MEMORANDUM

TO: SEC Advisory Committee on Tender Offers

FROM: Frank H. Easterbrook

RE: Acquisition of Control and Opposition to Acquisition

DATE: May 31, 1983

I

Because our meeting on May 13 focused on the particular suggestions of the joint subcommittees on acquisition of control and opposition to acquisitions, we never had an opportunity to discuss the approach to tender offers and their regulation reflected in the joint subcommittee's proposals. The Committee's approach to tender offers ultimately is more important than the detailed recommendations we make -- after all, we are not the people who will decide whether and how to regulate. Thus I think we need to give some additional thought to the assumptions underlying the joint subcommittee's work.

I would start where the joint subcommittee started: with the assumption (backed up by evidence detailed in the report of the economics subcommittee) that tender offers benefit shareholders of both bidders and targets. It is almost self-evidently true, and again the evidence supports this, that both the regulation of bids and the targets' defensive tactics will make initial tender offers more costly to mount, and thus there will be fewer of them. Fewer offers mean fewer occasions when shareholders collect premiums, and more importantly mean that all corporations

that are potential targets will trade for less in the market because their value as future acquisitions will be less. The premiums reflect real social gains from the more efficient use of the targets' resources; every time a tender offer is not made because of regulation or defense, these gains are lost.

This seems to be pretty much common ground among the members of the Committee, so much so that I think we should emphasize it prominently in our report.[1] Yet once we take the position that tender offers are beneficial as a rule -- and more importantly that the prospect of tender offers is useful in our capital markets -- we should be <u>very</u> sure of our grounds before we propose new regulations or even the continuation of old regulations.

It is easy to spot an "abuse" that arises from time to time. It is much harder to know that a new regulation is an effective antidote for the abuse. Perhaps people will find a way around the regulation (think of the substitution of hedged ten-

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1. In particular, we should consider and reject an attack on all tender offers that seems to be heard frequently in Congress and the newspapers -- that tender offers divert investment from new plants to financial chicanery, or equivalently that they "use up credit." Chairman Voelker said in our meeting with him that he hears this frequently from Congress. Yet it is simply a canard, as John Spurdle showed at our April meeting. The money lent for tender offers is recycled at once. Chairman Voelker largely agrees with this; his staff takes the view that tender offers have no effect at all on credit, while he thinks they have no substantial effect. Tender offers are no different from other capital transactions, such as the purchase of 80-100 million shares on the New York Stock Exchange every business day. People just shift from one investment to another; no real resources are used up. And if changes of control enable the new owners to make better use of the assets than the old owners and managers, there are substantial benefits for the economy. Mr. Voelker thought that dispelling the contrary impression that tender offers "use up" money and credit is largely a political problem. We could play a helpful role in resolving that problem.

dering in place of prohibited short tendering), and then there will be either a continuation of the abuse, plus the cost of regulation, or a need for still more regulation. And even if the regulation puts an end to what we perceive as abusive, we do not know that we have made a net gain for society unless we are sure that (a) people could not have home-brewed their own remedies for the abuse, at lower costs than those of regulation, and (b) the costs of regulation are lower than the costs of the abuse to which they are addressed.

In stock markets home-brewed safeguards against abuses are common and cheap. More on that at pages 7-10 below. Moreover, because tender offers have very large benefits for society, almost any deterrence of tender offers will itself be quite costly. Thus regulation will do more harm than good unless the abuses to be addressed are both dastardly and otherwise impossible to protect against. And the principal harm, it bears repeating, is in discouraging new offers.

All of this means, I think, that the Advisory Committee should start with the recommendation of the Department of Justice. The Department's comments, dated May 2, 1983, recommend that tender offers be regulated only the absolute minimum necessary to ensure confidence in securities markets and equitable treatment of the smallest investors. We should adopt that starting point as the Committee's and go from there.

II

The recommendations of the joint subcommittee take a different approach to the analysis and regulation of tender offers -- or, rather, two different approaches, one for regulation of targets and one for regulation of bidders.

The general approach certainly is not the one recommended by the Department. There is no effort to minimize the amount of regulation. There is no effort to evaluate the extent to which investors can protect themselves from the potential of abuses. There is no effort to determine the costs of regulation, or the extent to which the costs (principally discouraging new offers, wiping out the attendant gains) compare with the benefits of regulation.

With respect to the behavior of bidders, the joint subcommittee appears to reason as follows: if a tactic ever can be "abused" (where "abuse" means "used in such a way that different shareholders of the target obtain different returns from the offer"), then that tactic should be severely regulated or eliminated even if in most cases it is neutral or beneficial. Thus the joint subcommittee recommends elimination of short-term offers, proration pools and withdrawal dates shorter than the minimum offer period, open market purchases beyond 15%, and so on.

With respect to the behavior of targets, however, the joint subcommittee takes an almost opposite approach: if a tactic can ever be used constructively (where constructively means "with the effect of raising the price paid for the target's shares, given that an offer has been made"), then that tactic should be allow-

ed, subject only to the business judgment rule under state law. Because the business judgment rule is highly deferential to managers -- particularly managers who have indeed increased the price paid in a given tender offer -- the approach amounts to general approval and the absence of regulation for most tactics.

Why should the Advisory Committee take such radically different approaches, on the one hand regulating or banning bidders' tactics whenever there is a possibility of abuse, on the other hand permitting targets' tactics whenever there is a possibility that they will <u>not</u> be abused? The joint subcommittee did not articulate any rationale for the difference.

If we must pick one general approach, it should be the joint subcommittee's approach to the tactics of targets. If a given practice has proper uses, the Advisory Committee should recommend that the tactic be permitted (subject only to constraints in the articles or incorporation of the firm or state law), unless we have <u>very</u> strong proof that the gains from regulation exceed the costs. For almost every regulation the joint subcommittee has proposed, we have no such proof.

III

The joint subcommittee's approach to the regulation of bidders has a number of difficulties, difficulties so serious that I think the full committee should back up and start over. I don't want to argue the case point by point, though, so I'll confine my remarks to some observations about the general approach (part III) and some selected recommendations (part V).

First, despite the joint subcommittee's recognition that the Advisory Committee must consider the market as a whole, focusing on the prospective effects of regulations,2 the recommendations themselves systematically ignore the interests of bidders' and bystanders' shareholders. The focus is exclusively targets' shareholders, and the perspective usually ex post. The recommendations recognize the effect of regulations on the number of future offers only incidentally, as part of a "balancing" procedure. The shareholders of bidders get no recognition at all. Yet the shareholders of bidders and the shareholders of targets are, or can easily be, the same people, who want to maximize the value of their whole portfolios, not just to get the best price they can given than an offer lands on the table.

Second, the joint subcommittee makes no effort to quantify the effects it describes. If something is "abusive," how frequently is it abusive? What are the costs of abuse? How many abuses will be prevented by the regulations? What will the savings be? At what cost (including, as always, the cost in tender offers deterred and gains foregone)? I don't expect anyone to be able to quantify these things. We do not have the data for that. But before we recommend regulation, we should be sure of the comparative sizes of these things. We do not yet know these magnitudes.

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2. "Regulations must be evaluated in relation to their effect on all shareholders -- bidders, targets and the rest of the market alike (including the probability that any company will be a bidder or a target) -- rather than any single interest group" (recommendation A.5, page 2). See also recommendations B.1 and B.2.

Third, the subcommittee's equation of "abuse" with "anything that divides the gains of an acquisition unequally among the target's shareholders" is unwarranted, for two reasons.

This equation of abuse with unequal division assumes that shareholders _want_ equal divisions. There is no evidence that they do. Indeed, I think it more appropriate to assume that shareholders want to maximize the expected value of their shares, not to concentrate on how the gains are thwacked up in a given case. Almost all shareholders are repeat players in the market. If they do not get cut in on the gains today, they will tomorrow.

We think of a game as "fair" if people play at known odds. Buying stock in new companies is risky business; many people will lose a bundle. We do not think of this as unfair, however, because shareholders go in with their eyes open. The whole premise of the '33 Act is that shareholders should be allowed to make choices -- to take risks -- if they choose to do so intelligently. People will demand compensation for the risks they take, or they will shift to other, less risky, investments.

A shareholder who owns a share of stock in a randomly-selected firm (that is, one that could be either a bidder, a target, or a bystander) would not want equitable division of gains at the expense of a reduction in the number of offers. Every offer deterred means a reduction in the _expected_ value of that share, whereas a reshuffling of the gains when an offer does occur would not affect the expected value of the share at all. An investor interested in total returns thus would gleefully

permit what the joint subcommittee calls "abuses" whenever they increased the number of offers.

This may appear to overlook the fact that small shareholders are likely to be risk averse, and that such shareholders also may not play the game often enough to get their cut of the gains. This brings me to the second problem in the joint subcommittee's implicit definition of "abuse": these small, risk-averse shareholders can protect themselves very easily, at costs far lower than those entailed by the proposed regulations.[3]

Self-protection is simple. The small, risk-averse shareholder may simply sell his shares in the market -- getting the enhanced price available in a world of easy takeovers -- and buy something else. One option is to buy debt. Bonds and bond funds are not affected very much by tender offers, and the investor seeking security and identical treatment with the pros can get it through debt. Money market funds and banks are not affected at all by tender offers.

The other option is to buy a mutual fund or some other diversified portfolio. Then the investor is sure to hold bidders as well as targets and bystanders. More to the point, the "small" investor holding a mutual fund, pooled trust certificate, pension plan, or other diversified portfolio -- the way "small" investors hold more than 90% of their investments -- is delighted

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3. Daniel Fischel and I have made this point before, in greater detail, in articles you have seen. Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 711-14 (1982); Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1, 7-9 (1982).

by any rule that enables market professionals to improve their position. Professionals manage these funds and trusts. There is no problem of timing when a mutual fund or pension trust hears about a tender offer. The money manager can move with dispatch.

I thus find it ironic that the Advisory Committee should express great concern for the plight of the small investor, unable to take advantage of a tender offer or open market purchase program. The risk-averse small investor is the one whose funds are either under professional management or in debt instruments. The person who needs to read the tender offer forms and decide for himself is generally the investor with a goodly stake in the market, $100,000 of investment and up, who can well afford to hold a diversified portfolio all by himself and who is not likely to be baffled by the complexities of an offer. If he finds himself unsure, he can sell in the market, where professional investors, competing among themselves, have set a price fairly reflecting the probabilities of success of the various options open at the time.

Doubtless these forms of self-protection are imperfect. Not all small investors diversify their holdings or place them under professional management. But those who do not do so have reasons of their own. As things are (or were before 1968), they are free to choose. They can either protect themselves or take gambles. If regulation is put into place for the purpose of ensuring equal payouts to all shareholders in each offer, all shareholders lose this option. It is difficult to see how we help shareholders by denying them an option (taking risk in pursuit of larger gains)

they now have, while not creating any new option that they now lack. Regulation seems wholly destructive here.

Even those who think that the self-protection mechanisms discussed here have real costs should be willing to compare these costs -- small by any count -- with the costs of new regulation. The costs of regulation are unlikely to be smaller than the costs of self-protection.

IV

Having challenged the joint subcommittee's approach, I have an obligation to offer a different one. I think the Advisory Committee should recommend the repeal of the Williams Act and its implementing regulations, and the termination of all federal regulation of tender offers with a single exception. I would preserve the rule of Edgar v. MITE Corp., 102 S. Ct. 2629 (1982), that state prohibitory regulation of tender offers is not lawful to the extent it affects interstate securities transactions.[4] Because MITE was based on the Supreme Court's view of the Commerce Clause rather than the Williams Act, this will continue to be the rule unless Congress affirmatively authorizes states to regulate tender offers. So long, however, as there are no feder-

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4. That is to say, I agree with the joint subcommittee that we should preserve a national securities market. I think it important, for reasons that follow, to distinguish between state rules that simply implement agreements embodied in corporate articles and bylaws (which I would permit state courts to enforce) and state rules that override the terms of corporate articles and bylaws (which I think should be preempted whenever 50% or more of a corporation's shareholders live outside the state attempting to do the regulating).

al restrictions on the activities of bidders, I also would not recommend federal rules for the activities of targets.

Unlike the joint subcommittee's approach, this one uses the same assumptions for both bidders and targets. It avoids tipping the balance by regulating one group (bidders) much more severely than targets. It implements the principle with which I began: if you aren't very sure of your ground, don't regulate. Most important, it implements the system most beneficial to investors: competition.

The joint subcommittee says, and I agree, that defenses against tender offers could be beneficial to targets in some circumstances. Some firms, at some times, may be managed best if they stay "independent." Perhaps independence amounts to beneficial tenure for managers, perhaps it aids long-run planning. Perhaps the ability to keep a firm independent will assist managers in negotiating the best terms for any given acquisition. Some firms may prosper if the articles contain "fair price" provisions for their shares, or "mandatory tender offer" rules (similarly to the joint subcommittee's 15% proposal). Shareholders who value fair treatment highly might desire to hold stock in such firms, just as people who value environmental protection highly will buy shares of special mutual funds that limit their holdings to environmentally-responsible corporations.

I do not mean that these justifications are always substantial, or even that they are often substantial. They are certainly logically possible -- the fact that partnerships and close corporations have anti-takeover and fair-price features is proof

enough of this. My point is that an unregulated market will develop and offer such features to shareholders if they are valuable, just as corporations now offer a thousand other kinds of provisions in their articles governing the rights and priorities of their securities and the terms of shareholders' suffrage.

It might have been said, at the time the Williams Act was enacted, that the hostile tender offer was such a novel development that firms had not had the opportunity to tailor their organizations to respond to the possibilities. If that was ever true,[5] it is true no longer. We have had more than 20 years of hostile offers, and firms have by now identified themselves as amenable to acquisition or not. There is no need for legislation to ease the transition to a competitive marketplace in acquisitions.

Firms offer a dazzling number of investment instruments (debentures, bonds, preferred stock, common stock with different sorts of rights, warrants, and so on) to attract invesors' money. They compete in the products they offer. They compete in the kinds of internal governance they use, including all sorts of

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5. Which I doubt. Firms have always had the choice of holding themselves open to takeover or making themselves hard to digest. Firms with staggered boards, classified boards (elections by classes of security, some of which might be closely held), cumulative voting, preemptive rights, supermajority rules, and long-term contracts with managers have been hard to take over, by tender offer, proxy contest, or any other route. These anti-takeover provisions became less and less common throughout the 20th century, an evolution suggesting that openness to acquisition was beneficial to investors. It seemed to have more survival value than the opposite approach. See generally Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395 (1983).

differences in management structure and voting. These differences evolve over time according to the vicissitudes of the market and the value investors place on them. The more beneficial a structure for investors, the more likely it is to survive. Some rules are better for some corporations for others, and the degree of benefit changes from time to time.

The approach of the joint subcommittee seems to be that we know what is wise and beneficial for investors. I am far more skeptical. I do not know what is good for investors. Moreover, what is good for investors today, and in one firm, may be bad for them tomorrow or in another firm. Why should the Advicory Committee try to force all tender offers into one mold of procedure?

There is every reason to think that, left alone, corporations would offer investors as many different regimens of tender offer bidding and defense as they now offer different investment instruments and governance structures. Some firms would hold themselves open to acquisition; others would elect fair price provisions; others would set up super-majority rules; still others would make acquisition impossible (as it now is for close corporations and partnerships). Which of these methods or mixtures would prevail over the long run I do not know. Certainly only the methods beneficial to investors would survive in a competitive market.

If anti-takeover provisions are not beneficial to investors, they will depress the price of the stocks affected by them. At lower prices, these stocks will be more attractive as takeover targets. The market thus has at least one automatic compensation

device for undesired opposition to takeovers. There are other methods as well: firms that insulate their managers from the pressure of replacement via takeover will falter in their product markets, their stocks will decline in value, and they will change course, or fail, or be taken over. In the long run, useful provisions will dominate in corporate articles and bylaws.

The no-regulation method is more attractive still because it accomplishes everything the joint subcommittee recommends. Investors who do not want to take the risk of missing out on the gains of tender offers can buy stock in corporations with fair-price, anti-two-tier-offer, or other rules that ensure equal treatment of investors in the event of an offer. Other investors can make different choices.

I have referred to this as a no-regulation method. It is not no-regulation, however. It is regulation of the same sort that both state corporate law and the '33 Act envisage. State corporation laws are enabling statutes. Firms can pick any set of rules they want, so long as they announce them to the investors. State law usually just sets "default" terms, which govern in the event the articles and bylaws are silent. The states rarely attempt to dictate the substance of relations among investors and managers. See Judge Winter's powerful discussion of this, Government and the Corporation (1978). Similarly, the Securities Act of 1933 is a disclosure stature. Firms may offer, and investors may purchase, anything they can dream up, so long as the terms are disclosed. The Act rests on the assumption that investors with knowledge of the facts can and will make intelli-

gent, self-interested decisions. It rests on the further assumption that if one firm tries to bilk investors, it will not long survive the light of publicity and the scrutiny of professional investors. I have heard no argument in the Advisory Committee suggesting that we cannot safely follow the same assumptions in designing policy toward tender offers.

The only form of federal safeguard necessary here is one that protects the competition among corporations to design structures that investors want to have. There are two potential threats to the system of competition sketched above. One is state regulation, which may attempt to override the articles and bylaws and substitute a different scheme. The other is the activities of managers once a tender offer has been launched. The managers of a firm that has announced itself open to tender offers may attempt to welch on the deal and prevent the transfer of control. Arrangements that seemed advantageous to them when they were writing articles, bylaws, and contracts, the better to sell securities, may seem less beneficial once they have received the money and then feel their positions threatened.

Both of these are forms of opportunistic behavior. State regulation of tender offers is a lot like state regulation of plant closings. When a state is trying to attract business, it doesn't say anything like "Come to Erehwon, where you'll have to give two years' severance pay and pay extra taxes when closing your plant." It instead offers tax incentives and only later, when there is a net outflow of capital, attempts to switch the rules to grab the most it can. Similarly, most state tender

offer legislation should be viewed as an ex post switch in the rules of the game and prohibited accordingly in order to preserve a national market in securities.

Managers have similar incentives. They may hold themselves out as accepting no tenure, serving at the pleasure of the board and investors. They may hold the firm out as open to tender offers, the better to issue new securities for a high price and assure the market that they will be on their toes, only to act differently once the chance of an offer becomes a certainty. They cannot be allowed to change the rules once the game has begun. Attempts to change the rules may be subtle. A firm that selects an open-to-bids posture may attempt to run an auction, perhaps using lock-up options, once a tender offer is made. This amounts to a change in rules because it puts the first bidder at a disadvantage, penalizing or deterring first bids as surely as any express discouraging provision in the articles. I would expect state courts to enforce articles and bylaws rigorously, but if they do not there might be cause for a federal tender offer rule ensuring that firms stick with whatever position on tender offers they adopt in the articles and bylaws.[6]

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6. Firms with no unusual provisions should be deemed "open" to offers, and the managers accordingly prohibited from defending or running any sort of auction with a potential for giving the second bidder a preference. That would include selective disclosures of information and lock-up options.

V

Finally, I offer a few thoughts about the joint subcommittee's report, on the assumption that the Advisory Committee will adhere to the tentative votes taken on May 13.

Some of the proposals seem highly desirable and well thought out. The proposals designed to put cash and stock offers on a more equal footing, and to permit bidders to purchase stock without extensions of time triggered by competing bids, are examples of desirable changes. Others are less beneficial.

With respect to the 30 day offer period and the elimination of shorter proration and withdrawal rules: the time seems to me too long. As long as the rules also permit defensive and auctioneering statutes, 30 days is an eternity. The time seriously discourages offers. Moreover, the bidder's principal methods to encourage tenders -- and thus to make first bids pay -- are short proration and withdrawal periods. To deprive the first bidder of these methods is to make bids more expensive, more risky, and thus more scarce, to everyone's detriment.[7] At a minimum, I would return to the offer, proration, and withdrawal periond stated in the Williams Act itself before their extension by regulation. There is absolutely no evidence that these periods are inadequate for the market to react in an informed way, and there is good evidence that longer periods are very costly.

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7. See Fischel, Efficent Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1 (1978).

The recommendation in IV.B.1 that the definition of a group be tightened up seems an invitation to trouble. It is possible to define almost anyone acting in concert as a group. This would create new uncertainties and risks, again with little gain.

The recommendation in IV.B.2 that open market purchases halt after the acquisition of 15% of a firm is a Draconian response to a non-problem. If open market purchases are ongoing (and disclosed, since the §13(d) trigger is 5%), anyone who wants to do so can sell to the market and get the benefit. If the open market purchases are too rapid for small shareholders to participate directly, they nonetheless gain indirectly because money managers (who collect small shareholders' investments) will be the ones doing the selling. There is no evidence that shareholders of any size experience losses in open market purchase programs. Certainly there is no argument supporting more than a go-slow rule (say, one limiting open market purchases to 5% per week.)

At the same time, the tender-offer-or-nothing rule of IV.B.2 would have substantial costs. First, it would make assembly of a moderate-sized minority bloc (say 20%) more difficult by compelling the purchaser to use an expensive tender offer in place of open market purchases to acquire the last 5%. If the assembly of such blocs is made more costly, we can be confident that fewer blocs will be assembled. The incentive should run in the opposite direction, however. Blocs in the 15-25% range are a partial solution to the separation of ownership and control, to the fact that widely scattered shareholders have a great deal of difficulty in monitoring managers. The evidence is overwhelming, and

uncontradicted, that the assembly of such middle-size blocs is associated with gains to the investors whose shares are not acquired.[8] We should try to increase the number of occasions for such gains rather than to make bloc assembly more difficult.

Second, making the open market assembly of blocs more costly also makes tender offers more costly. Bidders will have to start with smaller blocs of shares if they seek control. Anything that makes acquisitions more costly means that there will be fewer acquisitions.

Third, the rule would have a substantial effect on other methods of changing corporate control, particularly the proxy contest. Most proxy contests now combine a campaign for votes with a purchase of shares (and the attached votes). Managers have a natural advantage in all campaigns, so the ability of insurgents to purchase shares may be indispensable to the conduct of a credible campaign. Under the subcommittee's recommendations, however, the insurgents would be defined as a group (IV.B.1), and the group would be limited to 15%, after which it would have to stop, make a tender offer, and wait at least 30 days to acquire another share. By then the record date would have come and gone, and the chances for success would have been reduced.

This might be an acceptable outcome if proxy fights were some plague in the market place. Far from it, though. The best

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8. E.g., Dann & DeAngelo, Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control, 11 J. Financial Econ. (1983) (forthcoming).

available evidence suggests that shareholders gain roughly 6-8% from proxy contests, whether the insurgents win or lose.[9] There seems to be a benefit here -- at least shareholders perceive a benefit, and those who don't can cash in their 8% gain and buy something else. Perhaps it arises because any contest keeps managers on their toes. Perhaps the debate about the corporation's future supplies new ideas for improvements. Perhaps the gain arises because during the contest someone has assembled a large bloc of stock, thus reducing the separation of ownership and control and, with it, reducing agency costs. I don't know the source of the gains, and I don't think the source makes any difference. What matters is that the gains are real, and the proposal of the subcommittee would jeopardize these gains for no good reason.

With respect to advisory votes (VI.C.3): These promise to be costly and complicated, yet without concrete benefits. If we are going to recommend that bidders be hobbled in selecting strategies, we need to restrict defensive tactics for real, not just to create cosmetic votes.

The portions of the recommendations on defenses ignore the effects of these defenses on the bahavior of bidders and the welfare of bidders' (and bystanders') investors. The defenses most in need of control are PAC-MAN attacks and lock-up (and crown jewel) options. These are the source of the greatest costs and risks to initial bidders. Lock-up options have the addition-

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9. Dodd & Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Financial Econ. (1983) (forthcoming).

al property of enabling second-highest bidders to win auctions. The argument that the lock-up may be legitimate because it's needed to "induce the white knight to enter the bidding contest" (VI.C.2), that is, to cover the second bidder's costs, neglects the fact that if a tender offer is so costly and risky for a bidder favored by the managers, it musty be even more costly for a first bidder. Any argument about the utility of lock-up options suggests strongly the need to preserve rather than undermine the incentives of first bidders, for if there are no first bidders there are no auctions. These are old tunes for me, though, see note 3 supra, and I won't sing them again here.