Federal Trade Commission

Office of the Regional Director

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COMMISSION APPROVED

April 29, 1986

The Honorable Raymond Lesniak, Chairman
Senate Labor, Industry and Professions Committee
New Jersey State Legislature
State House Annex CN-068
Trenton, New Jersey 08625

Re: Senate Bill No. 1539

Dear Senator Lesniak:

Thank you for your request of March 11, 1986, inviting our comments on Senate Bill No. 1539, "AN ACT concerning the protection of shareholder rights . . . ." We appreciate the opportunity to comment on this bill, and hope that our remarks will be of assistance.[1]

The Federal Trade Commission is charged by Congress with preserving competition and protecting consumers from deceptive and unfair business practices.[2] Accordingly, the Commission and its staff provide comments to federal, state, and local legislative and administrative bodies to assist decision-makers in analyzing legislative and regulatory proposals that may affect competition and consumer welfare.[3]

Senate Bill No. 1539 (hereinafter referred to as "S. 1539") is intended to "discourage hostile, bust-up takeovers financed by junk bonds in New Jersey."[4] Specifically, S. 1539 would prohibit

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1 This letter presents the comments of the Bureaus of Competition, Economics, and Consumer Protection, and of the New York Regional Office of the Federal Trade Commission. The views expressed are not necessarily those of the Federal Trade Commission or of any individual Commissioner, although the Commission has authorized their presentation.

2 See 15 U.S.C. § 41 et seq.

3 For example, by letter of July 22, 1985, we provided Governor Mario Cuomo with our comments concerning New York State Assembly Bill No. 6971--A, a bill designed to restrict corporate takeover activity in New York.

4 "Statement" accompanying S. 1539.

any New Jersey resident corporation[5] from combining[6] with an acquirer of ten percent or more of its voting stock,[7] within five years of the "stock acquisition date,"[8] unless the combination had been approved by the target company's board of directors prior to that date.[9] After the expiration of the five-year moratorium, a business combination could be effected only if (1) it is approved by the holders of two-thirds of disinterested voting shares,[10] or (2) all shareholders are compensated for their stock in accordance with various statutory criteria.[11]

We do not believe that there is any demonstrated need for this additional regulation of corporate takeovers. The Williams Act, a federal statute designed to protect shareholder interests

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5 "Resident domestic corporation" means a company incorporated in New Jersey with its principal executive offices and "significant business operations" located in that state. S. 1539 § 2m.

6 "Business combination" is broadly defined to include, among other things: (a) any merger or consolidation of a resident corporation with an interested stockholder; (b) any sale, lease, exchange, mortgage, pledge, transfer or other disposition, whether in one or more transactions, to or with an interested stockholder of assets of a resident corporation (i) having an aggregate market value equal to ten percent or more of the aggregate market value of all the assets or outstanding stock of that resident corporation, or (ii) representing ten percent or more of the earning power or income of that resident corporation; (c) the issuance or transfer to an interested stockholder by a resident corporation of any stock of that resident corporation that has an aggregate market value equal to five percent or more of the aggregate market value of all the outstanding stock of that resident corporation; and (d) the adoption of any plan for the liquidation or dissolution of a resident corporation proposed by or on behalf of an interested stockholder. S. 1539 § 2e.

7 The beneficial owner of ten percent or more of the voting power of the outstanding voting stock of the resident corporation is deemed an "interested stockholder." S. 1539 § 2j.

8 "Stock acquisition date" means the date on which a person first becomes an interested stockholder. S. 1539 § 2o.

9 S. 1539 § 3.

10 S. 1539 § 4b.

11 S. 1539 § 4c.

in the takeover process, already provides stockholders with time and information to evaluate cash and non-cash tender offers, including so-called "junk bond" financings.[12] Absent some well-defined, specific public harm that would be addressed by the proposed legislation, we do not believe further regulation of the takeover process is justified.

Investors in high yield takeover bonds are in most cases highly sophisticated financiers who hold these securities as part of a well-diversified portfolio and who are fully able to negotiate for a compensatory interest rate and whatever other guarantees are necessary and appropriate to protect them against the risk of default associated with the debt of a highly leveraged firm. Takeover bond financing of acquisitions does substitute debt for equity. But we are aware of no evidence that this increase in debt is contrary to the interests of the shareholders of the issuing firm or to the firm's long- or short-term prospects.[13]

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12 15 U.S.C. §§ 78l(i), 78m(d) and (e), and 78n(d) through (f) (1982). The Williams Act requires purchasers of more than five percent of a corporation's shares to make specified public disclosures and provides that a tender offer must remain open for not fewer than 20 business days. Some economists and legal scholars have criticized these provisions of the Williams Act on the ground that they provide too much time for stockholder evaluation of tender offers, thereby making takeovers unnecessarily expensive and favoring incumbent managements in takeover contests. _See_ Fischel, "Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers," 47 _Texas Law Review_ 1 (1978); Grossman & Hart, "Takeover Bids, the Free-Rider Problem and the Theory of the Corporation," 11 _Bell Journal of Economics_ 42 (1980); Jarrell & Bradley, "The Economic Effects of Federal and State Regulations of Cash Tender Offers," 23 _Journal of Law and Economics_ 317 (1980); and Smiley, "The Effect of the Williams Amendment and Other Factors on Transaction Costs in Tender Offers," 3 _Industrial Organization Review_ 138 (1975).

The Williams Act also mandates that tendered shares be purchased on a pro rata (rather than first shares tendered) basis and grants target management and stockholders standing to sue pursuant to its antifraud provisions.

13 Moreover, the Federal Reserve Board has issued an interpretation of its margin rule -- Regulation G -- that would, in effect, prohibit a corporation set up to facilitate a tender offer from issuing takeover bonds to finance more than 50 percent of the cost of an acquisition.

Moreover, this bill goes far beyond its stated goal of discouraging "hostile, bust-up takeovers financed by junk bonds." Instead, the bill will make any hostile tender offer -- regardless of how it is financed -- prohibitively more difficult. If enacted, S. 1539 would have the probable effect of discouraging all tender offers that had not already met with the approval of the target company's board of directors. This could impede the operation of the market for corporate control that generally serves to benefit New Jersey shareholders, improve the management performance of New Jersey corporations, and ensure that economic resources under the control of New Jersey corporations be transferred to their highest valued use.

If shareholders desire increased protection from so-called "corporate raiders," they can arrange it themselves. For example, shareholders can discourage unwanted suitors by adopting by-laws that stagger the terms of directors or that condition the consummation of a tender offer upon its acceptance by a super-majority of shareholders.[14] On the other hand, shareholders can decline to insulate incumbent management by refusing to enact such by-laws. If shareholders want to include pro- or anti-takeover devices in their corporate charters, that should be their prerogative. No single rule of corporate governance is likely to be suitable for all corporations. S. 1539 fails, for

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[14] For example, The Wall Street Journal of March 14, 1986, reported that "Dow Jones & Co. said it will seek shareholder approval of several anti-takeover measures at its annual meeting . . . . Dow Jones is proposing staggered terms for board members, which would prevent a majority of directors from being elected at an annual meeting; a 'fair price' provision that would require a prospective purchaser to make the same offer to all stockholders; and a requirement that the board consider non-economic factors in evaluating any takeover bid." According to The Wall Street Journal of March 20, 1986, as of the close of 1985, well over 300 of the Standard & Poor's 500 companies had passed some sort of anti-takeover measure.

the most part, to take this into account.[15] The result may be that the bill unduly intrudes upon what the U.S. Council of Economic Advisers has recognized as "essentially a private contractual relationship between a corporation's stockholders and its management."[16]

Insofar as S. 1539 is unnecessary for the protection of shareholder interests, its potentially harmful effects should be critically examined.

We believe that takeover activity is generally beneficial to corporate shareholders. Takeovers typically increase the wealth of shareholders of firms that are acquired. Target firm shareholders on average earn premiums of about thirty percent in tender offers and twenty percent in mergers.[17] By discouraging hostile takeovers, S. 1539 likely would reduce the expected profitability of hostile takeovers. This would result in a reduction of the expected wealth of all shareholders because the expected value of corporations as future acquisitions would be less. These prospective benefits, which are reflected in the value paid for the shares of companies that are acquired, would decline along with share prices as takeover activity lessened.

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15 Section 5c of the bill does provide the board of directors a limited opportunity to amend the by-laws of a corporation so that any attempt to take over the corporation will not be subject to the act. Under the bill, the board must amend the corporation's by-laws within 45 days of the bill's passage. However, it seems unlikely that the board would ever undertake such action except in response to shareholder pressure. The 45-day time limit makes it unlikely that shareholders will have adequate time to understand the bill and, if they believe the bill is harmful to their interests, to petition their directors to disavail themselves of it. The bill does contain some other exceptions to its coverage. <u>See</u> S. 1539 § 5.

16 U.S. Council of Economic Advisers, <u>Economic Report of the President</u> at 213 (1985).

17 In contrast, share values tend to decline following an unsuccessful tender offer. For a thorough survey of the numerous studies that demonstrate net stockholder benefit from takeover activity, see Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence," 11 <u>Journal of Financial Economics</u> 5 (1983); Jensen, "Takeovers: Folklore and Science," 62 <u>Harvard Business Review</u> 109 (1984).

Moreover, hostile tender offers, the specific target of S. 1539's regulatory scheme, may also produce significant gains to the nation's economy. Corporate acquisitions, including those resulting from "hostile" tender offers, can serve to shift assets to higher-valued uses, allow firms to realize economies of scale and distribution, and spur managerial excellence.[18] For example, companies whose markets are no longer expanding often generate more cash flow than can be reinvested productively in their traditional businesses. Rather than distribute this cash to shareholders, some corporate executives make unprofitable investments in mature markets or diversify into businesses with which they are unfamiliar and in which they perform poorly.[19] This creates profit opportunities that could be realized by means of hostile takeovers aimed at acquiring control of such firms and eliminating these inefficiencies. S. 1539 would reduce the incentive to cure such inefficiencies.

Under S. 1539, even after the expiration of the five-year moratorium, a business combination between a resident corporation and an interested stockholder could be effected only if one of two somewhat problematic conditions were satisfied. First, the business combination could be consummated if approved by holders of two-thirds of the disinterested shares. However, this would allow disinterested stockholders to hold up controlling parties, even beyond the five-year moratorium prescribed in the bill. For example, consider a firm that acquires ninety percent of the voting shares of another company. As we understand it, such an acquirer would be an "interested stockholder" and unable to vote its shares with respect to a merger of the companies. If just four percent of the voting shares of the acquired firm remained in the hands of persons hostile to the merger -- incumbent

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18 See U.S. Council of Economic Advisers, supra note 16, at 198, 199; see also Jensen & Ruback, supra note 17. But see D. Ravenscraft & F. Scherer, "The Profitability of Mergers," FTC Bureau of Economics Working Paper No. 136 (1986).

19 The apparent shift toward greater reliance on debt financing may well be a market response to this phenomenon. Unlike common stock, on which dividends can be withheld at management's discretion, debt instruments call for regular periodic interest payments. This constrains management's discretion with regard to the firm's cash flow and its ability to continue to use retained earnings to pursue unprofitable growth or diversification strategies. Thus, apart from the utility of takeover bonds as a means of financing acquisitions, these considerations portend significant efficiency gains from the increased use of debt financing, in and of itself.

managers, for example -- the merger could not be accomplished. The mere threat of such a hold up could significantly impede beneficial merger and takeover activity. It also impairs the efficiency with which capital markets rearrange asset ownership, and frustrates the preferences of the vast majority of the target firm's shareholders, 90 percent in our example, who would like to tender their shares.

Alternatively, the business combination could be consummated if the interested stockholder redeemed all outstanding shares of the resident corporation for consideration having the highest of several valuations.[20] This purchase option, however, could greatly -- perhaps prohibitively -- increase the cost of hostile takeovers, and to an amount that could not be determined in advance of an initial tender offer.[21] It could also discourage the taking of substantial investment positions quite apart from a fixed intent to gain control. As a consequence, firms could have difficulty in obtaining capital for product development, refurbishment of physical plant, expansion, and the like, thereby possibly affecting their viability.

Taken together, the requirements of S. 1539 could deprive shareholders of the gains they might otherwise realize through tender of shares to an acquirer. The costs of efficiency-enhancing acquisitions could be artificially inflated and productivity gains that could be realized in an open and competitive market in

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20 E.g., the higher of "(a) the highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by that interested stockholder for any shares . . . acquired by it (i) within the five-year period immediately prior to the announcement date with respect to that business combination, or (ii) within the five-year period immediately prior to, or in, the transaction in which that interested stockholder became an interested stockholder, whichever is higher . . . ; and (b) the market value per share of common stock on the announcement date with respect to that business combination or on that interested stockholder's stock acquisition date, whichever is higher . . . ." S. 1539 §§ 4c(1)(a) and (b).

21 The valuation provisions of S. 1539 would induce stockholders to engage in opportunistic behavior rather than to tender shares in a prompt manner: if the price of shares on the open market increased after the interested stockholder's acquisition of a ten percent position, other stockholders could tender at the market price; if the price of shares on the open market fell after the interested stockholder's stock acquisition date, tendering stockholders could demand a higher than market price pursuant to Section 4c(1) of the bill.

corporate assets and control could be greatly lessened. These costs, both to shareholders and to society at large, are justified only if the proposed regulation is necessary to avoid a well-defined and significant public harm. As the Council of Economic Advisers has cautioned:

> Public policy should not . . . be based on the outcomes of individual transactions, because it is impossible to predict in advance which transactions will succeed and which will fail. Public policy therefore must be based on aggregate trends describing the consequences of takeovers as a whole. On this criterion, there is no economic basis for regulations that would further restrict the merger and acquisition process.[22]

The need for further regulation of corporate takeover activity has not been established. Existing legislation governing corporate takeovers and internal shareholder governance adequately protect shareholders and the public interest in a fair, open, and competitive market for corporate assets and control.

We hope these comments are helpful to you. Please do not hesitate to contact us if you have any questions or would like further information.

Very truly yours,

Edward Manno Shumsky

Edward Manno Shumsky
Regional Director

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22 U.S. Council of Economic Advisers, supra note 16, at 196.