JAN 0 4 198

M E M O R A N D U M

TO: The Members of the Corporation Law Section

FROM: Charles F. Richards, Jr.

RE: Proposed Delaware Business Combination Statute

DATE: December 31, 1987

I am enclosing herewith a selection of materials which suggest that the proposed Delaware legislation is not the balanced bill its supporters would have you believe it to be. I believe that there is still time to achieve a balanced approach at the Bar Association level by amending the bill at the section level or remanding it to the Council with instructions to liberalize the "outs" along the lines suggested herein.

I enclose the editorial in today's Wall Street Journal against the current version of the bill. Some of you may have also seen Bob Samuelson's article in the current issue of Newsweek, apparently written after extensive discussions with Gil Sparks. The Wilmington Trust Company's earlier letter is included. Barney Taylor authorized me to advise the Council that the bank remains opposed to the modified bill, as I believe do the other correspondents whose letters are included. Of course, there has not been time for interested parties to express their views in writing since December 22.

Of particular importance, however, is the correspondence of Commissioner Grundfest, found at the back of the

packet, in his letters of December 10, 18 and 22. You will see that like the others, he does not support the compromise. I agree with his suggestion, as contained in his December 22 letter, that the stock of all directors, not just insiders, should be excluded from the formula. In addition, I would drop the percent required to 80%. Considering that 5% of shareholders are unresponsive, this would mean that an acquiror would have to get 80% out of 95% possible or 84.2% of the disinterested shares. This is still an overwhelming showing to require an acquiror to obtain. In addition to being a substantial impediment to takeovers, such an 80% hurdle assures that the offer must be a fair and full one to command such a super majority. The only real reason for opposing such a high threshold would be a desire to take away from shareholders their right to decide ultimately what they want to do with respect to their investment of their own money.

Without such a change, a very large percentage of companies are either takeover proof, or by placing small blocks could be made so easily. Another large group of companies could be taken over only if an acquiror could get essentially 100% of the disinterested shares. Such a statute is not balanced.

In addition, the §203(a)(3) vote should be lessened to a majority of the disinterested shares. In order to take advantage of subsection (3), an acquiror must first get control of the board. This would take 51%, an additional

requirement of a majority of the disinterested would take him to 75% -- that's enough.

With these changes, I could support the bill. While I may be in a minority on the Council, I believe that among shareholders and their representatives, academics, regulatory officials and people in the securities industry, the opposition to this bill is very widespread. A modification as outlined herein would do much to blunt this opposition and correspondingly reduce the risks of preemption, unconstitutionality, and the threat to Delaware's dominance in the corporate field though favoring the interests of management at the expense of shareholders and the public interest, not to mention the prospect of defeat in the State legislature.

I hope you will study these materials prior to the Section meeting, particularly Commissioner Grundfest's letters. I regret that all of these proceedings are so rushed and hurried, and that you do not have more time for reflection. Many of you have told me that you simply haven't had the time over the holidays to give these matters the attention they deserve. There is no good reason for this unseemly haste.

CFRjr/mrr
Enclosures

Washington Crosses Delaware

These are trying times in Wilmington, Delaware, the center of corporate commerce. Last April, the U.S. Supreme Court ignored the Commerce Clause in the *CTS* case, approving Indiana's anti-takeover law that protects in-state firms. Now 27 states have laws tilting the playing field in favor of target managers against unwanted bidders.

The Delaware treasurer doesn't want to abandon the state's laissez-faire approach, but frets that unless the state joins the anti-takeover wave, some big corporations will leave, depleting some of the 16% of state revenue derived from incorporations. Boeing, fearful of a bid from T. Boone Pickens, is leading the fight for a bill. No holds are barred in this battle because as Delaware goes, so goes the nation. The state is home to 180,000 companies, including more than half the Fortune 500 and nearly half the firms listed on the New York Stock Exchange.

As we read the proposal in its current form, this would be the end to any chance of a hostile takeover of any Delaware firm. Whatever damage the threatened U.S. Ways and Means Committee tax on takeovers did on October 19, imagine the reaction in the stock markets to this near-total devastation of the takeover market.

A committee of the state bar first proposed a bill nearly as toxic to hostile takeovers as the bill CBS got passed in New York when it was fighting off Ted Turner. The bill would prohibit bidders from merging with their targets or selling off target assets for three years, unless the bidder met one of two tests. A hostile bidder would have to purchase 90% of the target's stock in the single transaction when it crossed the 10% mark. Or the bidder must buy 90% of the target's stock and get the approval of the remaining "non-interested" shareholders, meaning those aside from the 90% owned by the bidder and whatever shares were owned by target management.

Loud complaints about the impossible 90% figures led to the bar committee's revising the number downward to 85% in the current version of the bill. This and some other cosmetic changes did little to allay the concerns of critics, including the Securities and Exchange Commission and the Federal Trade Commission. The major pension funds, such as California Public Employees' Retirement System, College Retirement Equities Fund, and even the Delaware Board of Pension Trustees, are screaming bloody murder on shareholders' behalf against the bill.

SEC Commissioner Joseph Grundfest wrote the Delaware bar committee that for Fortune 500 firms, his conservative estimate is that "the average firm already has a blocking percentage of about 15 percent." He cited numerous studies showing that directors of the Fortune 500 themselves own an average of more than 10% of the shares, often more than 20%, and that directors combined with management own an average of 17.5%. Studies also show that at least 5% of shareholders don't vote on tender offers, which makes it that much harder for a raider to get 85%. Management can also use "strategic behavior" to get stock into friendly hands. Mr. Grundfest concluded that it would be all but impossible for a raider ever to get 85% if management was in opposition.

Still, the odds are that on Monday the Corporation Law Section of the state bar will approve the bill, which will then go to the state legislature on a fast track. Delaware may decide it can't afford not to indulge in corporate protectionism if everyone else is doing it—with the stamp of approval of the federal government.

The alternative is for Congress to correct the *CTS* decision by doing its constitutional duty of regulating commerce "among the several states." The SEC wants congressional approval to use its authority under the Williams Act to flatten the playing field between bidders and targets by pre-empting all the state anti-takeover laws. Asking Congress to solve a problem is always dangerous and may be wishful thinking, but here there may be no alternative.

ROBERT J. SAMUELSON

Corporate Socialism



Those who beg for government protection are also inviting government control

You might not ever have to think about Delaware except for this: although its citizens represent only 0.3 percent of the nation's shareholders, more companies are incorporated there than in any other state. There are 179,000 of them, including 56 percent of the Fortune 500. Delaware may soon enact an antitakeover law, which—given the state's pre-eminent position—would amount to a national antitakeover law.

This is a ghastly idea. Its only purpose is to shield well-paid executives against hostile takeovers. Corporate leaders like to project themselves as defenders of the productive economy against sinister financiers and "raiders." In fact, hostile takeovers promote greater efficiency and productivity. The whole antitakeover exercise smacks of corporate socialism: the marshaling of government powers to protect established businesses against change and challenge.

Executives want to sleep easier at night, and Delaware is eager to please. The corporate franchise tax and other fees provide 16 percent of state revenues. A Supreme Court decision last spring seemed to permit tougher state antitakeover laws. Since then, 13 states have passed new laws, bringing to 27 the number with antitakeover statutes. Delaware officials fear that companies will reincorporate elsewhere if the state doesn't offer greater protection. The local bar association is drafting a proposal, which the legislature may approve in early 1988.

The speed with which these antitakeover laws have passed represents a political triumph for big corporations. They've largely succeeded in portraying hostile takeovers as an economic pestilence. By now, the indictment is familiar. The takeover threat (it's said) forces companies to focus on short-term profits and sacrifice long-term investment or research. Corporate raiders cheat small shareholders by coercing them to sell their stock at low prices.

There's just enough truth to the indictment to make it seem compelling. Ivan Boesky was just sentenced last week. Some takeover bids are phantom, intended mainly to create speculative opportunities in the stock market. Outlandish trading profits are made. Not surprisingly, corporate raiders and investment bankers are the new villains of popular culture—reviled in novels (Tom Wolfe's "The Bonfire of the Vanities") and movies (Oliver Stone's "Wall Street"). But beyond the imagery, the indictment against hostile takeovers is essentially false. Consider:

- They aren't rampant. In 1986 only 40—a record—were attempted, according to W.T. Grimm & Co.; a mere 15 succeeded. What is rampant is executive anxiety about takeovers. In one survey of 200 large companies, 57 percent said they'd been subject to takeover rumors.
- Hostile takeovers haven't cut total investment or research. Between 1979 and 1986, corporate-financed research and development rose 51 percent, after adjusting for inflation. The increase between 1969 and 1976—when hostile takeovers barely existed—was only 12 percent. Investment, as a share of gross national product, is higher now than in the 1970s.
- There's no evidence that shareholders fare worse in hostile takeovers than in friendly ones—those negotiated by the managers of merging companies. Typically, investors get 25 to 40 percent more than the previous market price.

Still, the corporate rhetoric continues. Listen to H. B. Atwater Jr., chairman of General Mills. He deplores financial "manipulations" and bad "bust-ups." He says hostile takeovers create "no new wealth." He's probably right. But they can improve use of the existing wealth by redirecting wasteful corporate investment. Ironically, General Mills proves the point.

Useful threat: General Mills has an "extremely profitable base [business] that subsidized poor diversification," as Michael Porter of the Harvard Business School writes. The company is the second largest cereal maker (Wheaties, Cheerios) and the leader in cake mixes (Betty Crocker). Food profits financed diversification in everything from toys to fashion to furniture. In 1985 Atwater overhauled the company. He sold poorly performing businesses and turned the toy and fashion operations into separate companies, whose stock was distributed to General Mills's shareholders.

The results have been dazzling. The toy and fashion businesses have done better as independent companies. Focusing on fewer businesses, General Mills improved its return on shareholders' equity from 19 to 31 percent. Since 1984 its stock price (including the value of the spun-off companies) has risen about 150 percent. That's more than three times greater than the overall market rise. But suppose Atwater hadn't acted and a raider had? In 1985 someone could have bought General Mills for 50 percent more than its market price and, by doing what the company itself did, profited enormously. Would that be a financial "manipulation" or undesirable "bust-up"?

The economic value of hostile takeovers doesn't lie in the few that occur. It lies in the mere threat, which motivates managers to stay efficient. Just because the pressure operates through the stock market doesn't make it illegitimate. The Delaware antitakeover proposal aims to reduce the threat. Management-approved mergers are exempted. For others, the proposal would make it difficult for investor groups to borrow the money to finance hostile takeovers. Notably, many public pension funds—large stockholders representing millions of retirees—oppose the plan.

What Delaware and shortsighted executives are jeopardizing is a division of labor that's worked well for decades. Congress has left the details of corporate law to the states, as long as states don't use it to settle major issues of national policy. Once that happens—as it is happening here—the question arises: why should Delaware have such power? The logical response is to abolish state corporate charters and replace them with a federal charter.

This step has long been advocated by social activists, but it's fraught with dangers. It would represent a huge politicization of the economy. Through federal charters, corporations could become the target of every passing political and social fad. It would be an economic nightmare. But if business leaders want corporate socialism, that's what they're risking. Those who beg for government protection are also inviting government control.



WILMINGTON
TRUST

Bernard J. Taylor, II
Chairman of the Board
Dial Direct 302 651 1500

December 8, 1987

A. Gilchrist Sparks, III, Esquire
Chairman
Council of the Corporation Law
Section of the Delaware State Bar Association
c/o Morris, Nichols, Arsht & Tunnell
1105 North Market Street
Wilmington, DE 19801

Dear Mr. Sparks:

We have obtained a copy of the Council of the Corporation Law Section's discussion draft of November 19, 1987, of a proposed anti-takeover bill. It is our understanding that the Council seeks comment from interested parties before deciding on whether to recommend the bill to the General Assembly.

We are strongly opposed to the bill in its present form because we believe that as a practical matter it will prevent takeovers of Delaware corporations without management consent. We believe that the ultimate decision on such matters should be left with the shareholders, not the board of directors.

As Delaware's largest bank with the nation's twelfth largest trust department having $85.6 billion in trust assets, we feel an obligation to speak for those many thousands of shareholders that we represent whose interest would be materially and adversely effected by this legislation. It is our view that if adopted, this draft anti-takeover legislation will significantly reduce the market value of assets under our control by billions of dollars. We see no basis for the State of Delaware to adopt legislation which would have such a draconian effect.

We understand the impetus for proposals such as is made here to stem from the U.S. Supreme Court's approval last April of an Indiana statute adopted in the name of shareholder protection. We see little shareholder protection in the proposed statute. Instead, we see an absolute bar to any hostile tender offer in that management, as a practical matter, is given the absolute right to veto any such offer. We do not believe this to be in shareholders' best interests nor those of the State of Delaware.

We could support some amendment to our corporate statutes which would give some further protection to shareholders against coercion to tender their shares in a hostil tender offer, but we believe this proposal goes much too far.

One of the propositions advanced in support of the proposed bill is that Delaware needs to adopt legislation to prevent our chartered corporations from being put into play or else a number of those presently chartered will leave the State and locate elsewhere. We do not believe that to be the case. We think the existing advantages of Delaware as a corporate situs are formidable, including the protection against hostile takeovers afforded by such decisions as Household, Unocal, and Newmont, among others. We do not believe that a significant number of Delaware corporations will attempt to leave Delaware or that, if they did, their institutional shareholders would support such an effort.

We urge the Council either to scrap the proposed measure altogether or to consider substantial modification to ameliorate the ability of management to further entrench itself at the expense of their shareholders.

Sincerely,

Bruce J. Taylor Jr.

BJT:jw

cc: The Honorable Michael N. Castle
The Honorable Richard S. Cordrey
The Honorable Terry R. Spence
The Honorable Thomas B. Sharp
The Honorable Joseph R. Petrilli
The Honorable Myrna L. Bair
The Honorable Orlando J. George, Jr.
The Honorable Michael E. Harkins

Ernst Dannemann , Chairman of the Board
Bruce O. Kallos , Chairman of the Investment Committee
State of Delaware
Board of Pension Trustees

Thomas Collins Building
P.O.Box 1401
Dover, DE 19903

December 7, 1987

David B. Brown, Esquire
Secretary
Council of Corporation Law Section
Potter, Anderson & Corroon
350 Delaware Trust Building
P.O. Box 951
Wilmington, DE 19899

Dear Mr. Brown:

The Council of Corporation Law Section of the Bar Association is currently considering draft legislation which would effectively eliminate hostile takeovers of Delaware chartered corporations. Because of the large number of U.S. corporations chartered in Delaware, this legislation would have far-reaching effects upon business combinations across America. As representatives of the Board of Pension Trustees, we strongly oppose this legislation because of the impact it will have on the cost of providing pensions for our 9,300 retirees and 26,000 active employees.

The SEC and a number of states have completed studies which show an adverse share value impact when anti-takeover measures are in place. The state guarantees defined pensions to our retirees. The better the return on our $1.3 billion pension fund, the lower the taxpayer cost of providing those pensions. The proposed legislation is adverse to shareholder value and adverse to the Fund's interests.

With increasing and diverse anti-takeover and other corporate governance legislation in place at the state level, the Federal Government may move to preempt state corporation law and impose a federal corporation law. Securities and Exchange Commission Chairman David Ruder said these state statutes "diminish the efficiency, depth and liquidity of the nation's securities markets." Uniform, federal corporation law would eliminate Delaware's currently advantageous position. Corporations would no longer have any reason to remain here and we could loose substantial revenue when they re-incorporate elsewhere.

Shareholders stand to lose if the Delaware proposal is passed. Former SEC Economist Gregg Jarrell estimates that widespread adoption of anti-takeover statutes will cost shareholders up to $50 billion. Numerous studies show similar state statutes cost shareholders billions of dollars and have a negative effect on our markets and on this country's competitiveness. The Federal Trade Commission said a New York statute cost shareholders $1.2 billion - an average decline in equity value of nearly one percent for each of the 94 firms studied. By raising the cost of acquisitions, such regulations deter acquisitions, the reports says, denying premiums to shareholders of firms which otherwise would have been acquired. According to the report, they may further harm both shareholders and consumers by protecting and entrenching inefficient managers. A study by the New Jersey Office of Economic Policy concluded that the state's anti-takeover statute "adversely affects shareholders" and should be allowed to expire. "The possibility of removing entrenched management and the realization of economic efficiencies as a result of takeovers has enormous value for the process of improving U.S. corporations," the New Jersey report says. "Our economic system will be weakened and our position on the world economic scene diminished" if shareholders lose this check against management prerogatives.

An Ohio law that increased companies' ability to resist takeovers caused declines in stock prices that averaged 2% for 36 concerns headquartered in the state, according to a study by the Office of the Chief Economist of the Securities and Exchange Commission. The economists estimate that the loss in the value of shares of the 36 companies could range from $754 million to $1.45 billion.

Studies reveal that the shareholders of target companies typically realize stock price gains of between 16 and 34 percent. Shareholders of bidding firms earn only about 4 percent. Professor Michael Jensen of the University of Rochester estimates takeovers have increased shareholder wealth by $400 billion (in current dollars) between 1977 and 1986.

The SEC has determined the average premium from takeovers of $100 million or more is almost 43%. The SEC also recognizes that estimates are likely to understate substantially the true gains from takeover activity because it excludes "the more important impact of the takeover, (which) may well be on those firms and managers who are not taken over, but who change their behavior as a result of the general deterrent threat of a takeover." (Grundfest and Black 9/28/87)

If those companies in which the Fund holds an equity position were protected from hostile takeovers, the market value of those equities would be substantially lower than if there were no takeover protection. This decrease in value of the fund plus opportunity losses because potential value adding takeovers are avoided, would have to be made up by increased contributions to the fund, putting an increased burden on Delaware taxpayers. In addition, Delaware stands to loose much more if our action triggers a federal corporation law and we loose our position as a safe haven.

We strongly urge this legislative proposal be abandoned.

Sincerely,

Ernst Dannemann
Chairman
Board of Pension Trustees

Bruce O. Kallos
Chariman
Investment Committee

BOK:blm

cc: Governor Michael N. Castle
Secretary of State Michael E. Harkins
Senator Richard S. Cordrey
Senator Thomas B. Sharp
Senator Myrna L. Bair
Senator Nancy W. Cook
Representative Terry R. Spence
Representative Joseph R. Petrilli
Representative Orlando J. George, Jr.
Representative Philip J. Corrozi
Members of the Board of Pension Trustees

Attachment

Let Corporate Takeovers Keep Rolling

By Frederick Iseman

Congress will compound the financial treachery of Ivan F. Boesky and Dennis Levine if it uses the insider trading scandal as an excuse to suppress "raider" takeovers.

Mr. Boesky and Mr. Levine broke the laws of the marketplace. But to stop takeovers because of their abuse by insider traders is as foolish as closing banks because people rob them.

Early this year, at the request of Sir James Goldsmith, I undertook a study of his takeovers of American companies. The evidence suggests that raider takeovers, when carried through to completion — the very takeovers that Senators William Proxmire and Howard Metzenbaum now wish to suppress — serve a useful economic function, pruning conglomerates to make them perform faster, better and in a manner more productive of wealth.

The outcry against takeovers comes from large corporations that object to being held accountable for their mistakes. These companies have demonstrated nearly feudal political power with which to resist the market's imperatives. The economic cost of letting them off the hook will make Ivan Boesky's $100 million penalty seem infinitesimally small.

What is a "raider" takeover? The transaction can be characterized simply as buying a collection of companies wholesale, in conglomerate form, at a bulk discount in the stock market, and selling them retail, one at a time. The raider's profit is the difference between the value the stock market puts on a company when it is buried inside a large rag-bag conglomerate and the higher value that the same company is perceived to have standing on its own, or when united with a company that specializes in the same industry. Sometimes an enterprise will be valued twice as highly on its own. Often the raider will keep the conglomerate's principal business and run it after selling off the other parts.

"Raiders" do not destroy value when they take over a company. They must increase it. Otherwise, they themselves cannot gain. There is as much mystery in this as there is in buying a parcel of land, subdividing it and keeping a nice home site for oneself.

The chairmen of great conglomerates find it offensive that their constituent parts may be worth a lot more outside the company than in, but that is the case. The best executives, like Robert Anderson of Arco, have "raided" themselves and restructured successfully. Contrary to what many critics say, wealth is created in this fashion. It is created at the shareholder level, at the "raider" level and again at the level of the spun-off companies as they flourish and grow.

Frederick Iseman is former executive editor of California Magazine.

Congress should not suppress them

The economic and financial success of "boot-strap, bust-up" takeovers contrasts sharply with the many takeovers, hostile and not, conducted by the same Fortune 500 companies that so hypocritically and strenuously complain about the insecurity of corporate life. More frequently than they care to admit, these companies make corporate life more insecure than it has to be by departing from the businesses they know for ones they don't. By doing so, they frequently fail to create value and thereby deliver themselves into the predators' jaws. Over and over, the big corporate conglomerator of yesterday becomes the breakup target of tomorrow.

Raiders tend to be better acquirers than conglomerates because they are dependent upon borrowed capital. They cannot afford to make bad deals. If they do, they quickly find they've done their last. Big corporations, however, have the means (in shareholders' cash and stock), to make dreadful mistakes. No legislator called hearings when Diamond Shamrock acquired Natomas Oil, nor again a few years later when much of the value of the acquisition had to be written off. Corporate error is tolerated by Congress; individual shrewdness is not.

Fortunately, the financial markets have different set of values. Pension managers, bank trust departments and the most conservative financial institutions have taken to voting for raiders with their stock because economic logic dictates that they do so. Companies see that and they are scared. They will do anything to fend off economic justice: pay greenmail, threaten pension funds, booby-trap their companies with "poison pills" and incite fear among unsophisticated employees.

Robert Miller, vice chairman of Chrysler, says: "I shouldn't spend my nights worrying about corporate raiders. I should be worrying about how to make better cars." But Mr. Miller should spend his nights worrying about corporate raiders. It will concentrate his mind wonderfully on the task of making better cars during the day. If he does so successfully, Wall Street will bid Chrysler shares up to a level at which he may sleep soundly.

The fight over "raider" takeovers is a political fight. It is a fight between complacent corporations and hungry financial entrepreneurs, between professional managers with too little stock and shareholders with stock and dividends upon which they depend, between predators and the unfit members of the herd. Every pension recipient, insurance policy holder and shareholder will lose if business lobbyists and captive Congressmen succeed in stifling the restructuring being forced upon them. If the threat of hostile takeovers is not permitted to press companies now, the economic consequences of unreadily facing aggressive foreign competitors may be far worse. The steel industry is an example of a big industry that wasn't challenged until it was too late. Perhaps the auto industry can still save itself.

The ordinary shareholder is at a disadvantage in this fight. Unlike management, he cannot use the corporate treasury to hire lobbyists and lawyers. And shareholders are too geographically diffuse to bring the political pressure to bear in a Congressional district that management and labor can. But if corporate goals are dictated by political instead of financial ends, shareholders — and the nation's economy as a whole — will be the losers.

The Levine-Boesky scandal, as it worsens, makes a fine tool to stop another economic movement. Those two, and there ilk, have done the great disservice of blackening every deal any arbitrageur ever touched. But Mr. Boesky, at his worst was only able to cheat some shareholders. Congress, in its wisdom, can cheat all of them, on a scale that even Mr. Boesky would admire.

University of Delaware

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December 6, 1987

Mr. David B. Brown, Esq.
Secretary, Corporate Law Section
Delaware Bar Association
Potter, Anderson and Corroon
350 Delaware Trust Building
Wilmington, DE 19801

Dear Mr. Brown,

We understand that the Delaware Bar Association is considering recommending to the General Assembly the passage of a law that would severely restrict hostile takeovers of Delaware chartered corporations. As we understand the proposed legislation, managers of firms incorporated in Delaware would be guaranteed permanent jobs. Any shareholder owning 10% or more of the shares in the company being acquired would be precluded from any transactions with the acquiring firm for three years, unless the shareholders received management approval or overcame nearly insurmountable obstacles. Our opinion is that any law which virtually prohibits hostile takeovers would not be in the State's best interest for several reasons.

First, hostile takeovers are only "hostile" to entrenched management, rarely to stockholders. Competition for all resources and products, including competition for executive positions, is necessary to enhance the U.S.'s ability to produce for global markets.

Second, hostile takeovers are not common. Last year there were 40 hostile takeovers attempted, and only 15 were successful (Samuelson, "Shielding Management", Washington Post, 9/23/87). The greatest value of the hostile takeover option may not be to the companies that are actually taken over, but rather to those companies which will operate more efficiently because of the threat of a potential hostile takeover.

Third, there is a considerable body of empirical evidence that cites large gains to shareholders as a result of takeovers. Jensen and Ruback show permanent stock price increases of 10% when mergers were successful. When hostile takeovers are involved the average value of the stock increased by 16 to 34% after the takeover ("The Market for Corporate Control - The Scientific Evidence", J. of Fin. Ec., 49, Vol. 11, 1983). Grundfest and Black found a 51% premium in the stock prices of companies recently acquired in takeovers, increasing shareholder wealth by $184 billion between 1981 and 1986 ("Stock Market Profits from Takeover Activity", U.S. Securities and Exchange Report,

9/28/87). In contrast, when restrictive legislation is passed, stock prices fall. A recent SEC study found that when Ohio passed a law that increased the ability of companies enfranchised in Ohio to resist takeovers, the price of the average share of stock of those companies fell by 2%. The conclusion of that study is that strengthening takeover defenses "may not be in the best economic interest of shareholders" ("Study on the Effects of Legislation on Shareholder Wealth", 5/18/87).

Finally, extremely restrictive legislation on other forms of economic activity has not worked to enhance America's ability to produce and compete - witness the examples of price supports in agriculture, steel import quotas, "voluntary" restraints in the automotive industry, and government allocation of airport landing spaces. "Those who want the government to regulate mergers and acquisitions must have considerably more faith in the government's ability to foresee whether the merger will prove profitable and beneficial than in the ability of those who have their own money at stake" (Buttarazzi, "Corporate Takeovers: What is the Federal Role?", Heritage Foundation, 9/29/87).

We encourage you not to recommend this extremely restrictive legislation. If the concern is that, without further limitations on merger activity, Delaware corporations will move to other states, we feel certain that legislation could be written which would prohibit some of the abuses that have occurred in hostile takeovers (e.g., prohibiting greenmail), and still permit those takeovers that will improve the ability of American firms to adapt to the rapid changes occurring in the world today.

Sincerely yours,

Charles R. Link, Professor of Economics

Saul D. Hoffman, Associate Professor of Economics

Donald Puglisi, Professor of Business Administrat:

Anita M. Schwarz, Assistant Professor of Economics

Eleanor D. Craig, Associate Professor of Economics

Kenneth J. Koford, Associate Professor of Economic

Bertram F. Levin, Associate Professor of Economics

David E. Black, Associate Professor of Economics

Richard J. Agnello, Associate Professor of Economi

HARRISON J. GOLDIN
COMPTROLLER

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER

December 9, 1987

David B. Brown, Esq.
Secretary
Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, DE 19801

Dear Mr. Brown:

I have reviewed the exposure draft of the Delaware Bar Association's proposed anti-takeover bill. I have decided to comment because of the importance of this proposal to all stockholders in Delaware corporations.

As Comptroller of the City of New York I am the custodian, asset manager or trustee of five New York City actuarial pension systems, with combined assets of over $30 billion. These funds are invested in more than 1,300 different companies, a significant number of which are incorporated in Delaware. Additionally, I am Co-chair of the Counsel of Institutional Investors, an association of over 50 pension funds with aggregate assets of more than $200 billion, whose members are concerned about the rights of stockholders.

As a stockholder I am deeply troubled that the proposal would effectively eliminate the prerogative of owners to determine whether a corporation should engage in a "business combination" with an "interested stockholder." Stockholders are entitled to evaluate proposed business combinations for themselves and determine whether they prefer to realize a higher return on their investment immediately or await the long-term gain that should accompany orderly growth in a well-managed corporation. The proposal removes this prerogative.

To be sure, if a board of directors determines that a proposed business combination is in the best interest of stockholders, the draconian provisions of the legislation are not invoked. However, if a board of directors rejects a proposed transaction (or does not consent to the acquisition of 10% of the company's shares by the person proposing the business combination) the hurdles to the business combination are practically insurmountable.

Additionally, the proposal as drafted includes all publicly traded corporations, save companies that "opt-out" of its restrictions. This opt-out provision turns good corporate governance on its head. Putting aside the issue of permitting one generation of stockholders to compromise the rights of future generations, corporations should at least be required to secure the concurrence of their owners on the basic decisions involved in assessing proposed business combinations, unless stockholders act affirmatively to grant the board of directors the discretion to erect the barriers provided by the proposal. Moreover, as the proposal is drafted, even if stockholders elect to require a company to remove the statutory hurdles to a business combination, the effect of such a vote is delayed for 18 months. Thus, even where stockholders expressly reject the statute's barriers, a company's management can still keep the obstacles to business combinations in place for half the period they would have been in effect had no vote been taken. Why any stockholder would undertake the expense of proposing an amendment to the by-laws or the certificate of incorporation when so little can be gained is a hard question to answer.

I appreciate the opportunity to comment on a matter than concerns all stockholders.

Sincerely,



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James S. Martin
Executive Vice President
(212) 916-4019

December 7, 1987

David B. Brown, Esq.
Secretary, Council of Corporate Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, Delaware 19801

Dear Mr. Brown:

As the equity component of the nation's largest private pension system - with billions of dollars invested in the stocks of hundreds of Delaware corporations - CREF opposes the takeover legislation that the Delaware Bar Association is now considering.

I don't see how Delaware can maintain its position as the country's de facto arbiter of corporate law if it ignores the interests of shareholders - the owners of American corporations. Studies by the Federal Trade Commission, the SEC and the New Jersey Office of Economic Policy have concluded that state takeover legislation similar to that proposed for Delaware has resulted in billion-dollar losses to shareholders. By effectively precluding tender offers not approved by the boards of target companies, such legislation takes from shareholders their traditional right to sell their shares to whom and on what terms they choose.

It is particularly disturbing that - unlike recent legislation eliminating directors' financial liability for violating the duty of care - the Delaware proposal does not require the affirmative vote of shareholders in order to apply to a particular company. This omission may reflect the likelihood that informed shareholders would reject the "protection" offered by takeover legislation if they were offered the chance to vote.

Chairman Ruder of the SEC has testified that "limitations on the free transferability of securities... implicate issues of national concern regarding the efficiency, depth and liquidity of the Nation's securities markets... Just as it would be imprudent for Congress to use tender offer regulation as a guise for federal regulation of corporate governance, it is imprudent for the states to

use their authority over matters of internal governance as a guise for regulating the interstate market for tender offers."

You may also be interested that at the recent ABA National Institute On the Dynamics of Corporate Control where our Senior Vice President and Associate General Counsel, Peter Clapman, was on the faculty, the proposed Delaware statute came under considerable debate and some criticism along these lines. For example, the proposal does not require the Board to act on a proposed bid within a prescribed period. In addition, the proposal does not take into account the fact the insiders or management of the company could control 10% of the shares, thus raising the spectre of a conflict of interest between such shareholders and the 90% who favored the bid.

In summary, we believe this proposed approach is inconsistent with the historic role of Delaware in the corporate field and the state's concern for true shareholder protection.

On the premise that there may be revisions to the proposal that is ultimately submitted to the Legislature, we request advance copies and the opportunity to comment further.

Sincerely,

James S. Martin
Executive Vice President

CalPERS
P.O. Box 942701
Sacramento, CA 94229-2701
(916) 326-3829

December 4, 1987

David B. Brown, Esq.
Secretary, Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, Delaware 19801

Re: Draft Antitakeover Legislation

Dear Mr. Brown:

On behalf of the California Public Employees' Retirement System (CalPERS), I am writing to urge your Council's opposition to the draft antitakeover legislation, currently being circulated for comment.

As you may know, CalPERS is the largest publically funded retirement system in the nation, with current assets having a market value in excess of $43 billion. As such, CalPERS is recognized as a major institutional investor.

In furtherance of the fiduciary duty owed to its 560,000 active members and 212,000 retirees and beneficiaries, CalPERS is committed to activities that, we believe, will protect the long-term interests of shareholders. In our view, the draft antitakeover legislation scheduled for vote by the Bar Section or December 11, 1987 may significantly harm the value of shareholders' investments in Delaware corporations. Former Securities and Exchange Commission Economist Gregg Jarrell has estimated that widespread adoption of this type of antitakeover statute will cost shareholders up to $50 billion; the Federal Trade Commission found that a similar New York statute cost shareholders $1.2 billion, with an average decline in equity valu of nearly one percent for each of the 94 firms studied. The New Jersey Office of Economic Policy concluded that the state's comparable antitakeover statute "adversely affects shareholders" and should be allowed to expire.

The emergence of this type of state statute, enjoying increasing popularity since the CTS v. Dynamics Corp. of America case, has resulted in CalPERS' decision, as well as that of numerous other influential institutional investors, to seek federal preemption o takeover legislation. If Delaware joins this current statutory "fad," our lobbying efforts would have to be increased; our fiduciary duty would require no less.

As I am sure you can recognize, CalPERS has no allegiance to unscrupulous corporate raiders. Achieving our long-term investment objectives depends upon the strengths of the corporations in which we invest. We firmly believe, however, th a fully efficient market is a freely competitive market. To all an inefficient or incompetent management to entrench itself, in the guise of "shareholder interests," will serve to depress stoc values and undermine the integrity of our economy.

Thank you for considering our concerns. If we can provide additional information to you, please feel free to contact me at the number on this letterhead, or Richard H. Koppes, CalPERS' Chief Counsel, at (916) 326-3666.

Very truly yours,

DALE M. HANSON
Executive Officer

DMH:cl

cc: Sarah Teslik, Esq.
WILLKIE, FARR & GALLAGHER
818 Connecticut Ave., NW
Washington, DC 20006

The Honorable Michael N. Castle
Governor, State of Delaware
Carvel State Office Building
Wilmington, DE 19801

The Honorable Michael E. Harkins
Secretary of State, State of Delaware
Townsend Building
Dover, DE 19901

The Honorable Richard S. Cordrey
President Pro Tempore
River Drive
Box 846
Millsboro, DE 19966

The Honorable Thomas B. Sharp
Senate Majority Leader
2226 East Huntington Drive
Wilmington, DE 19808

The Honorable Orlando J. George, Jr.
Minority Leader
4401 Whittier Road
Wilmington, DE 19802

T. Boone Pickens
United Shareholders Ass
1667 K St. NW, Ste. 77
Washington, DC 20006

The Honorable Myrna L.
Minority Leader
4 Little Leaf Court
Foulk Woods
Wilmington, DE 19810

The Honorable Terry R.
Speaker of the House
26 Freeport Road
New Castle, DE 19720

The Honorable Joseph R.
Petrilli
Majority Leader
12 High Meadow Lane
Newark, DE 19711

PERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
(916)
326-3400

December 3, 1987

Mr. David B. Brown, Esq.
Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington DE 19801

Dear Mr. Brown:

The California Public Employees' Retirement System represents 750,000 active and retired participants. The $40 plus billion in assets represents diversified holdings in over 1,000 corporate and government securities plus some real estate equity and mortgage securities.

As shareholders we believe the Delaware Proposal for Anti-takeover legislation will cost the Fund millions of dollars. Former SEC Economist Gregg Jarrell estimates the widespread adoption of antitakeover statutes will cost shareholders up to $50 billion. Our share of that cost, because of our size and exposure to the larger capitalization sector of the market, would be up to $500 million.

The entrenchment of management and the abridgment of market disciplines will only lead to less efficiency and lower productivity for the U.S. economy. In addition, this proliferation of separate state securities statutes seriously "diminishes the efficiency, depth and liquidity of the nation's securities markets", (in the words of SEC Chairman David Ruder).

We believe it is absolutely essential that:

- managements be accountable to their owners, the shareholder
- Shareholders, not management or one-sided legislation, deci what their property is worth and who should be running it.
- Equity securities represent a uniform national standard covenant, preferably based on the principle of one-share, one-vote.

We urge you to reject this proposal to amend your state's corporation statute.

Sincerely,

for Greta E. Marshall
Investment Manager

GEM:jm

cc: Dale Hanson
Executive Officer

STATE OF CALIFORNIA

STATE TEACHERS' RETIREMENT SYSTEM

INVESTMENTS OFFICE
P.O. BOX 163749
SACRAMENTO, CA 95816-3749

(916) 386-3710

GEORGE DEUKME

December 8, 1987

David B. Brown, Esq.
Secretary, Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, DE 19801

Dear Sir:

I am the Chief Executive Officer of the California State Teachers' Retirement Fund. This fund is recognized as the third largest public pension fund, with some $20 billion dollars in assets, and annual cash flow of well over $2 billion dollars. The California State Teachers' Retirement System has investments in over 4,000 companies. The size and nature of our fund mandates investment in the shares of publicly traded companies, so we feel that the "Wall Street Rule" cannot be easily applied, and therefore must address any area of concern within Corporate Governance, in a manner consistent with our fiduciary responsibility and duty.

The proliferation of State anti-takeover laws is a matter of the greatest concern to the California State Teachers' Retirement System. When the California Legislature drafted legislation similar to the anti-takeover proposal now being contemplated by Delaware, we vigorously approved it. Delaware's passage of such legislation would take on an even greater significance than passage of similar legislation in all the other states combined. This is because of Delaware's unique position with respect to corporations. It is our understanding that Delaware has been selected as the incorporation state for over 150,000 corporations, and that this number includes most of the Fortune 500 corporations. This number also represents nearly 50 percent of all the corporations listed on the New York Stock Exchange.

The proposed Delaware Takeover Legislation will cost shareholders billions of dollars. The legislation goes far to protect incumbent management at the expense of both shareholders and bidders. It will, if passed, have a "chilling effect" on takeovers, with the result that very few or no offers will be made. A large portion of the wealth in the recent bull market was directly attributable to takeovers. We firmly believe that every shareholder should have the right to sell his or her shares to the highest bidder, if that is what he or she chooses to do. This right should not be abridged by management's or

government's interposition between buyer and seller. Through all manner of defensive measures, such as "poison pills", golden parachutes, tin parachutes, wanton issuance of preferred and common stock, lobbying on the Federal and State level for protective legislation, management is insulating itself from the judgment of shareholders. It will soon be accountable to no one, not even the shareholders, who are the owners of the corporation. This has serious consequences for the millions of people in this country, small investors, whose vehicle for stock investment are pension funds.

We urge you and your colleagues to reconsider and reject the passage of anti-takeover legislation in Delaware. As stated above, Delaware's pre-eminent role in corporate law in this country, surrounds such legislation with national importance.

Very truly yours,

L.D. Kurmel
Chief Executive Officer

LDK/JMH:cm

HARVARD UNIVERSITY

GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

GEORGE F. BAKER FOUNDATION

MICHAEL C. JENSEN
Professor of Business Administration

SOLDIERS FIELD
BOSTON, MASSACHUSETTS 02
(617) 495-6058

December 8, 1987

David B. Brown, Esq.
Secretary, Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, Delaware 19801

Dear Sir,

I have long been an admirer and defender of the Delaware Corporate Law and one of those who fought mightily against the thesis of those who argue that Delaware is engaged in a "race for the bottom." The Delaware Antitakeover Proposal causes me great concern because I am convinced that this law will do enormous damage to corporate America and to the shareholders of Delaware corporations.

My estimates indicate that over the period 1977-1986 merger and acquisition activity has generated benefits to shareholders of approximately $400 billion (measured in 1986 dollars). These benefits have been driven most recently by takeovers of major American companies that have followed inefficient diversification strategies.

The proposed Delaware law makes impossible hostile takeovers that require financing based on the prospective value of the deal. Thus, it will substantially diminish the move towards efficiency in corporate America that is being brought about by takeover activity. Your proposed bill will eliminate exactly those takeovers that are most beneficial to the economy and to shareholders and leave relatively unscathed those that are most harmful, that is those acquisitions by well financed large corporate acquirers.

I believe a strong case can be made for the fact that the recent market crash was proximately caused by the House and Ways Means Committee Anti-Raider Tax Bill. I say proximately, because it generated a 150 to 200-point decline in the week prior to October 19 which then, resulted in a major breakdown of the institutional trading structure. I believe last weeks substantial decline in stock prices was itself caused by major publicity about the likely passage of the Delaware Antitakeover Proposal. I have great fear about what is likely to occur in the capital markets if you make the mistake of pushing this unwise proposal through the Delaware Legislature.

Lastly, I am very concerned about the long-run implications of Delaware joining this unwise move to protecting incompetent managers of our largest firms through antitakeover bills. This will add considerably to the pressures for Federal chartering. We are highly likely to first get a Federal preemption of state antitakeover legislation, and I fear

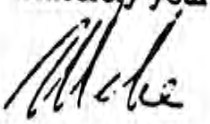
that that regulation may be worse than what we currently have. Most of all I am concerned about the implications of Delaware's action for the increased likelihood of Federal Corporate chartering, which I believe would be a disaster for the economy as well as for Delaware.

The playing field is already heavily tilted against the small hostile offerer and your bill will make that field look very much like an open draw bridge.

I am enclosing a recent Wall Street Journal editorial of mine and a longer piece that discusses the benefits associated with hostile takeovers, the underlying economic forces that are causing these takeovers, and how they are bringing about major increases in productivity and efficiency in corporate America. I am also sending several chapters of a thesis by a Doctoral Student here at Harvard, Amar Bhide, who studied all hostile takeovers in 1981 and 1985. He finds that hostile takeovers are more beneficial than a random sample of voluntary takeovers.

If I can be of any additional help, please do not hesitate to contact me.

Sincerely yours,



Michael C. Jensen

Professor of Business Administration
Harvard Business School
and
LaClare Professor Business and Finance
William E. Simon School of Business
University of Rochester

Enclosures: 3



November 8, 1987

David B. Brown, Esq.
Secretary
Council of Corporate Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington DE 19801

Dear Mr. Brown:

On behalf of the United Shareholders Association (USA), I am writing to urge the Council to oppose the draft antitakeover legislation, when the Council meets on December 11, 1987.

USA is a national organization with 15,000 active members, founded in 1986, which supports the interests of the owners of the thousands of companies incorporated in your state. According to a New York Stock Exchange survey of America's 47-million shareholders, there are more than 142,000 shareholders in Delaware. That's nearly one shareholder per every four households in the state. These citizens, and thousands more who own stock indirectly as part of pension and retirement funds, employe ownership plans, IRAs and insurance policies, stand to lose if this proposal becomes law.

Numerous studies show similar state statutes cost shareholders billions of dollars. Former Securities and Exchange Commission economist Gregg Jarrell estimates that widespread adoption of antitakeover statutes will cost shareholders up to $50 billion. According to a Federal Trade Commission report, the New York freeze-out statute - which is similar to the Council's draft statute - cost shareholders $1.2 billion. The New Jersey Office of Economic Policy concluded that its antitakeover statute, which is similar to the Delaware draft, "adversely affects shareholders" and should be allowed to expire.

This proposal, if enacted into law, will strengthen calls for federal preemption of state antitakeover statutes and could threaten Delaware's preeminent position in corporate regulation.

1667 K STREET NW • SUITE 770 • WASHINGTON DC 20006 • (202) 393-4600

No shareholders are asking for the "protection" offered by this proposal. Shareholders, and our nation's economy, should not suffer the consequences of a statute that protects only weak, inefficient managers.

I urge you to reject the discriminatory draft proposal on December 11. Thank you for this opportunity to comment.

Sincerely,

James E. Heard
Executive Director

December 7, 1987

David B. Brown, Esq.
Secretary, Council of Corporation Law Section
Potter, Anderson & Carroon
350 Delaware Trust Building
Wilmington, Delaware 19801

Dear Mr. Brown:

I am writing to express my opposition and the opposition of the members of the Massachusetts Pension Reserves Investment Management Board to the proposed antitakeover legislation (Sec.203) currently being circulated by the Delaware Bar Association.

As fiduciaries for a $1.9 billion public pension fund with over $800 million invested in the domestic equity market, we are of the opinion that such legislation poses a serious threat to our investment earnings. The proposed ammendment serves only to entrench corporate management, insulates them from fair tender offers, and denies stockholders, both institutional and individual, a voice in corporate governance.

Given Delaware's status as an incorporation state for a large number of corporations, this proposal will have far reaching repurcussions on the way such business is conducted in the United States. The proposals for federal legislation currently pending before various Congressional subcommittees could be substantially impacted, since balanced tender offer reform could not be accomplished without Federal preemption of the Delaware statute.

I urge your Association to act as quickly as possible to block this proposed ammendment.

Yours very truly,

Daniel J. Kelly, Esq.
Deputy Director/General Council

DJK:mm

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

OFFICE OF
THE COMMISSIONER

December 10, 1987

David B. Brown, Esq.
Potter, Anderson & Corroon
350 Delaware Trust Building
P.O. Box 951
Wilmington, Delaware 19899

Dear Mr. Brown:

We are pleased to provide these comments on a proposal before the Council of the Corporation Section of the Delaware Bar Association to amend Delaware's General Corporation Law by adding a "business combination" provision as section 203. */ The proposed legislation, if enacted by the state's legislature, would restrict the ability of acquirers to engage in business combinations with target corporations for three years after acquiring ten percent of the target firms' shares.

The enactment of proposed section 203 is likely to deter takeovers that benefit both shareholders and the economy as a whole. For these reasons, discussed more fully below, we believe that the approval of proposed section 203 would not be in the public interest. If the Council nevertheless recommends the approval of section 203, we urge it to consider making that provision inapplicable to corporations that do not affirmatively elect to be covered by its provisions through amendments to their certificates of incorporation. An affirmative "opting in" provision would ensure at least that shareholders have a voice in determining whether to restrain their ability to transfer control of the corporation.

Effect of Takeovers on Economic Welfare

Proposed section 203 appears to reflect a conviction that management-opposed corporate takeovers are undesirable and should be constrained. In fact, takeover activity can serve a number of important and desirable economic purposes, such as facilitating the redeployment of assets to more efficient uses and encouraging

*/ The views expressed in this letter are our own, and do not necessarily represent the views of the Commission or of any other Commissioner. The other three Commissioners declined to authorize the Commission staff to file a similar letter. However, a majority of the five Commissioners agree that the case has not been made to date that proposed section 203 is either a necessary or a desirable response to corporate takeover activity.

corporate management to improve firm efficiency. The supposition that takeovers serve no useful economic purpose is thus both theoretically and factually incorrect. Although not every takeover ultimately produces benefits, takeovers in the aggregate enhance economic efficiency and benefit both shareholders and consumers.

Management-opposed corporate acquisitions are most commonly carried out because bidders expect to improve the performance of target corporations and raise the price of their shares. 1/ Such outsiders pay a substantial premium over the market value of the shares of target corporations because they believe that the targets will be worth more under their control. 2/

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 improve 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 (wealth-maximizing) uses by selling or changing the use of underperforming facilities. Consequently, even well-managed companies may become targets for takeovers if their performance (and profitability) could be further improved under the control of other firms.

The transfer of corporate control in such circumstances benefits the bidder, the target company's shareholders, and the economy as a whole. The successful bidder benefits by securing the opportunity to realize gains from the improved performance of the acquired target. Shareholders benefit in two ways. First, 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 motivates incumbent management to improve its performance. The entire economy can

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1/ See Bradley, Desai and 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).

2/ There is evidence that the stock of most target companies significantly underperforms the market in the pre-offer period. See Gilson, supra note 1, at 852-53, and sources cited therein.

benefit both from the transfer of corporate control to more efficient management and from the incentives that takeovers create for improved managerial performance.

Numerous studies have shown that takeovers, on average, lead to an increase in the stock market's valuation of both the acquired and the acquiring firms compared to the market as a whole. One study found that share prices of acquired firms increase by an average of 53.4 percent. 3/ Different studies report that the share prices of acquiring firms increase by smaller amounts, ranging from approximately 2 percent to approximately 7 percent. 4/ The market thus values both the acquiring company and the target company more highly than in the absence of a takeover. 5/ In the aggregate, takeovers therefore enhance the welfare of shareholders of both acquiring and target companies. 6/ Restrictions on takeovers, by contrast, may well undermine economic efficiency and harm the competitiveness of American companies by impeding the flow of corporate assets to value-maximizing uses.

Asserted Disadvantages of Takeover Activity

Several purported disadvantages of takeover activity are often cited to justify restraining corporate acquisitions.

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

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

5/ Similarly, share prices of both bidding and target firms usually decline after unsuccessful takeover bids to below the pre-offer level. Bradley, Desai and Kim, supra note 1, at 189-204; Jensen and Ruback, supra note 4, at 8.

6/ The legal and economic literature discussing the benefits of takeovers is vast. See, e.g., Economic Report of the President, supra note 4, at 187-216; Jensen and Ruback, supra note 4; Gilson, supra note 1; Easterbrook and Fischel, supra note 1; Bradley, Desai and Kim, supra note 1; 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.

END

First, it is claimed that some acquirers may simply oust good management by mistake and reduce corporate efficiency by installing a less capable management team. 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 are best left to investors, who stand to profit from correct decisions and lose from poor ones.

Second, it is alleged 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. There is no evidence, however, that takeovers in fact lead to plant closings and lay-offs that would not have occurred otherwise. 7/ If closings and lay-offs are necessary to achieve greater economic efficiency, the target's management would have been forced eventually to take the same steps to remain competitive. Such measures, however painful to individuals, increase the efficiency of the firm and enhance its viability. More fundamentally, most economic changes that increase efficiency -- and thereby increase aggregate societal wealth -- create dislocations that can reduce the welfare of some individuals. 8/ Inhibiting asset transfers that benefit society as a whole would impose a cost on society that could exceed the benefit to displaced individuals and communities.

7/ 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).

8/ This is true of virtually every major technological advance, which renders earlier technologies obsolete and may harm firms and individuals dependent on the earlier technologies.

Third, it has been asserted that the financing of corporate acquisitions through high yield (or "junk") bonds saddles acquiring firms with "excessive" debt. The critics assert that an excessive debt burden assumed by American corporations threatens both the acquiring companies and the economy as a whole. Critics also 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. 9/ But even as to those takeovers that are so financed, it is highly improbable that a corporate bidder would undertake obligations it believes likely to render an acquired company unprofitable, because doing so would defeat the very purpose of its investment. It is not in the acquirer's interest to shut down profitable operations or 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. Moreover, the sophisticated institutional investors who buy high yield bonds, which include pension funds, insurance companies, mutual funds, and other financial institutions, are unlikely to lend money for takeovers unless they expect them to be profitable. 10/

9/ H. Sherman and R. Schrager, Junk Bonds and Tender Offer Financing 18 (1987), reprinted in Hearings on Hostile Takeovers, supra note 7, at 627.

10/ To be sure, bond issuers and investors may prove wrong in their assessment of the ability of any firm to satisfy its debt burden. Firms do default on debt obligations from time to time. But even in the case of default, the harm is not as great as the critics allege. The bankruptcy of a firm will rarely result in the liquidation of the profitable portions of its business. Creditors of a bankrupt firm may find it in their best interest to allow the firm to reorganize and to continue to operate the profitable portions of the business. Even if reorganization is not feasible, creditors would find the sale of profitable facilities to another firm that would continue to operate them more beneficial than their elimination, and therefore will seek an appropriate buyer. Consequently, only the unprofitable portions of a firm's operations are likely to be liquidated.

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. But this is precisely the sort of redeployment of corporate assets to more efficient uses that results in benefits to society.

In a related vein, it has been asserted that acquiring firms take over firms with high cash flows and low debt for the purpose of appropriating, or "looting," their financial assets before reselling them at a profit. This argument is particularly unpersuasive because it would have the corporate acquirer looting its own assets. An acquirer that purchases 100 percent of the shares of the target company would be hard pressed to come up with ways to benefit from stealing from itself. 11/ In any event, the average takeover target has a below average cash flow ratio and an average debt to equity ratio. 12/ This finding is consistent with the notion that corporate buyers acquire firms because they can increase the value of the target firms by managing them more efficiently.

Fourth and 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. 13/

11/ Where an acquirer does not control 100 percent of the acquired firm, the corporate laws of every state, including Delaware, protect minority rights against fraud or abuse by majority shareholders.

12/ Pound, Lehn, and Jarrell, supra note 6, at 29.

13/ 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).

The Proposed Legislation

Proposed section 203 governs "business combinations" with takeover targets. If enacted, section 203 would prohibit owners of ten percent or more of the voting shares in Delaware corporations, who are defined by section 203(c)(5) as "interested stockholders," from merging with or conducting other specified business activities with target corporations. Section 203(a) would prohibit any "interested stockholder" from engaging in any "business combination" with a target corporation for a period of three years after becoming an interested stockholder, unless the business combination or the purchase of shares was approved by the target corporation's board of directors before the acquirer became an interested stockholder. 14/ Proposed section 203(c)(3) defines "business combination" to include, inter alia, any merger or consolidation of the target company with the interested stockholder, or any sale, lease, exchange, or other disposition of important assets of the target corporation to or with the interested shareholder. 15/

Effect of "Business Combination" Restrictions on Takeover Activity

Proposed section 203 would tend to insulate incumbent corporate management from contests for corporate control. 16/ The successful bidder for corporate control most commonly seeks to consolidate the target into its operations through a mer-

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14/ Proposed section 203(a) also exempts any stockholder who acquired at least 90 percent of the corporation's shares in the transaction in which it became an interested stockholder or a stockholder who acquired at least 90 percent of the corporation's shares after becoming an interested stockholder and who obtains a majority vote of the remaining stockholders approving the business combination.

15/ Among other things, section 203(c)(3) would prohibit any type of disposition to or with an interested stockholder of assets of the target corporation having a market value of ten percent or more of either of the aggregate market value of the target firm's assets or the aggregate market value of the target firm's stock, or the issuance or transfer to an interested stockholder of shares in the target corporation.

16/ The importance Section 203 gives to management's interests is shown by the fact that even a vote of the "disinterested" stockholders to opt out of the statute and thereby facilitate the transfer of corporate control does not become effective for 18 months. § 203(b)(4).

The Proposed Legislation

Proposed section 203 governs "business combinations" with takeover targets. If enacted, section 203 would prohibit owners of ten percent or more of the voting shares in Delaware corporations, who are defined by section 203(c)(5) as "interested stockholders," from merging with or conducting other specified business activities with target corporations. Section 203(a) would prohibit any "interested stockholder" from engaging in any "business combination" with a target corporation for a period of three years after becoming an interested stockholder, unless the business combination or the purchase of shares was approved by the target corporation's board of directors before the acquirer became an interested stockholder. 14/ Proposed section 203(c)(3) defines "business combination" to include, inter alia, any merger or consolidation of the target company with the interested stockholder, or any sale, lease, exchange, or other disposition of important assets of the target corporation to or with the interested shareholder. 15/

Effect of "Business Combination" Restrictions on Takeover Activity

Proposed section 203 would tend to insulate incumbent corporate management from contests for corporate control. 16/ The successful bidder for corporate control most commonly seeks to consolidate the target into its operations through a mer-

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14/ Proposed section 203(a) also exempts any stockholder who acquired at least 90 percent of the corporation's shares in the transaction in which it became an interested stockholder or a stockholder who acquired at least 90 percent of the corporation's shares after becoming an interested stockholder and who obtains a majority vote of the remaining stockholders approving the business combination.

15/ Among other things, section 203(c)(3) would prohibit any type of disposition to or with an interested stockholder of assets of the target corporation having a market value of ten percent or more of either of the aggregate market value of the target firm's assets or the aggregate market value of the target firm's stock, or the issuance or transfer to an interested stockholder of shares in the target corporation.

16/ The importance Section 203 gives to management's interests is shown by the fact that even a vote of the "disinterested" stockholders to opt out of the statute and thereby facilitate the transfer of corporate control does not become effective for 18 months. § 203(b)(4).

ger. 17/ Section 203 would prohibit management-opposed bidders from merging target corporations or engaging in a number of common business activities for three years after acquiring target company shares. In addition, section 203 would prohibit the sale or other disposition of substantial target company assets to or with such bidders for three years. Since many corporate acquirers finance acquisitions through debt securities that are then partially retired through the sale of some acquired assets, this prohibition would, at a minimum, significantly increase the cost of financing takeovers. Proposed section 203 also effectively blocks corporate acquisitions for the purpose of redeploying assets to more efficient uses. By discouraging acquisitions whose profitability depends on the ability of the acquirer to dispose of corporate assets, proposed section 203 is likely to undermine market mechanisms that shift assets to their most valued uses. For these reasons, a three-year ban on business combinations in many cases is likely to have the same effect as an outright ban on takeovers that do not receive the blessing of target companies' management.

Empirical Evidence on Effect of Anti-Takeover Legislation

Two 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 18/ similar to section 203 analyzed the extent of the economic harm caused by restrictions on "business combinations." 19/ 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. 20/ As the study noted in conclusion: 21/

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

18/ New York Bus. Corp. Law § 912.

19/ 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).

20/ Id. at 41, 46-47.

21/ Id. at 47.

> [D]espite the political rhetoric advocating the regulation of takeovers on behalf of stockholders, 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.

Another study, conducted by the office of the Chief Economist of the Securities and Exchange Commission, also confirms 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 directors to consider the interests of persons other than the shareholders in assessing takeover bids. 22/ 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.

Consideration of an "Opting-In" Mechanism

If the Council decides to recommend the enactment of proposed section 203 in some form, despite the concerns discussed above, we suggest that the Council consider modifying the bill to make it inapplicable to corporations that do not affirmatively elect to be covered by its provisions through amendments to their certificates of incorporation. In its present form, proposed section 203 applies to all corporations that do not "opt out."

A decision to limit shareholders' right to transfer corporate control is a serious matter that should require affirmative shareholder action. A requirement that shareholders approve a decision to opt into proposed section 203 could ensure that shareholders have a voice in determining whether the corporation requires the "protection" offered by this proposed legislation. We recommend that a corporation's decision to opt into the statutory scheme be made solely through a shareholder vote amending the certificate of incorporation.

22/ 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.).

Conclusion

Corporate law should remain neutral in contests for corporate control, providing an advantage neither to acquirers nor to target managements. Neutrality of the law with respect to takeovers promotes shareholder sovereignty, economic efficiency, and consumer welfare. As the owners of corporations, shareholders are the most motivated, and best equipped, to determine in each case whether a takeover bid is beneficial. It is their capital that is at risk if they make an incorrect decision. The unimpeded ability of shareholders to transfer control of corporations to outside bidders is important for ensuring that American corporations remain competitive. Proposed section 203 is inconsistent with these principles.

We believe that proposed section 203 is an undesirable reaction to corporate takeover activity. Corporate takeovers can and do adversely affect the financial interests of some parties, but this fact alone is not a proper basis for imposing serious constraints on a commercial endeavor that produces more benefits than costs. Vigorous takeover activity is important to a sound and healthy domestic economy. It should not be curtailed to preserve the status quo and protect incumbent managers from challenge.

Sincerely,

Terry Calvani
Commissioner

Daniel Oliver /DSC
Daniel Oliver
Chairman

END

PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION OF COLORADO
1300 Logan Street Denver, Colorado 80203 (303) 832-9550

December 14, 1987

David B. Brown, Esq.
Secretary, Council of Corporation Law Section
Potter, Anderson and Carroon
350 Delaware Trust Building
Wilmington, Delaware 19801

Re: Antitakover legislation.

Dear Mr. Brown:

On behalf of the Public Employees' Retirement Association of Colorado I am writing to you in response to the current antitakeover legislation being proposed by the Delaware bar council scheduled for vote on December 18, 1987.

We, at PERA are sensitive to shareholders interests and feel that this type of legislation, if inacted in its current form, would not be in the best interests of the common shareholder. Our fund is approximately 7 billion in assets and we are considered a major institutional investor and fully support the rights and interests of all shareholders.

It would appear that this legislation would be extremely cumbersome and restrictive for companies wanting to acquire, or gain control, of other companies without managements approval. The negative effects would seem to have a far reaching and adverse affect on our countries competitiveness in terms of corporate growth. We do not support unethical corporate raiders nor entrenched incompetent management. We do support a freely competitive market however. This legislation would not only greatly hinder that competitive process but it would be very expensive for shareholders. The former Securities and Exchange Comission Economist Greg Jarrell pointed out that the adoption of this type of antitakeover statute could cost shareholders up to $50 billion. If we expect continued corporate growth in America we do not feel it should be impeded by this type of initiative.

Thank you for the opportunity to voice our concerns and if you would like any additional information please call me at (303) 832-9550.

Sincerely,

Norman Benedict

Norman G. Benedict
Deputy Executive Director

EXECUTIVE OFFICERS
Robert J. Scott, Executive Director
Norman G. Benedict, Deputy Executive Director
Steven R. Brown, Deputy Executive Director
Nancy A. Williams, Deputy Executive Director

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

December 8, 1987

Mr. Norm Veasey
Richards, Layton & Finger
One Rodney Square
P. O. Box 551
Wilmington, Delaware 19899

Dear Norm:

Thank you for your letter of November 19th requesting my comments or suggestions on the exposure draft of the proposed Delaware takeover legislation.

In an October 7, 1987 speech to the 26th Annual Corporate Counsel Institute in Chicago, a copy of which is enclosed, I stated the following:

> "Limitations on the free transferability of securities of corporations which are owned by shareholders nationwide diminish the efficiency, depth, and liquidity of the nation's securities markets. Accordingly, I believe that Federal law should control in that area by preempting state statutes that unduly interfere with the free transferability of securities. I believe that corporations whose activities and ownership are national in scope should not be given protection against takeovers by the states where their primary production facilities are located. Just as I believe it to be imprudent for Congress to regulate internal corporate affairs through tender offer regulation, I believe it is imprudent for states to use their authority over matters of internal governance as a means of regulating the interstate market for corporate control."

Sincerely,

David

David S. Ruder
Chairman

DSR:klm

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE SECRETARY

December 10, 1987

Council of the Corporation Section
of the Delaware Bar Association
c/o David B. Brown, Esq.
Secretary of the Council
Potter Anderson & Corroon
350 Delaware Trust Building
P. O. Box 951
Wilmington, Delaware 19899

Dear Council Members:

I appreciate the opportunity to submit my views on th proposed Delaware business combination legislation which the Council will be considering on December 11, 1987 and which may be considered by the Delaware legislature early next year. I must emphasize that the views expressed herein are my own, and not necessarily representative of those of the Commission.

I think we can all agree on the importance of any action taken by the Delaware legislature with respect to matters of corporate law. 1/ I can also appreciate Delaware's desire to stay on the leading edge of corporate law developments, particularly in the takeover area, where there is a dramatic impact upon corporate structure. Nonetheless, it is equally important to recognize that action for the sake of action is unwise and inappropriate. In this regard, Delaware exercised sound judgment in not rushing to adopt an Indiana-type statute in light of CTS. At least half of the states that did adopt such statutes, did so with a clearly protectionist purpose with overnight

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1/ Apart from its preeminence in matters of developed corporate law, it's especially important to note that action by Delaware is likely to impact upon Congressional consideration of preemptive legislation.

specials designed to preclude a hostile takeover of a "hometown" company. 2/

The new proposed legislation is likewise not warranted. There is simply not a demonstrated need for such legislation, 3/ and it's constitutional validity is a open question under the CTS analysis.

The focus of Delaware's concern in proposing this legislation at issue appears to be "coercive" takeovers, where minority shareholders are "squeezed out" on unfavorable terms. 4/ Although the incidence of third-party two-tier tender offers is limited 5/ and their adverse or coercive effects open to debate, if Delaware believes that they present shareholder protection concerns, then the legislation should specifically restrict two-tier offers and not restrict offers which do not present these concerns. 6/ If legislation were to eliminate the coercive nature of front-end loaded bids by providing that shareholders in a second step takeout would be assured of

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2/ E.g., North Carolina-Burlington, Washington-Boeing, Minnesota-Dayton Hudson, Massachusetts-Gillette/Kenner Parker, and Florida-Harcourt Brace Jovanovich.

3/ According to published reports, some large companies currently incorporated in Delaware, such as Boeing, have threatened to reincorporate in a more "favorable" jurisdiction. Admittedly, such threats, if they are acted upon, would not be without consequence to the state since a significant portion of the states revenues are derived from corporation fees. Nevertheless, this does not appear to be a factor in any court's analysis of such statutes. I would further note that while nearly 50% of the Fortune 500 are incorporated in Delaware, the resident shareholders population is de minimis.

4/ See, "Delaware May Staunch Leveraged Takeovers," Investment Dealers Digest 47 (November 23, 1987).

5/ There were only six third-party two-tier tender offers during fiscal 1987.

6/ The legislation would also need to include offers by issuers, since defensive recapitalizations can have the same "coercive" effects.

receiving the same compensation, then shareholders would in a position to reasonably assess the economic merits of an offer and could accept it or reject it accordingly. T Board of Directors' role would not be usurped -- it could still make a recommendation regarding the offer and, with the exercise of proper business judgment, take steps to fend off what it perceived to be an inadequately-priced bid. This kind of approach would reasonably supplement federal tender offer regulation which provides that shareholders be treated equally in a tender offer, but which does not otherwise require equal treatment in a second step transaction. 7/ The proposed legislation, although not as onerous as the New York statute, still go too far in that it would affect all tender offers, even fairly-priced any and all cash offers with a back-end takeout on the same terms. As an aside, the assertion by some proponents of antitakeover legislation, notably Mr. Lipton, that the proposed legislation would further tip t balance in favor of raiders is, quite frankly, incredible Certainly this legislation is not the most restrictive th could be adopted, but it obviously does not favor takeove bidders, and in all likelihood would have a significant chilling effect on the making of bids in the first instance.

Moreover, the proposed legislation's constitutional validity is open to question under the CTS analysis. Admittedly, it contains a number of "escape clauses" whic increase the likelihood that it would survive challenge, but it is still not certain that it would pass constitutional muster. Specifically, while the Supreme Court indicated in its Commerce Clause analysis that Indiana had an interest in protecting domestic companies and resident shareholders, it noted that every applicatio of the Indiana act would effect a substantial number of Indiana residents. 8/ This would rarely, if ever be, the case in Delaware. Furthermore, the Delaware legislation would not, as noted by the Court in its Supremacy Clause analysis, allow shareholders to evaluate the fairness of

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7/ See Rule 14d-10 under the Securities Exchange Act of 1934 (the "All-Holders and Best-Price Rule"), 17 CFR 240.14d-10.

8/ CTS Corp. v. Dynamics Corp. of America, __ U.S. __, 107 S.Ct. 1637 (1987).

the offer collectively. 2/ With the proposed Delaware legislation an offeror would be precluded from proceeding with a merger even if approved by a majority of shareholders.

Regardless, however, of the constitutional merits of the proposed legislation, as noted above, it would operate more to entrench management rather than to provide effective protection of shareholders. Current decisional law, in Delaware and other jurisdictions, allows Boards of Directors substantial latitude in responding to unsolicite takeover attempts. These issues should continue to be resolved on a case by case basis, or addressed by legislation which clearly and specifically focuses upon shareholder protection concerns.

Sincerely,

Charles C. Cox

Charles C. Cox
Commissioner

2/ Id. The Court concluded that the Indiana statute did not upset the Williams Act policy of neutrality since it put the investment decision in the hands of shareholders, albeit collectively, thus favoring neither management nor the offeror. The Delaware legislation, on the other hand, gives the Board the authority and thus, arguably, upsets the neutrality policy.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

December 10, 1987

VIA TELECOPY

David B. Brown, Esq.
Secretary
Council of the Corporation Law Section
of the Delaware State Bar Association
c/o Potter, Anderson & Corroon
350 Delaware Trust Building
P.O. Box 951
Wilmington, Delaware 19899

Summary. Delaware, as the pre-eminent corporate domicile, should not precipitously adopt a sweeping antitakeover law and should carefully consider the broader implication of any such action. Proposed Section 203 is a highly effective and discriminatory antitakeover statute that will, if enacted, harm stockholders. It will also protect a class of hostile takeovers that may be least beneficial to the economy while deterring more desirable transactions. The proposed safeguards of a 90% acquisition test, circumscribed stockholder approval standard, and an opt-out provision are more cosmetic than real. Corporations and their stockholders already have the power to adopt charter amendments similar to Section 203, and an enabling approach based on an "opt-in" election presents a more fruitful avenue for consideration. Corporate threats to migrate from Delaware are overstated and the Council should most certainly reject all suggestions to make Section 203 more restrictive.

Gentlemen:

I greatly appreciate the invitation to comment on proposed business combination legislation that would be codified at 8 Del. C. § 203. The comments offered in this letter are the result of a preliminary analysis of the proposed legislation. With further opportunity for reflection and discussion with informed observers, I might change my perspective on certain matters discussed below.

At this point, however, I am troubled by the implications of the proposed statute, and believe that it would create a substantial impediment to hostile takeovers and corporate restructuring throughout the economy. I am also concerned that it would impose substantial losses on stockholders. Many of these concerns would be ameliorated if the statute is recast as an enabling provision that allows stockholders, acting by majority vote, the opportunity to elect to be governed by the provisions of proposed Section 203. Section 102(b)(7), adopted by the legislature in 1985, is cast in this more suitable form. The views expressed in this letter are my own and do not necessarily reflect the views of the Commission or of Commission staff.

I. Delaware's Special Role in Corporate Governance

Before addressing the merits of the proposed legislation it may be useful to consider Delaware's role in the national debate over corporate governance and takeovers.

Although only three-tenths of one percent of America's stockholders reside in Delaware,[1] about 56% of the Fortune 500 and 45% of the companies listed on the New York Stock Exchange are chartered in Delaware.[2] The disparity between Delaware's position as the pre-eminent corporate domicile and its role in the national economy has been the subject of extensive comment.[3]

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[1] New York Stock Exchange, Fact Book 1987, at 57.

[2] See Barrett, Delaware Moves Closer to Adopting Law to Deter Hostile Takeovers, Wall St. J., Dec. 9, 1987, at 41, col. 4. Delaware's influence would be greater still if measured by a capitalization weighted index.

[3] See, e.g., Baysinger & Butler, Race to the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. Corp. L. 431 (1985); Nader, The Case for Federal Chartering, in R. Nader & M. Green, eds., Corporate Power in America (1973); Schwartz, A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125 (1976); Henning, Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come, 21 DePaul L. Rev. 915 (1972).

Some commentators suggest that Delaware's dominant position is the result of an efficient competitive process.[4] Under this view, Delaware's position as a corporate domicile is the socially beneficial outcome of a regulatory regime that promotes efficient corporate decisionmaking and provides competence and predictability in resolving corporate disputes. Proponents of this view believe that a federal corporation law is undesirable because it would preclude healthy competition among the states.[5]

Other commentators suggest that Delaware's pre-eminent position as a corporate domicile is the result of a "race to the bottom" in which states aggressively cater to management interests at the expense of stockholders and other corporate constituencies.[6] Under this view, Delaware's position as a corporate domicile is the result of its willingness to accede to management desires at the expense of stockholders and other social interests, and federal chartering of large public companies may be desirable.

For many years the evidence strongly favored the proposition that Delaware's pre-eminent position is the result of efficient competition and not the outcome of a race to the bottom. More recently, however, the evidence has been mixed, particularly with regard to state governance of the takeover process. Concerns have been raised that local political and economic interests may dominate a state's approach to corporate governance.[7] Moreover, studies have

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[4]See, e.g., Winter, State Law, Shareholder Protection and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977); Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982); Easterbrook, Manager's Discretion and Investor's Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540 (1984).

[5]See, e.g., Dodd & Leftwich, The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation, 53 J. Bus. 59 (1980); Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 Yale J.L. Econ. & Org. 225 (1985).

[6]See, e.g., Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974).

[7]See Macey & Miller, Toward an Interest-Group Theory of Delaware Corporation Law, 65 Tex. L. Rev. 469 (1987); Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111 (1987); Romano, The State Competition Debate in Corporate Law,

found statistically significant stockholder losses in response to a state's decision to adopt antitakeover legislation.[8] Some commentators thus argue that a state's incentive to maintain local revenues and to preserve intrastate social and economic interests may govern its decision to adopt antitakeover legislation regardless of adverse consequences to stockholders or larger social or economic constituencies.[9]

The antitakeover laws adopted by various states have not gone unnoticed in Washington. There is at present a divergence of views within Congress on whether states should be free to adopt widely varying antitakeover laws or whether federal law should provide a uniform playing field.[10]

I have, in the past, been a strong supporter of competition and diversity among the states in regulating corporate activity. For present purposes, however, one need not take a position in this debate. It is sufficient to recognize that Delaware's decision regarding Section 203, whatever that decision may be, will be taken into account in the ongoing "race to the bottom" controversy. If Section 203 is adopted, some observers will believe more strongly in the "race to the bottom" theory, and support for the "healthy

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0 Cardozo L. Rev. 709 (1987).

[8] See Office of the Chief Economist of the SEC ("OCE"), Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers (May 18, 1987); Schumann, State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statute (Federal Trade Commission, 1987). I am aware of studies by Margotta and collaborators that criticize the Ohio and New York studies and suggest no significant stockholder losses due to adoption of state antitakeover statutes. I find these criticisms and studies methodologically flawed and unpersuasive. See Margotta & Badrinath, Longer Term Effects of New York's 1985 Takeover Legislation (Northeastern Univ. Working Paper 87-39, 1987); Margotta, McWilliams & McWilliams, Longer Term Effects of Ohio Takeover Legislation (Northeastern Univ. Working Paper 87-40, 1987). I would be glad to describe my reservations regarding Margotta's methodology, should the issue be relevant.

[9] See, e.g., Macey & Miller, supra note 7.

[10] See, e.g., S. 1323, 100th Cong., 1st Sess.; H.R. 2172, 100th Cong., 1st Sess.

competition" theory may decline.[11] It is clear, moreover, that a decision by Delaware to adopt an antitakeover statute will be subject to far greater scrutiny and debate, and is more likely to provoke a federal response, than decisions by other states that do not have as dominant a role in the corporate chartering process.

Whether a federal response is desirable is an entirely different question. For present purposes it is sufficient simply to observe that enactment of Section 203 increases the probability of federal scrutiny.

II. Corporations Can Already Protect Themselves

Delaware corporations that wish to adopt protections analogous to proposed Section 203 already have the power to do so, in substantial part, by appropriate charter amendments.[12] Indeed, many Delaware corporations have already adopted a variety of antitakeover charter amendments, including fair price/supermajority provisions, straight supermajority requirements, anti-greenmail provisions, classified boards, blank check preferred stock, and dual-class recapitalizations.[13] Some antitakeover measures are adopted by corporate boards without prior stockholder consent. Poison pills are probably the best known example in this category. The more extreme antitakeover provisions have engendered substantial concern about harm to stockholders[14] and, in the

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[11] As Professor Romano has observed, "Takeovers are of particular interest because they generate a puzzle for the state competition literature. Some commentators who contend that state competition produces laws that benefit shareholders have also maintained that mechanisms which facilitate management's efforts to thwart hostile bids, such as actions codified by takeover statutes, are not in the shareholders' interest and should be banned." Romano, The State Competition Debate, supra note 7, at 726.

[12] I am not suggesting that a corporation could perfectly mirror Section 203. There seems little doubt, however, that a corporation could come quite close through the charter amendment process.

[13] See Rosenbaum, Takeover Defenses: Profiles of The Fortune 500 (Investor Responsibility Research Center, 1987).

[14] See, e.g., Gilson, The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept, 34 Stan. L. Rev. 775 (1982); Ruback, An Overview of Takeover Defenses (MIT Sloan School of Management Working Paper, Sept. 1986); Update--The Effects of Dual Class Recapitalizations on

case of dual-class recapitalizations, a federal response.[15] Despite the variety of approaches that Delaware-chartered companies have taken, I am aware of no corporation that has adopted a provision remotely similar to that embodied in the proposed statute.

The absence of such provisions in corporate charters suggests either: (1) that they are not desired by Delaware companies; (2) that if managers desire them, they do not believe stockholders would vote to approve them; or (3) that managers have not put the issue to a vote because the process by which legal innovations are diffused through the corporate community has not yet reached a point where such measures are under active consideration.

If managements desire protections equivalent to Section 203, but have not sought to adopt them through the charter amendment process because they expect stockholders would reject such proposals, then legislation would impose upon stockholders a restriction that they would not voluntarily adopt. Such an approach is inconsistent with Delaware's traditional reliance on an enabling approach that looks to stockholder ratification as an important safeguard in the decision to delegate authority to management.

Delaware's recent decision to require stockholder approval as a condition for the duty of care exemption in Section 102(b)(7) is an example of the enabling approach properly applied. Proposed Section 203 is an example of the concept misapplied in a fashion that prevents stockholders from expressing their preferences. Indeed, instead of an opt-

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shareholder wealth," including evidence from 1986 and 1987 (July 16, 1987) (mean shareholder losses of 0.9% from dual-class recapitalizations); OCE, The Effects of Poison Pills on the Wealth of Target Shareholders (Oct. 23, 1986) (mean shareholder losses of 1.7% from poison pill adoptions); OCE, Shark Repellants and Stock Prices: The Effects of Antitakeover Amendments Since 1980 (mean shareholder losses of 3.00% from adoption of supermajority provisions, classified boards, and blank check preferred stock; statistically insignificant losses of 0.7% from adoption of fair price/supermajority provisions).

[15] See Securities Exchange Act Release No. 34-24623, 52 Fed. Reg. 23665 (1987) (notice of proposed rule 19c-4 concerning dual-class recapitalizations); H.R. 2172, supra note 10.

in provision as found in Section 102(b)(7), Section 203 relies on a largely illusory "opt-out" provision which provides no meaningful safeguards.[16]

Most fundamentally perhaps, the failure of companies to adopt similar provisions on their own, despite statutory power to do so, suggests that the statute may either be unnecessary or contrary to the will of stockholders. Reformulating the statute as an enabling provision would effectively address these concerns and facilitate stockholder consideration of an alternative that should stand or fall on its own merits, in the context of the particular circumstances encountered by individual corporations and their stockholder.

III. The Exceptions Don't Work

Section 203 provides three mechanisms through which its three-year standstill provisions can be avoided: (1) through an acquisition that takes a stockholder from less than 10% ownership to more than 90%; (2) through an acquisition approved by majority vote of the independent stockholders; and (3) through a stockholder vote to opt-out of the provisions of the section. Unfortunately, these exceptions don't work. If these provisions are to provide real relief from an otherwise overbroad statute, they need substantial revision.

A. The 90% Rule

The first exception from uniform application of the three-year standstill applies to a bidder who owns less than 10% of a target's shares and moves to at least 90% in a single transaction. This provision is far from being the "barn-door size exception" some have suggested.[17] Indeed, I am aware of no case in which a tender offer obtained more than 90 percent of the target's shares despite management opposition as expressed in a recommendation not to tender and in management's decision not to tender its own shares. A comprehensive examination by the SEC's Office of the Chief

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[16]Part III.C. below discusses the "opt-out" provision in more detail.

[17]See memorandum dated November 23, 1987 from M. Lipton of Wachtell, Lipton, Rosen & Katz to clients.

Economist of all hostile tender offers between 1982 and 1987 (144 offers) has also found not a single case in which a hostile bidder received over 90% of the outstanding shares.[18]

Apparently, the combination of opposition by the target's managers, who do not tender their own shares, the existence of some stockholders who accept management's recommendation not to tender, and the inevitable presence of some nonresponsive stockholders who would not tender into any offer, no matter how attractive, makes it extremely difficult to purchase more than 90% of the outstanding shares in a single step without management support. Nonresponsive stockholders are not opposed to the offer, they are simply nonresponsive. The presence of nonresponsive stockholders--who can account for more than five percent of a publicly traded corporation's shares--stacks the deck against any bidder who must accumulate a 90 percent block. It also means that a very small percentage of a corporation's stockholders (target managers, for example, or an ESOP) may have effective veto power over use of this exception.

The exception should be revised to prevent a small group of dissenters from thwarting the preferences of a substantial majority. This can be accomplished in at least two ways. First the threshold can be lowered from 90 percent to 75 percent or some other realistic figure. That would require meaningful opposition in addition to the usual background noise generated by nonresponsive stockholders. Second, the approval percentage can be expressed as a percentage of shares

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[18]Source: Memorandum from Kenneth Lehn, Chief Economist, Securities and Exchange Commission (December 8, 1987). In only one case did a nominally hostile acquisition result in more than 90% of the outstanding shares being tendered. That case was Pantry Pride's tender offer for Revlon, Inc., where no merger agreement was signed but management decided to tender its own shares and facilitate an orderly transfer of control after Pantry Pride won a lawsuit enjoining Revlon's lock-up option. See Wall St. J., Nov. 4, 1985, at 2 col. 2.

tendered by disinterested stockholders.[19] A combination of the two approaches may also be better than either alone.[20]

B. The Majority Vote Exception

The second exception to the three-year freeze is where the bid has been approved by a majority of independent stockholders. This provision, too, has major flaws that make it likely to be of limited practical value.

First, it is not clear from the wording of the proposal whether the vote by independent stockholders is to take place before or after the interested stockholder acquires 90% of the outstanding voting stock. If the vote takes place afterward, it may be almost impossible to obtain a favorable vote because of difficulty in convincing nonresponsive stockholders to vote at all. The sellers of the 90% stake are likely to be the more active stockholders, and thus also the ones most likely to vote. Those that remain will be disproportionately nonresponsive. Thus, even though a transaction has been approved by far more than a majority of independent stockholders through the action of tendering, a majority vote of the small number of remaining stockholders might not be possible. If the exception is intended to permit a vote in advance of crossing the 90% threshold, this should be clarified.

Second, there is no provision in Section 203 by which a bidder wishing to buy 90% of the outstanding shares can require the corporation to hold a vote on the matter in any reasonable period of time. A stockholder who does not control the corporation and its board of directors can obtain such a vote only by conducting a proxy fight at the time of the annual meeting. A proxy fight adds substantial cost to a

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[19]This would prevent a target's managers from vetoing an attractive bid simply by refusing to tender their own shares. This proposal is analogous to the provision in Section 203 for waiver of the three-year freeze if a majority of independent stockholders approve a second step transaction after the original bidder exceeds ten percent ownership.

The Council should also consider excluding shares held in employee plans from the independent stockholder category. Otherwise management may be able to create a virtually absolute bar to use of the exception by contributing shares to an employee plan with pass-through voting.

[20]By observing that improvements can be made that would limit the harmful effects of the proposed bill, I do not mean to suggest that I would endorse the bill if so modified.

takeover bid, and the substantial delay vitiates much of the protection provided by the statute.[21] This long, built-in delay stands in marked contrast to the Indiana approach, as approved by the Supreme Court in the CTS case. There, the Court emphasized that Indiana's antitakeover statute required the corporation to hold a stockholder vote within 50 days, a time period that the Supreme Court found to be reasonable.[22]

The majority vote provision may also have the perverse effect of encouraging two-tier takeovers, an art form that has become relatively rare as used by hostile bidders (although it is still alive and well as a takeover defense).[23] An offeror who makes an any-and-all offer but fails to reach the 90% level may have trouble obtaining a majority vote from the remaining stockholders, who either were nonresponsive or opposed the offer. However, without acquiring control and ousting the existing board of directors, the bidder cannot obtain a timely stockholder vote at all. Therefore, one would expect bidders to adopt a strategy of buying 51% of the outstanding shares in a first step tender offer, leaving enough shares outstanding so that a vote in favor of a second step can be obtained. Thus, the statute may well deprive stockholders of any-and-all offers and push bidders into making partial and two-tier offers. In light of concerns expressed by the Delaware courts and others about two-tier tender offers,[24] this may not be a desirable statutory scheme.

A statute that requires a company to hold a stockholder vote within a short period of time (e.g., 50 days as in Indiana) at the request of, say, a five percent stockholder, and allows a one-tier, any-and-all offer to have a fair chance of success avoids at least some of these problems.

C. The "Opt-Out" Provision

The opt-out provisions, as crafted, are wholly ineffective. To opt out other than by a stockholder initiated bylaw amendment requires approval by the board of directors.

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[21]Even a majority shareholder may have to wait for the next annual meeting if the target has a staggered board and the directors refuse to call a special meeting.

[22]CTS Corp. v. Dynamics Corp. of America, ____ U.S. ____, 107 S. Ct. 1637 (1987).

[23]See Grundfest, Two-Tier Bids are Now a Defensive Tactic, Nat'l L.J., Nov. 9, 1987, at 26.

[24]See, e.g., Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

Few directors are likely to support a proposal that reduces their discretion and makes a hostile takeover more probable. Opt-out provisions that rely on board approval are thus much more cosmetic than real. Moreover, even if boards willing to subject themselves to a greater probability of a hostile takeover could be found, the 45-day window for directors to opt out of the provision is unduly short, especially since the directors of many corporations may not even meet in a given 45-day period.

Since opting out by boards of directors is likely to be both uncommon and uncontroversial, the more important source of opting-out is stockholder action. This, too, is made unusually, even deliberately burdensome. For the stockholders to opt-out without affirmative action by the board of directors a stockholder must first wait up to a year for the next annual meeting.[25] Second, the stockholder must sustain the considerable expense of mounting a proxy fight to have a reasonable chance of success. Third, even if the stockholders vote to opt out, their action will not become effective until 18 months after it is adopted. During this period the board would be free to engage in a wide spectrum of defensive maneuvers, asset sales, and corporate restructurings. I know of no other situation where such a delay is imposed before a stockholder-adopted bylaw takes effect. Moreover, an interested stockholder's vote is sterilized in the voting process, but management's "no" vote is counted. All this seems more than sufficient to discourage any rational stockholder from ever seeking to opt out of Section 203 by stockholder vote.

If Delaware really believes that the three-year freeze is a matter on which stockholders should make the ultimate decision, the appropriate procedure would be to use an "opt-in" format, similar to that used in Section 102(b)(7) relating to director liability for breach of the duty of care). Managers would have ample incentive to bring such a proposal to the stockholders for a vote. The stockholders, in turn, will have an opportunity to consider the proposal on its merits, without the roadblocks and expenses that the current version places in the path of a stockholder seeking to cause a company to opt out of Section 203. If desirable, the statute could provide for a vote of independent stockholders, excluding both management and any interested stockholder.

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[25]Under the SEC's proxy rules, a shareholder who does not want to conduct a separate mailing must submit a proxy proposal to the corporation almost six months in advance of an annual meeting. This could stretch the pre-meeting lead time to as much as 18 months.

IV. The Statute's Deterrent Effect

A. Disincentives for Hostile Takeovers

The best information regarding the potential effect of standstill provisions similar to those proposed in Section 203 comes from New York, where a similar statute with a five-year standstill and fewer exemptions has been in effect since 1985. Although cause and effect cannot be definitively established, to the best of my knowledge there has not been a single hostile takeover attempt against a New York corporation since the New York law was adopted.

The three-year standstill provision will create substantial barriers to hostile takeover activity. It will make financing takeovers more difficult and expensive and reduce the incentives to engage in many beneficial takeovers. It will also create the possibility of back-end loaded transactions into which few stockholders will tender because of the prospect of "free-riding" on the acquirer's activities becoming a holdout who will have to be "bribed" with a payment that exceeds the tender offer price.

Financing will be more difficult and expensive because bidders will be forbidden for a three-year period from merging the acquired company into the entity that issued the debt used to finance the acquisition, or from realizing the full benefits of divestitures. At a minimum, this will substantially increase carrying costs and increase risk to lenders. As a practical matter, it may also make financing difficult if not impossible to obtain for many transactions.

In addition to its effect on financing, the statute will also inhibit takeovers motivated by a desire to improve efficiency by combining similar operations or by divesting operations that can be better run by someone else. Efficiencies from combining similar operations can only be realized by merging the operations of the bidder with those of the target. The statute, however, prohibits such a merger for three years after a hostile takeover. The consequences are a loss in aggregate efficiency, fewer transactions, and lower premiums to target stockholders.

Efficiencies from divestitures can still be realized in sales to third parties, but the gains must be shared with minority stockholders. Thus, there is a real risk that stockholders who would otherwise tender may instead adopt free-riding and holdout strategies. If a tendering stockholder expects a bidder to sell off target assets and pay out the proceeds in dividends so as to pay down debt, the stockholder may decide that the value of nontendered shares exceeds the value of tendered shares. This will often be the

case because the price the bidder offers in the tender will presumably leave room for the bidder to earn a profit in the transaction. By holding out, a stockholder can obtain a free-ride on the value of the gains that would otherwise accrue to the bidder. This is especially true if the corporation has a fair price provision that precludes a lower-valued second step notwithstanding payment of extraordinary dividends. If too many stockholders decide to free-ride on the transaction, too few shares will be tendered and the offer will fail.

Second, if stockholders expect the bidder to provide a sweetener to induce nontendering stockholders to approve a second-step merger, they again may refuse to tender because they want to receive those extra benefits. Again, this creates an incentive not to tender that would otherwise be absent, and may cause a transaction to fail.

Corporate law has generally sought to minimize the problems created by free-riding and holdout incentives. Freeze-out mergers, combined with an appraisal remedy to ensure fair treatment of minority stockholders, are the usual response to these problems. It is curious now to see a proposed statute that may create these problems as a byproduct of an effort to quell hostile takeovers.

B. Special Treatment for Conglomerate Acquisitions

Conglomerate acquisitions generally involve a large company buying a smaller firm. These transactions are often funded out of cash on hand or borrowing that can be repaid from excess internal cash flow at the acquiring firm. These conglomerate acquisitions are the only hostile acquisitions that would not be significantly affected by Section 203. Because the acquisition is conglomerate in nature, there is no need to integrate the target's operations with the bidder's existing operations, and because access to the target's cash flow or assets is not needed to repay debt, little concern arises over the three-year ban on a second-step merger. Thus, these transactions can go on largely unaffected by the standstill prohibitions.

The statute's lesser impact on conglomerate acquisitions is a source of concern because there is substantial theoretical and empirical reason to believe that these transactions are least likely to involve efficiency gains. Instead, they are more likely to involve reshuffling of assets to satisfy managers' desire to expand the size of their firms through strategies that benefit neither stockholders nor the

economy.[26] Indeed, there is substantial evidence that most empire-building conglomerate acquisitions ultimately fail and that the acquired operations are divested.[27]

The statute is also discriminatory in that it will permit large corporations to buy small corporations, because the large acquiror will be able to sustain the burden of not being able fully to integrate operations or realize the full gains from sales of assets for three years, but will make it much harder for small corporations to buy large corporations. When a large company buys a smaller company, the smaller company is more likely to be in a single industry business, so that economic efficiency does not require selective disposition of assets. In contrast, when a small corporation buys a larger corporation, rapid integration of operations is more likely to be critical to the takeover's success. Also, the larger corporation will often operate in several lines of business, some of which may be a poor fit with the acquirer's business plans. Section 203 would impede disposition of these poorly fitting businesses.

In short, Section 203 discriminates in two ways: (1) it protects potentially inefficient conglomerate acquisitions and penalizes more efficient types of takeovers; and (2) it protects large companies (who can make hostile bids but are unlikely to be targets of such bids), and puts at risk small companies (who will be unable to make hostile bids but can still be targets of hostile bids by large companies).

V. Will Corporations Migrate?

Press reports suggest that threats by one or more corporations to migrate from Delaware to jurisdictions that have more stringent antitakeover regimes have, in part, motivated the Council's decision to recommend antitakeover

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[26] See, e.g., Levy & Sarnat, Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers, 25 J. Fin. 795 (1970); Melicher & Rush, The Performance of Conglomerate Firms: Recent Risk and Return Experience; Ravenscraft & Scherer, Mergers, Sell-Offs and Economic Efficiency 217 (Brookings Inst. 1987) (providing extensive evidence on the "dubious payoffs and appreciable risks of conglomerate merger-making.")

[27] See Porter, From Competitive Advantage to Corporate Strategy, Harv. Bus. Rev., May/June 1987, at 43 (noting the "dismal" track record of most diversification efforts by large companies); Ravenscraft & Scherer, supra note 26.

legislation.[28] Careful analysis of these threats suggests, however, that they may not be credible.

The threat to migrate is not credible for several reasons. As an initial matter, any management that seeks stronger antitakeover protections has at least two courses of action available to it. It can try to reincorporate in another state or it can try to adopt antitakeover charter amendments. In either event, stockholder approval is necessary. A proposal to migrate from Delaware will require full and accurate disclosure under the federal securities laws of the antitakeover rationale for the move. Similar disclosure would have to accompany antitakeover charter provisions.

Assuming, arguendo, that managers and stockholders are given a choice between (1) reincorporating in another state and (2) remaining in Delaware but adopting antitakeover charter amendments that provide protections functionally equivalent to those offered by the foreign state, which would they prefer? For a variety of reasons, I believe that both managers and stockholders would prefer to remain in Delaware with stockholder-approved antitakeover measures rather than migrate to another state. The greater certainty of the law in Delaware and the expertise of the judiciary are only two of the many arguments that would tilt the balance in Delaware's favor.

If stockholder approval can be obtained then there is no need to leave Delaware to achieve the desired level of protection against takeovers. Stockholders will approve charter amendments as quickly as a proposal to migrate. But if a battle over approval is likely, management will have greater flexibility and a better capacity to respond to stockholder objections if it fashions a series of charter amendments subject to approval than if it simply tries to migrate to another jurisdiction where stockholders will be ceding control to a legislature, judiciary, and bar with less experience than Delaware's in corporate matters. The argument that migration is inevitable if Delaware does not adopt an antitakeover statute is therefore not persuasive.

To the best of my knowledge, no corporation has actually migrated from Delaware to take advantage of any antitakeover provision. Precipitous action in response to a conjectural threat that is unlikely to be credible is not wise. This is particularly the case because Delaware will have the opportunity to fashion a response in a timely manner if the threat later turns out to be material.

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[28] Barrett, supra note 2.

VI. Should the Bill Be Stronger?

Press reports suggest that some observers believe that proposed Section 203 is not a sufficient deterrent to takeover activity.[29] These observers suggest that Section 203 be strengthened or abandoned in favor of a more aggressive antitakeover bill.

This is precisely the wrong advice. As already explained, the Delaware statute has real teeth. If anything, it has too many teeth. The argument that stronger impediments are necessary is based on conjecture, particularly in light of the fact that the statute is modelled on a New York law that has successfully stopped all hostile takeovers.[30]

The debate will be difficult enough if Delaware proceeds with the proposal currently on the table. The issues will only be exacerbated if Delaware adopts a measure that is at all stronger than proposed Section 203 without affording interested parties a further opportunity to comment.

VII. Procedure Before the Legislature

Down the road, if and when Delaware's legislature has an opportunity to consider Section 203, it will be important to respect principles of procedural due process and afford interested parties an opportunity fairly to be heard. This is especially true in light of the limited period provided for comment on the Council's proposal. The legislature has a right to conduct its own inquiry into the merits and drawbacks of legislation submitted before it. The need for independent scrutiny is all the more pronounced when a proposed amendment to Delaware's Corporation Code has clear national significance, affects several substantial constituencies with no direct voice in Delaware's affairs, and raises questions that have been at the center of an extensive national debate. The

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[29] See, e.g., Clough, Lipton Suggests Revisions to Controversial State Takeover Measure, Investment Dealers' Digest, Dec. 7, 1987, at 16.

[30] The criticism that Indiana-type statutes "don't work" because they allow a potential bidder to put a company in play also strikes me as flawed because it ignores the significant procedural impediments inherent in the Indiana-type voting process and overlooks management's ability to engage in defensive maneuvers during the long delay mandated by statute. Accord, Bartlett, Beware of State Takeover Laws: Contrary to What Some Experts Say, They Do Have the Power to Stop Raiders in Their Tracks, Fortune, Nov. 9, 1987, at 179.

need for scrutiny is also enhanced by the complex and untested nature of the proposed legislation. Whatever the substantive conclusion of Delaware's legislative process, it will be valuable for Delaware to establish a public record that clearly supports its conclusion and rebuts any possible suggestion that legislation was adopted with less than the fullest care and consideration.

VIII. The Constitutional Question

I express no opinion on whether proposed Section 203 would or should be considered constitutional following the Supreme Court's decision in CTS Corp. v. Dynamics Corp., 107 S. Ct. 1637 (1987). I observe, however, that a provision fashioned as an opt-in proposal that requires a majority vote of stockholders, wherever they may reside, raises a set of constitutional issues quite different from those presented by the present version of Section 203.

IX. Conclusion

I have serious reservations concerning the adverse consequences that would follow adoption of Section 203. Many of these reservations would be diminished if Section 203 were recast as an enabling provision pursuant to which stockholders could elect by majority vote to adopt certain back-end restructuring prohibitions. I greatly appreciate the opportunity to share my views with the Committee.

Sincerely,

Joseph A. Grundfest
Commissioner

cc: Members of the Council



OFFICE OF THE COMMISSIONER

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 18, 1987

VIA TELECOPY

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Gentlemen:

In the week since the Council's December 11 meeting, I have had the pleasure of discussing proposed Section 203 with several members of the Delaware bar. These conversations have stimulated many further observations about the probable consequences of the proposed legislation. Time constraints prevent me from addressing the full range of issues that have been raised. Accordingly, I will limit my comments to a single issue on which the introduction of empirical data may assist the Council in its deliberations.

Clifford L. Whitehill, Senior Vice President, General Counsel, and Secretary of General Mills, Inc., observes in his comment letter that, "the most important provisions which should be reviewed as to a compromise [include] reducing the 90 percent to perhaps 80 percent." Mr. Whitehill is referring to the 90 percent thresholds of Sections 203(a)(2) and (a)(3). In my letter of December 10, I suggested that those thresholds be reduced to 75 percent. I further suggested that the thresholds be reformulated to apply only to shares tendered by disinterested stockholders. Mr. Whitehill also suggests that, in the event an opposed tender offer achieves less than his suggested 80 percent, "a supermajority of the remaining disinterested shareholders could still approve a merger." I am informed that there is also support for an 85 percent threshold as well as for the originally proposed 90 percent standard.

I have heard a range of predictions about how easy or difficult it might be to achieve a 90% tender rate in a fully hostile transaction. It seems that these assessments have been based largely on personal experience and highly

subjective assessments. In an effort to advance the discussion, this letter collects and analyzes data describing the likely consequences of various exemption percentages. As a caveat, I should emphasize that I have not had an opportunity to conduct a complete literature search. I am also informed that there are raw data within the Commission that, with further time and resources, could perhaps be analyzed to cast further light on the issue. I am, however, aware of no data that would substantially change the findings reported below. The views expressed in this letter are, again, my own, and do not necessarily reflect the views of the Commission or of Commission staff.

The analysis proceeds in four steps. First, I review available data that describe the size of management and other insider holdings. These data are relevant because they describe the frequency with which management can form a "blocking coalition." If the threshold is 90 percent, then management with a 10 percent holding can form a blocking coalition. If the threshold is 80 percent, then a 20 percent position is required for a blocking coalition. Whenever management can form a blocking coalition it will be impossible for a bidder to qualify for an exemption unless management tenders at least some of its shares. Under these circumstances, the exemptions will, as a practical matter be useless.

Second, I review the evidence regarding the percentage of shareholders that are nonresponsive. Because the threshold tests used in Section 203 rely on affirmative tender percentages, shareholders who simply abstain are effectively conscripted into the blocking coalition. Thus, to calculate the effective size of a corporation's blocking coalition, management and insider holdings must be aggregated with the probable percentage of shareholders who will be nonresponsive.

Third, I discuss the opportunities available for management to create or solidify blocking coalitions by placing shares with ESOPs or other friendly parties. As takeover lawyers know full well, the takeover process is highly strategic. The process is characterized by move and countermove and, as in a good game of chess, it is necessary to think more than one move into the future. Accordingly, it is incorrect to assume that current distribution of shareholdings will remain unchanged if the Delaware statute, as currently drafted, becomes law. Predictions based on current shareholder distributions more likely underestimate the frequency with which blocking coalitions can be formed because managements will take measures to create such coalitions.

Fourth, I explain why it is difficult to infer from observed tender offer percentages what actual tender offer ratios would be in the event the Delaware statute becomes law. Such predictions are difficult because they rely on a series of counterfactual assumptions that must be applied to a heterogeneous sample that is small relative to its degree of variability. Nonetheless, I offer some observations about how such data might be interpreted.

I. Evidence on Management Ownership

In considering the appropriate threshold percentage for the exceptions to the three-year freeze, it is important for the Council to consider how often the target's directors, by virtue of their stock ownership, will have an absolute veto over use of the exceptions simply by not selling their own shares.

Morck and Vishny. Table 1 provides data on stock ownership by the boards of directors of Fortune 500 firms as of 1980. The data were compiled by Professors Randall Morck and Robert Vishny of the University of Chicago based on information in the Corporate Data Exchange. Data were available for 454 of the 500 firms.

The Morck-Vishny data understate actual ownership because Corporate Data Exchange only reports individual ownership levels that exceed 0.2%. The data also understate management's blocking power because they exclude shares held by family members who are not directors and shares held by employees, either in employee plans or otherwise.

Table 1

Director Share Ownership for
Fortune 500 Firms, as of 1980

Mean for all firms . . . . . 10.6% Ownership

Percentage of firms with 5% director ownership 42.1%
Percentage of firms with 10% director ownership. . . . 31.7%

Director ownership in deciles:

for 10% of firms, directors own at least 35.0% of shares
for 20% of firms, directors own at least 20.3% of shares
for 30% of firms, directors own at least 10.8% of shares
for 40% of firms, directors own at least 6.5% of shares
for 50% of firms, directors own at least 3.5% of shares
for 60% of firms, directors own at least 2.3% of shares
for 80% of firms, directors own at least 1.2% of shares
for 90% of firms, directors own at least 0.5% of shares
for 100% of firms, directors own at least 0.0% of shares

Morck, Vishny & Shleifer. In a recent NBER publication, Morck, Vishny & Shleifer report that in friendly transactions the average board ownership is in excess of 20 percent.[1] In hostile transactions the board owns an average of 8.3 percent.[2] Average board ownership over the entire sample is 10.9 percent.[3] The authors find, however, that "while the hostile targets have a lower average board ownership than the whole sample, this difference is not statistically significant. The higher board

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[1]The sample is based on "all publicly traded Fortune 500 firms as of 1980. Of the 454 firms in the sample, 82 have been acquired or went through an LBO in the period 1981-1985." R. Morck, A. Shleifer & R. Vishny, Differences Between Hostile and Family Targets: Asset and Ownership Structure, National Bureau of Economic Research, Conference on the Economic Effects of Mergers and Acquisitions (Feb. 1987) at 3. The "characterization of acquisitions is based on the nature of the initial activity over the control of the company. An acquisition is called hostile if a hostile bid was followed by an acquisition by a white knight as well as if it was a straight successful hostile tender offer contested by the management." Id.

[2]Id. at 9.

[3]Id.

ownership of friendly targets comes from higher ownership of the top officers, while stakes of outside board members do not seem to be much different from either those in hostile targets or in the whole sample."[4]

Demsetz. In a 1983 publication, Harold Demsetz reports that "a substantial fraction of outstanding shares are owned by directors and management of corporations in all but the very largest firms."[5] For a sample of fifty firms tracked over the ten-year period spanning 1973-1982, Demsetz found an average management and director ownership percentage of 17.5 percent.[6] The management ownership percentages ranged from a high of 32.5 percent among the firms too small to be listed on the Fortune 500 to a low of 2.1 percent for the ten largest manufacturing firms on the Fortune 500.

OCE Study. Firms smaller than the Fortune 500 firms have, on average, even greater management ownership. In a recent study by the SEC's Office of the Chief Economist, a random sample of 100 publicly held firms had average insider holdings of 21.2%, compared to the 10.6% average reported by Morck & Vishny for the Fortune 500 firms.[7] Moreover, when the sample was divided into quintiles by size of firm, average insider holdings increased as the size of firm decreased, as shown in Table 2.[8]

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[4] Id.

[5] Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J. Law & Econ. 375, 388 (1983).

[6] The sample was composed of the ten largest, ten smallest, and ten median manufacturing firms as ranked in the 1975 Fortune 500, plus ten randomly selected firms too small for inclusion on that list, as well as ten randomly selected public utility firms.

[7] Office of the Chief Economist, Memorandum on Inside Holdings of Publicly Traded U.S. Corporations (July 9, 1987). To the best of my knowledge, these results have not as yet been publicly released. If there is an interest in these data, I will attempt to forward them promptly.

[8] Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J.L. & Econ. 375, 388 (1983), reports similar results.

Table 2

Average Inside Holdings
and Firm Size

Size Class	Mean Equity Value of Firms in Class ($ millions)	Average Insider Holdings
1 (smallest 20% of firms)	$ 15	30.2%
2	46	28.8%
3 (median 20% of firms)	154	20.2%
4	374	13.8%
5 (largest 20% of firms)	3,200	13.0%

II. Evidence on Nonresponsive Stockholders

In several conversations I have heard that, on average, approximately five percent of stockholders can be expected to be nonresponsive in a hostile takeover context. A quick literature search failed to reveal any published data that would confirm or reject this generally accepted estimate.

In an effort to develop data on the percentage of nonresponsive shareholders, we studied tendering percentages for a sample of 70 any-and-all cash tender offers made during the 1982-87 period, including the hostile-turned-friendly deals reported in the Chief Economist's survey cited in my letter of December 10.[9] The table below shows the number of shares tendered as a percentage of the shares not already owned by the bidder.

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[9]A copy of the OCE memorandum was provided to members of the Council earlier this week. The data on shares sought and shares tendered were provided to us by Skadden, Arps and First Boston. No doubt, a larger sample, as well as other measures of the level of nonresponsive shareholders, could be developed given additional time. Because of time constraints, the process by which these estimates were derived will be described in a separate memorandum that is currently being prepared.

Table 1

Shares Tendered in Any-and-All
Cash Tenders, 1982-1987

Percentage of Available Shares Tendered	Number of Companies	Percent of Sample
50.0% or Less	2	3%
50.1% to 70.0%	5	7%
70.1% to 80.0%	6	9%
80.1% to 90.0%	10	16%
90.1% to 95.0%	22	31%
95.1% to 97.0%	17	24%
97.1% to 100.0%	8	11%

The table suggests that, while it is often possible to obtain more than 90% of the available shares in a fairly priced any-and-all cash offer that is supported by the target's management, it is more difficult to exceed 95 percent even with management support. Only in a small minority of cases does a management-supported tender offer exceed 97 percent.[10] Thus, the data suggest that in a typical tender offer, a minimum of 3 percent and more commonly about 5% of the available shares, will be held by nonresponsive shareholders. These data are consistent with the generally accepted five percent estimate, and I will use that figure as an average nonresponse rate.

III. Strategic Behavior

If a firm's managers recognize that they can create a blocking coalition by placing stock in friendly hands they will certainly have an incentive to do so. Currently, when control effectively follows the majority, it is relatively difficult, although not impossible, for managements to create blocking coalitions. As the minimum necessary size for a blocking coalition decreases, the cost of creating such a coalition also decreases. Reducing the size of a minimum blocking coalition from 50 percent (the level that prevails under a majority rule regime) to 10 percent (the level implied by Section 203's exemptive thresholds) will certainly make it much easier to build such blocking coalitions. The Council

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[10]Some of the cases where a high percentage of shares was tendered may reflect high inside ownership, for which 100% tendering is likely, rather than a high percentage of tenders received from independent shareholders.

should expect a proliferation of such activity in the event it adopts thresholds that require only small blocking coalitions in the range of 10 or 20 percent.

There are several methods a management can use to create or strengthen a blocking coalition. Observers have already noted that "the use of ESOPs has risen dramatically, but substantial issues of fairness also surround their use because employees may be overreached by them."[11] Indeed, "[T]he use of the 'leveraged' ESOP as a takeover defense has also become common,"[12] and adoption of Section 203 may accelerate the trend because ESOPs can be useful in forming a blocking coalition. Management can also place shares with investors who contract to vote as management instructs or who, for a variety of reasons, can be expected to follow management's lead.

All assessments based on current data should therefore be viewed as conservative underestimates of the extent to which managements will be able to frustrate the exemptive mechanisms of Section 203(a) by creating blocking coalitions.

IV. Actual Tender Offer Experience

In my letter of December 10, I wrote, "I am aware of no case in which a tender offer obtained more than 90 percent of the target's shares despite management opposition as expressed in a recommendation not to tender and in management's decision not to tender its own shares." This statement remains correct to the best of my knowledge as of the date of this letter: no one has yet demonstrated a single case in which a bid hostile throughout the takeover contest received more than 90 percent of the tendered shares.

This point remains significant, especially in light of the preceding evidence that suggests that managements will frequently be able to stop a hostile offeror from obtaining 90 percent of a company's shares by simply refusing to tender their own shares. In many of these situations, management could be an isolated minority, and still frustrate the will of a unanimous body of disinterested stockholders, by simply refusing to tender their shares.

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[11] Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 76, n.210, citing Note, The False Promise of Worker Capitalism, 95 Yale L.J. 148 (1985). See also Simmons, Ward & Watson, An ESOP Can Be An Effective Antitakeover Device, Nat'l L.J., June 30, 1986, at 25, col. 1.

[12] Coffee, supra note 11.

Earlier this week I provided to members of the Council certain data gathered by the Commission's Office of the Chief Economist that support my assertion. In particular, I provided a list of 24 transactions which began as hostile transactions but eventually turned friendly. My staff and I have carefully examined many of these transactions and have reviewed Wall Street Journal reports describing the percentage of shares tendered at various points during the battle.

We find it difficult to draw any useful generalizations from these data for a variety of reasons. For example, in many situations stockholders will not tender their shares until the eleventh hour because they are awaiting a competing bid or expect changes in a competing bid. Also, when a battle turns from hostile to friendly that is a signal that management plans to tender their shares, dramatically increasing the odds the hostile bid will prevail and increasing the incentive for shareholders to tender. For these and other reasons we find it difficult to draw any reliable inferences from reports that describe the number of shares tendered at points prior to successful completion of a hostile bid. The only fully reliable sources of data are tender rates in offers that were opposed through completion and, as stated above, none of those exceed 90 percent.

V. Conclusion

The data presented in this letter provide a basis for calculating the frequency with which blocking coalitions are likely to occur at various threshold levels. It is important to emphasize that this focus on currently existing blocking coalitions is quite conservative because managements will often be able to gather support from outside their coalition. Under these circumstances even a small amount of independent support may make the exemptions unavailable. The data also do not predict the extent to which managements will behave strategically by creating or expanding blocking coalitions in the future. Further, to the extent the data rely on skewed samples, in which larger firms are over-represented, the data underestimate the extent to which managements are able to form blocking coalitions. For all these reasons, the conclusions that follow should be considered quite conservative. If anything, they are biased towards supporting higher threshold levels that are otherwise warranted.

The generally accepted nonresponse rate of about five percent must be added to the size of management holdings in order to calculate effective blocking coalitions for purposes of the Section 203(a) exemptions. The data presented in Parts I and II of this letter suggest that for Fortune 500-type firms, the average firm already has a blocking percentage of

about 15 percent. Therefore, on average, it will be impossible for a hostile bidder to satisfy a 90 percent threshold. Even if the threshold is dropped to 85 percent it will be impossible for a hostile bidder to qualify for the exemption unless he receives essentially unanimous support from all other shareholders. If the intention is to make the exemption available for bidders who are able to obtain the consent of 90 percent of disinterested shareholders then, on average, the threshold should be set at about 75 percent.

For firms that are too small to be in the Fortune 500 the thresholds would have to be set at lower levels because of the larger size of the average blocking coalition. With average insider holdings in excess of 30 percent, and a five percent nonresponsive rate, a 65 percent threshold would require effective unanimity among disinterested shareholders in order for a bidder to qualify for an exemption. Therefore, for these corporations, the simple majority rule that now prevails in contests for corporate control does not seem wide of the mark.

The Morck and Vishny data allow a closer analysis of the incidence of blocking coalitions for larger firms. Morck and Vishny find that in 42.1 percent of their sample directors already own five percent of the corporation's shares.[13] Add to that coalition a five percent nonresponse rate and the data demonstrate that with a 90 percent threshold for the 203(a) exemptions, a full 42.1 percent of bidders for Fortune 500-type firms will never be able to qualify for the exemption unless they get the target's directors to tender some of the directors' shares. If the threshold is dropped to 85 percent than 31.7 percent of these firms will still be "bulletproof."[14]

With an 80 percent threshold the Morck-Vishny data suggest that about 25 percent of firms will have automatic blocking coalitions and thus be bulletproof.[15] At a 75 percent threshold about 20 percent of the firms are bulletproof.[16]

These data suggest that the 90 percent thresholds required for the 203(a) exemptions do not establish a "barn

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[13]See Table 1, Line 2, supra.

[14]Id. Line 3. (Adding five percent nonresponse rate to 10 percent director ownership.)

[15]Table 1, supra.

[16]Id.



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

December 22, 1987

VIA TELECOPY

David B. Brown, Esq.
Secretary
Council of the Corporation Law Section
of the Delaware State Bar Association
c/o Potter, Anderson & Corroon
350 Delaware Trust Building
P.O. Box 951
Wilmington, Delaware 19899

Gentlemen:

I am writing in response to a request for information that would be useful in estimating the extent to which shareholdings of corporate boards are attributable to the holdings of inside as opposed to outside directors. This information may, I am informed, be relevant to ongoing deliberations because there is debate over the extent to which the shareholdings of board members should be excluded from the calculation of the Section 203(a)(2) exemption. Among the options under consideration are exclusion of shares held by all board members, exclusion of shares held by current inside directors only, exclusion of shares held by current and former inside directors, and exclusion of shares that can be voted at the direction of the corporation either pursuant to a contractual rights or because the corporation can assert some element of control over the holders of those shares. In addition, shares beneficially held by an excluded person, relatives of an excluded person, and other related entities may also be subject to an exclusion for purposes of calculating the Section 203(a)(2) exemption.

At the outset, I wish to emphasize that my comments on the potential scope of a possible compromise should not be construed as support for the effort to enact a Delaware antitakeover law. The success of Delaware's corporation law depends on an enabling approach that allows shareholders to elect governance mechanisms most suitable to their corporation's particular circumstances. The Section 102(b)(7) exemption adopted by the legislature in 1985 relies on such an enabling approach. It is well within the traditional formula that has served Delaware well. The proposed legislation signals a dramatic departure from that venerable principle. For that reason, as well as for the additional reasons set

forth in my letter of December 10, 1987, I continue to urge great caution in this enterprise.

Although I recognize that there are arguments on both sides, the data lead me to favor sterilizing the shares held by all directors, not just directors who are current or former officers of the corporation. As before, the views expressed in this letter are my own, and do not necessarily reflect the views of the Commission or of Commission staff.

The table below sets forth data provided by Morck & Vishny concerning ownership of stock in Fortune 500 firms by: (i) the entire board of directors; (ii) the top officer (generally the chief executive officer); and (iii) the top two officers of the corporation.*

Director and Top Officer Stock
Ownership for Fortune 500 Firms, as of 1980

Mean ownership for all firms:

Entire Board of Directors owns 10.6%
Top Two Officers own 6.3%
Top Officer owns 4.8%

Shareholder Group	Percentage of Firms With 5% Ownership	10% Ownership
Entire Board of Directors. . .	42.1%	31.7%
Top Two Officers	22.9%	16.7%
Top Officer.	17.4%	12.6%

Ownership for top two deciles:

for 10% of firms, directors own at least 35.0% of shares;
top two officers own at least 24.0% shares;
top officer owns at least 16.2% of shares;

for 20% of firms, directors own at least 20.3% of shares;
top two officers own at least 7.1% shares;
top officer owns at least 2.9% of shares.

As the table indicates, the top two officers own 5% or more of a company's shares in 22.9% of the cases. This is less than the 42.1% of corporations for which the entire board of directors owns at least 5% of the shares. Moreover, the 80th percentile for top officer ownership is 7.1%, compared to

*Where a number two officer could not be reliably identified, Morck & Vishny used only the top officer.

an 80th percentile for 20.3% for the entire board of directors. Thus, in many cases, there is significant ownership by directors who are not among the two top officers of the corporation. I do not, unfortunately, have data on ownership by all officers who are directors, nor do I have data that further refine the ownership interests among former insiders who remain on the board and others.

These data are partial and difficult to interpret. While it is possible to speculate about the allocation of shareholdings within a board, it is important to recognize that the Morck & Vishny data relate only to Fortune 500 firms and that it is probably incorrect to extrapolate from this database to other firms. Given additional time, it would be possible to develop data on share ownership by officers who are directors, officers who are not directors, directors who are not officers, employee plans, and other categories that it might be useful to consider. Current time constraints do not, however, permit such data gathering efforts.

In sum, I recognize that in defining disinterested shareholders for purposes of the Section 203(a)(2) exemption, a line can be drawn at various points. I would urge at a minimum that the holdings of insiders, former insiders, and any of their relatives or related entities be excluded for purposes of the 203(a)(2) exemption. The better resolution would, I think, exclude all board members on the rationale that board members who have decided to label a transaction as hostile should not be in a position to transform their vote into an absolute veto regardless of whether they are current or former insiders. The 203(a)(2) exemption should rely on the actions of shareholders who truly are disinterested with respect to the vote of the board that makes the operation of Section 203 relevant at all. Moreover, the required vote should also be reduced below an 85 percent threshold for the reasons set forth in my prior letter of December 18, 1987. As explained in that letter, the data support a test in the vicinity of 75 percent.

I appreciate the opportunity to respond to the request for further information.

With best regards,

Sincerely,

Joseph A. Grundfest

Joseph A. Grundfest
Commissioner