote of all shareholders. The proposed legislation, as noted, requires a two-thirds vote and disenfranchises "affiliated" shareholders from the vote. These are serious restraints on the freedom of shareholders to control the corporations they own. The inclusion of an opting-out provision embodies an implicit recognition that the proposed legislation may be harmful to the interests of shareholders. An ineffectual opting-out provision, however, does little to ameliorate that harm.

Conclusion

The case has not been made to date that the proposed legislation is a necessary or desirable response to corporate takeover activity. On the whole, we believe that vigorous takeover activity enhances economic efficiency and thus benefits consumers, workers, and shareholders. We are troubled that the proposed legislation would impede many of the beneficial consequences of takeovers without offering countervailing benefits. We urge you to consider whether the proposed legislation would unduly interfere with the market for corporate control to the detriment of the economy and consumer welfare generally.

Sincerely,

Jeffrey I. Zuckerman
by KP

Jeffrey I. Zuckerman
Director
Bureau of Competition

31/ Corporate bylaws generally may be amended without the approval of the shareholders. *See* Tex. Bus. Corp. Law Ann § 2.23 (Vernon 1988). 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.