MEMORANDUM

TO: Senator Andrew G. Knox

FROM: A. Gilchrist Sparks, III, Chairman of the Corporation Law Section of the Delaware State Bar Association

DATE: January 24, 1988

You have asked me to address the status of the record before the legislature concerning the availability of additional empirical data relating to the impact that the 85% stock threshold, which triggers exemptions to the self-dealing prohibitions in House Substitute No. 1 to House Bill 396, will have on takeovers. The short answer is that, as S.E.C. Commissioner Joseph A. Grundfest has acknowledged, there are "no studies that analyze stock ownership concentrations according to the formula now proposed by the Bar" in the legislation pending before you.

1. Commissioner Grundfest's December 10, 1987 Letter to the Council of the Corporate Law Section of the Bar ("Council").

In his December 10 letter, Grundfest stated his objection to what at that time was the 90% stock acquisition threshold that an interested stockholder would have to acquire in order to avoid the strictures on self-dealing which that draft of the legislation contained. At page 8-9 of that letter (Exhibit A), Grundfest argued that thus the 90% threshold in that draft was too high and that there should be a revision which would prevent a small number of dissenting

stockholders from blocking even a highly leveraged hostile offer. Grundfest stated that this could be accomplished by lowering the threshold "from 90% to 75% or some other realistic figure", or by defining the approval percentage as a percentage of shares tendered by disinterested stockholders, i.e. shares not owned members of management. He also suggested that a combination of the two approaches might be better than either alone.

2. Commissioner Grundfest's December 18, 1987 letter to the Council

Grundfest wrote to the Council again on December 18, arguing again that the 90% threshold was too high, offering data relating to stock ownership by members of boards of directors and discussing the practice of placing stock in an Employee Stock Ownership Plan ("ESOP") -- stock controlled by "friendly parties" who will not tender -- as a means of blocking a hostile offer. Grundfest reiterated his suggestion that the 90% threshold be lowered "from 90% to 75% or some other realistic figure".

3. Commissioner Grundfest's December 22, 1987 Letter to the Council.

Grundfest wrote on December 22 to discuss options which were then being considered by the Council as a possible compromise on the 90% threshold issue. The particular issues then being considered were a reduction of the threshold from 90% to 85% and the exclusion of shares of management directors

and those shares whose vote the board could direct (i.e. ESOP shares) from the 85% threshold. At page 3 of that letter (Exhibit B) Grundfest stated that "I do not, unfortunately, have data on ownership by all officers who are also directors." He then went on to speculate that, given additional time, "it would be possible to develop [additional] data", but that current time constraints do not permit such gathering efforts.

4. The Compromise.

On December 23, 1987 the Council recommended a compromise bill which, among other things, (1) lowered the 90% threshold to 85%, and (2) excluded from that threshold percentage stock owned by directors who are also officers of the Company and stock held in ESOP-type plans which did not have pass through votes entitling plan beneficiaries to vote the stock themselves. These compromises addressed three fundamental concerns of Commissioner Grundfest (1) that the percentage be below 90%, (2) that stock owned by directors who are also officers be excluded from the percentage, and (3) that ESOP stock controlled by management be excluded. With these exclusions the 85% threshold will not be a true 85% of the stock not owned by the offeror for, under Grundfest's own data, on the average, somewhere around 6% to 7% of every Company's stock is owned by the two top officers of a company -- who more often than not are board members. Excluding these shares from the 85% means that 85% is really a 78%-79% threshold --

only 4% more then what Grundfest personally sought at the outset.

5. Commissioner Grundfest's December 31, 1987 Letter.

Grundfest wrote on December 31 (Exhibit C) that the December 23 compromise draft contained "changes for the better, but they do not go far enough" (at p. 2). In that letter, Grundfest contends that the stock of all directors should be excluded from computing the 85% threshold and that the threshold of 75% "seems more reasonable" -- primarily, it seems, because it is a number that he, in his subjective judgment, prefers (at p. 4). ("I repeat my earlier observation that a 75% supermajority for Section 203(a)(2) seems adequate . . ."). Interestingly, however, Grundfest could not offer any objective empirical data with which to challenge the formulation of the 85% threshold, which was derived from his own earlier suggestions. In fact, he states in that letter at p. 3:

> "The 85 percentage threshold should also be lowered. Current available data do not provide a basis upon which to estimate the incidence of blocking coalitions [i.e. the ease with which 16% of the stock can collectively block a bid] under the new Section 203(a)(2) because those data do not distinguish among inside directors and independent directors. They also do not describe the incidence of ESOP holding without pass-through voting."

Grundfest also notes at p. 2:

> What is the appropriate size of the supermajority that should be required for purposes of invoking the Section 203(a)(2) exemption? Answering this question is quite difficult both because of the lack of directly relevant data and because the adoption of Section 203 could, for reasons set forth in my letter of December 10, cause transactions to become back-end loaded and thereby make it more difficult to achieve any threshold level regardless of the fairness of the offer. (Emphasis added).

6. Commissioner Grundfest's January 20, 1988 Written Statement.

In his January 20, 1988 written statement to the House and Senate Judiciary Committees Grundfest -- who on December 31 had no data at all to offer -- began to speculate that data going to the 85% threshold might be available:

> In my view, the 85 percent threshold contained in the proposed Section 203(a)(2) exemption should be lowered. The definition of interested stockholders whose shares are not counted for purposes of this exemption should also be expanded. There are objective data that can help the legislature determine the appropriate parameters of such an exemption, but to the best of my knowledge these data have not as yet been gathered and analyzed in a form that is directly responsive to the issues posed by the pending legislation.

Yet, in response to a question by Representative Davis during his testimony on January 20, Grundfest admitted:

> Now I have to be very candid and tell you I don't know how this new 85% threshold works because I haven't been able to find data that subdivides board ownership along the same lines as it's proposed in the exemption [i.e. the stock directors who are officers are not figured in the 85% threshold]. (Emphasis added).

When asked by Chancellor Brown whether data could be obtained, Grundfest speculated that the raw information from which data which bears on the operation of the 85% threshold probably exists and, in response to Representative Davis, stated that he would do all he could to make the data available -- but did not have any idea when it would be available, including whether it would be available for the suggested reconvened March hearings which Grundfest himself had called for. But again -- in response to a subsequent question by Representative George about the benefit of 85% threshold -- Grundfest noted:

> The honest answer to your question is I don't know how [takeovers] would operate under the 85% standard with the new definition of disinterested stockholders [i.e. a definition which excludes management directors and stock controlled by management] . . . .
>
> What I don't know is the percentage of corporations for whom that [85%] exemption would still be useless as a practical matter and for whom that exemption would exist on paper only - I don't know the answer to that. (Emphasis added).

In response to a question by Representative David Ennis about the type of additional information the SEC might have, all Grundfest could say was:

> We know also we have some data on tape that have to do with ownership of corporations. What we don't know is whether the data descriptors that explain what's in each field of the tape are relevant to the questions raised by this statute. It would have to take a very careful analysis. We haven't done it yet, but based on some initial conversations, I'm afraid that it's

> unlikely that the data that was put on tape for other reasons in the past will wind up being directly responsive to this question. So I think the short answer is there's an 80% chance that we're going to have to sit down with paper and figure out how to classify some of these [director stock] holdings. (Emphasis added).

And in response to a question from Senator Knox -- Grundfest stated "I think the data exist but nobody has had the time to do the analysis" (emphasis added). When Senator Knox pointed out that this statement appeared to be contrary to Grundfest's statement in his December 31 letter to the Council that "current available data do not provide a basis upon which to estimate the incidence of blocking coalitions", i.e. of the ability of director owned shares to block an offeror from meeting the 85% threshold, Grundfest responded:

> If I said that I certainly was not writing as carefully as I should have.

7. Conclusion.

The record shows that in fact no data presently exists which addresses the effect of the 85% threshold -- and the removal of director/officer and management controlled ESOP stock from that threshold -- on the likelihood of offerors reaching the 85% threshold. The record does show that all of Grundfest's suggestions on the threshold and director-owned stock questions were considered and many adopted in whole or in part by the Council and Corporation Law Section. Quite simply, Grundfest -- for no empirically cognizable reason -- feels a 75% threshold is "more reasonable". Grundfest can

only speculate that at some point months, if not years away, he may be able to analyze data he thinks exists which may, or may not, explain why 75% is a better number than 85%. The Corporation Law Section Council, the Section itself and the Delaware State Bar -- based on the data that does exist and which Grundfest presented prior to his January 20 testimony -- believe that 85% as defined in the bill is the optimal threshold and that there is no reason for the legislature to wait until some indefinite time in the future for Commissioner Grundfest, an avowed opponent to this legislation, to "develop" data from a base which even he cannot definitely state exists.

Exh. A

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.

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

OFFICE OF
THE COMMISSIONER

Exh. B

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

OFFICE OF
THE COMMISSIONER

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

Exh. C

December 31, 1987

VIA TELECOPY

E. Norman Veasey, Esq.
Richards, Layton and Finger
One Rodney Square
P.O. Box 551
Wilmington, Delaware 19899

Dear Mr. Veasey,

I greatly appreciate the opportunity to cooperate with the Council of the Corporation Law Section of the Delaware State Bar Association as it considers the merits of a proposed new Section 203 of the Delaware General Corporation Law. Although Section 203 has been modified in response to extensive criticism from a broad spectrum of observers, the proposed legislation remains highly controversial. Whatever one's views regarding the merits of proposed Section 203, I think it clear that the legislative process deserves a public dialogue in which all perspectives can be fully and fairly aired. Accordingly, even if the Section and Executive Committee approve Section 203, and even if the legislation is promptly introduced in the General Assembly, I trust that the Delaware Legislature will have an adequate opportunity to evaluate the proposed legislation and form its own judgments regarding the advisability of enacting such a law.

Section 203 is not a technical corporate law issue. It goes to the heart of the philosophy of the Delaware Corporation Law and touches on questions with national implication. It deserves careful legislative consideration commensurate with its significance.

Before commenting on the proposed revisions to Section 203, I wish to reemphasize that my comments should in no manner be construed as support for the underlying initiative. I continue to believe that, if Delaware is to enact an anti-takeover law at all, it should rely on the enabling approach that currently dominates Delaware law. Delaware has, in the past, successfully addressed controversial corporate governance issues by providing shareholders with an opportunity to elect whether they wish to modify the legal regimes that govern corporate activity. This enabling approach respects the contractual arrangements that exist at the time an investor acquires his or her shares, and allows those arrangements to be changed only with the consent of a majority of the investors whose rights would be affected by the proposed modification.

This sensible and democratic approach has served Delaware and Delaware-chartered corporations well. Most recently, it was applied in Section 102(b)(7) to address the difficult issues raised by increased liability imposed on directors for breaches of the duty of care. Proposed Section 203 represents a dramatic and unwarranted departure from Delaware's traditional and successful reliance on an enabling approach to corporate law.

To date, none of the arguments that I have heard in support of Section 203 adequately address this fundamental question. The decision not to cast Section 203 as an enabling provision clearly suggests a desire to impose the law's restrictions on shareholders who would not otherwise elect to be governed by those restrictions.

The changes reflected in the December 23 draft are changes for the better, but they do not go far enough. The most significant change involves the exemption provided by Section 203(a)(2). As initially proposed, Section 203(a)(2) would have required that a bidder obtain at least 90 percent of the outstanding shares in order to be exempt from the statute's three-year moratorium. In my letters of December 10, 18, and 22, I explained that, as a practical matter, this exemption was unlikely to be useful. The December 23 version of the proposed statute lowers the required threshold to 85 percent and would "exclude for purposes of determining the number of shares outstanding those shares owned (i) by persons who are directors and also officers, and (ii) employee stock plans in which employee participants do not have the right to determine confidentially whether

shares held subject to the plan will be tendered in a tender or exchange offer...." While this modification is an improvement, the exemption provided by Section 203(a)(2) remains problematic because the category of holdings excluded from the threshold computation is too narrow and the 85 percent threshold remains too high.

The category of stockholders whose positions are excluded from computation of the 85 percent threshold should be expanded. A corporation, through its officers, may have the effective right to control the tender or voting of shares held by third parties. Those shares should be excluded from the computation on the same rationale that leads to exclusion of inside directors' holdings. Former officers may also have interests closely aligned with current inside directors. For example, a retired CEO may remain on a corporation's board while the central issue raised by a takeover proposal is the viability of a strategy initiated by the former CEO and continued by a successor who was selected specifically to implement those policies. Thus, shares held by former insiders may also be proper candidates for exclusion from the 85 percent test of Section 203(a)(2). Moreover, strong arguments can be made that the stock of all directors should be excluded from the calculation of the Section 203(a)(3) threshold, and the best rule would exclude all directors' holdings from that computation. Further analysis may reveal additional situations where it is prudent to expand the category of excluded shares. Accordingly, the drafters may also wish to consider an amendment to Section 203(a)(2) that would allow the courts to expand the category of excluded shares in light of relevant facts and circumstances.

The 85 percent threshold should also be lowered. Current available data do not provide a basis upon which to estimate the incidence of blocking coalitions under the new Section 203(a)(2) because those data do not distinguish among inside directors and independent directors. They also do not describe the incidence of ESOP holdings without pass-through voting.

Focusing on the percentage of firms that are able, with a high degree of certainty, to block application of the Section 203(a)(2) exemption reflects a worst case analysis that diverts attention from a more central question: What is the appropriate size of the supermajority that should be required for purposes of invoking the Section 203(a)(2)

exemption? Answering this question is quite difficult both because of a lack of directly relevant data and because adoption of Section 203 could, for reasons set forth in my letter of December 10, cause transactions to become back-end loaded and thereby make it more difficult to achieve any threshold level regardless of the fairness of an offer. A threshold set at 85 percent is too high because it allows a 15 percent minority to dominate corporate decisions in an environment where back-end loading creates an incentive for stockholders to want to be among the minority. A threshold set at 75 percent seems more reasonable, and is still potentially difficult to achieve because it provides a veto to a 25 percent minority in a back-end loaded environment.

The best available evidence from voting behavior studies that draw upon social choice theory suggests that the optimal rule would rely on a simple majority and eliminate the potential back-end loading caused by the statute. That literature is relatively complex, and I understand that a simple majority approach is not now a feasible compromise before the Corporation Law Section. Accordingly, I repeat my earlier observation that a 75 percent supermajority for Section 203(a)(2) seems adequate to assure that a bidder's offer is attractive to a substantial majority of disinterested shareholders.

To buttress this point, I would draw an analogy to the political world. In the political arena, a candidate who wins an election with 65 percent of the vote can claim victory by a landslide. A 75 percent victory signals a political dynasty. An 85 percent threshold, if accomplished, would probably instigate a voting fraud investigation unless the opposition was particularly hapless. The parallel to the corporate context is apt, and I would argue that a 75 percent threshold is more than adequate to assure that a bidder's offer is fair and reasonable.

Finally, I have substantial problems with the synopsis and several other provisions of the proposed legislation. Rather than debate those issues on a point by point basis, I observe that if Section 203 is recast as an enabling provision, many of my questions would be answered.

Once again, I appreciate the invitation to share my views with members of the Council and am grateful for the attention that has been given to my prior letters. The views expressed in this letter are my own and do not necessarily reflect the views of the Commission or of Commission staff.

With best wishes for a Happy New Year,

Sincerely,

Joseph A. Grundfest nm

Joseph A. Grundfest
Commissioner

cc: David B. Brown, Esq.
A. Gilchrist Sparks, III, Esq.