M E M O R A N D U M

TO: Members of the General Assembly

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

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RE: Relevant Questions Relating to Proposed Section 203

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1. Why should any state legislature enact legislation regulating abusive takeovers?

By way of background: How did all this start? Delaware did not always permit individuals to effectively seize a company's assets as their own by acquiring 50.1% of the company's stock and then merge out the other 49.9% of the stockholders. Prior to 1967, unless the stockholder owned more than 90% of a corporation it took a two-thirds vote of the stockholders of the "target" company to merge the target and acquiror and, even then, the merged-out "target" stockholders had to receive stock or other securities of the acquiror, but not cash, in that merger. Thus, prior to 1967 even if an acquiror purchased two-thirds of a "target's" stock, it could not "cash out" the one-third he did not own.

In 1967, § 251 was amended. If two-thirds of the stockholders of the "target" company approved, the remaining one-third (not owned by the acquiror) could be "cashed out" by merger. Only as of 1969 -- by further amendment to § 251 -- was a majority stockholder (i.e., in theory an acquiror owning 50.1% of the stock) empowered to merge out a 49.9% minority stockholder (i.e., the "target" minority). In short, opponents of § 203 ignore the fact that our law gives to a majority stockholder the ability to eliminate the minority against their will.

The ability of majority stockholders to "merge out" the minority has been abused by offers being made which are calculated to result in the purchase of a bare majority of the stock of a company financed by the offeror's commitment to lenders immediately "squeeze out" the minority, carve up and sell off assets of the company, and thus allow the offeror and his lenders (not the stockholders) to capture the true value of those assets. These abuses should not be permitted to continue.

2. <u>What does it mean to be "squeezed out"?</u>

Stockholders get "squeezed out" in the following fashion: The acquiror, using a Delaware company established for the takeover ("Acquisition Co.") and of which he owns 100% of the stock, purchases slightly more than 50% of the stock of the target company ("Target"). Once owning a majority of Target's stock, the acquiror then merges Target into Acquisition Co. and pays the minority stockholders of Target -- who cannot prevent it -- either an amount of cash for their shares which the acquiror chooses or gives them a bond or debt instrument which pays interest over time. Because of this mechanism, acquirors are able to get away with paying less than what they would have to pay to stockholders, if there were a free market with willing sellers rather one with sellers whose only choices were to sell their stock now or be merged out later. In most cases, minority stockholders' only recourse if they believe the cash or instrument they get does not reflect the true value of their shares is to seek a judicial appraisal of their stock, an expensive and lengthy process that may, years later, get them a better price for this stock. Meanwhile the acquiror, through Acquisition Co., owns all of the stock of Target and can do as he pleases with its assets. Often, assets are sold off or mortgaged and the money obtained is dividended in some fashion to the acquiror as 100% stockholder who can thus finance the cost of acquiring all of Target's stock. The minority, no longer stockholders of Target, have no legal right to share in the benefit of any asset sale or mortgage -- all the money goes to acquiror, they get nothing. To prevent this scenario from occurring and to permit the assets of the company to be utilized for the benefit of all stockholders, management is often forced to use defensive tactics, which in the past has led to other abuses, such as the "buying off" of the raider by payment of what is known as "greenmail." And this entire environment of leveraged deals and easy money has been riddled with stock speculation, insider trading, illegal "tipping" of arbitrageurs -- in short, the "Ivan Boesky phenomena" of widespread illegal activity on Wall Street so well publicized this past year.

3. <u>How can a state fail to act to correct these abuses? What have been the effects on target companies?</u>

The literature is full of examples of (a) incredible profits obtained by "raiders" for corporations (b) in deals that are never consummated and (c) thus in which stockholders are left as participants in a ravaged, debt-laden company.

<u>Examples</u>:

1. <u>Paul Bilzerian</u> - has made "unsuccessful" bids for H.H. Robertson, Cluett Peabody, Hammermill Paper, Allied Stores and Pay 'n Pack. He made himself and his partners nearly $200 million in three years.

2. <u>Herbert Haft</u> - has unsuccessfully bid for Supermarkets General, Safeway, Jack Eckerd; never taken over a target; takes "greenmail" freely. He made nearly $190 million on these deals alone.

3. <u>T. Boone Pickens</u> - has never purchased any company; has made "runs" at, among others, Phillips Petroleum, Unocal, Gulf. The profit is about $380 million on these deals.

4. <u>Cyril Wagner & Jack Brown</u> (affiliates of T. Boone Pickens) - have made bids for, among others, Gencorp Inc., Midcon Corp. and Lear-Siegler Inc; have ultimately dropped all bids; sold their shares back to the target company or to the "white knight" that acquired the target for huge profits; participated in the Pickens bids for Gulf and Phillips.

<u>Here are the effects on companies.</u>

1. Louis Lowenstein, Professor of Finance & Law, Columbia University, November 16, 1987, <u>The New York Times</u>

> Productivity in the long run is a function of savings and reinvestment and America [in the 1980's] was saving almost nothing and much of what it was reinvesting came from abroad. At <u>Allied Stores</u> [the object of several takeover attempts] there were earnings of less than $300 million to pay interest charges of more than $450 million. . . . [M]ost of those who remain at risk [as a result of leveraged takeovers] never got to enjoy the party. At <u>Supermarkets General</u>, where I was president in the late 1970's, the new Merrill Lynch controlled company has less than $150 million in earnings to pay more than $200 million in interest expense. But in the buyout nothing was done to protect the many nonunion staff members whose pension benefits were left unfunded and are, therefore, no more secure than junk loans.

2. Senator William Proxmire, <u>The National Law Journal</u>, November 9, 1987:

> One of the fundamental issues associated with tender offers is corporate debt. Debt has been the dominant concern of economic policy-makers generally throughout the 1980s. Aggregate economic statistics show that corporate debt is proliferating, and it is proliferating to a large extent because of battles for corporate control. American corporations sold $263 billion worth of debt in 1986, double the 1985 figure, and five times the figure in 1982. In 1986, American industry spent some $177 billion in hostile bids, much of that in the form of new debt. This sum was, for the first time in U.S. history, greater than the amount spent on acquisitions of new plant and equipment.

Highly publicized examples illustrate the connection between corporate debt and unfriendly tender offers. Phillips Petroleum Co., in defense against bids by T. Boone Pickens and Carl C. Icahn, tripled its debt to $7.3 billion. Similarly, Unocal Corp. increased its debt from $1.2 billion to $5.2 billion after its contest with T. Boone Pickens. The Goodyear Tire & Rubber Co. now services $4 billion in debt, following a bid by British financier James Goldsmith. Owens-Corning Fiberglas Corp. added some $2.6 billion to its debt portfolio. Recently, Chicago-based Borg-Warner Corp. fended off a takeover by floating debt of some $4 billion to purchase its stock, and increased its debt loan tenfold.

. . . The distinguishing characteristic of this profile is leverage. In the majority of mergers and takeovers, the financing terms involve a trade of stock, or a loan largely secured by the acquiror's credit. In some of the most controversial takeovers, however, financing is essentially secured by the assets of the target company.

The bidder secures loans from a bank in order to purchase the shares of the target company. Then, to repay these loans, the bidder often must issue new debt under the aegis of the newly acquired company, or even sell some of the assets to generate needed cash. Similarly, in defending against a bidder, a corporation may itself issue new debt in order to purchase its own stock to keep it from the hostile bidder.

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Former, SEC Chairman John Shad summarized the situation:

The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers and others . . . The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple

> of their losses from acquisition-related bankruptcies. The premiums come first, the consequences later.
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> Some of the conclusions of such economists as Mr. Jensen are contested. Specifically, Prof. Louis Lowenstein of Columbia University School of Law pointed out that Mr. Jensen's studies relied on stock prices within 60 days of the merger or takeover. When Professors Magenheim and Mueller of the University of Maryland looked at the share price of the surviving firm within three years following the merger, they found that the share price had slumped significantly.
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> Target companies are not necessarily industry laggards. The average targets in the study, in fact, were "extraordinarily profitable companies." In addition, "Seven or eight years on average following merger, profitability had declined sharply relative to pre-merger levels."

3. January 11, 1987 <u>Washington Post</u> Article by Mark Potts:

> Economists estimate that the total outstanding debt of American corporations has increased between $300 billion and $400 billion in the past three years, fueled by such factors as borrowing to pay for takeovers; leveraged buyouts in which companies have gone private using borrowed money to buy out public stockholders; financing of takeovers and other corporate investments with risky junk bonds, and massive restructuring programs undertaken to repel takeover efforts by raiders such as <u>T. Boone Pickens, Jr.</u> and <u>Carl C. Icahn</u>.
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> . . . For years, corporate debt has averaged about 70 percent of net income. But in the past three years it has begun rising, and by the end of 1986, the average company's debt was equal to about 90 percent of its net income, according to an estimate by Data Resources.

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"This merger mania is continuing, and unfortunately that's plunging our corporations deeper and deeper into debt," said Sen. William Proxmire (D-Wis.). "The result is a terrific exchange of equity for debt. That makes our corporations that much more fragile."

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Phillips Petroleum Co. is a prime example of how a takeover battle can leave a company suddenly and deeply in debt. The Bartlesville, Okla.-based oil company, the target of back-to-back takeover attacks by Pickens and Icahn two years ago, finally won its freedom through a massive financial restructuring through which it bought back about half its stock to give shareholders values approaching what Pickens and Icahn were offering.

But to pay for the transaction, the company had to borrow heavily, on top of debt it already had as the result of two previous acquisitions. In the wake of the restructuring, Phillips found itself $8.6 billion in debt, giving it a debt-to-equity ratio of about 85 percent (30 percent is considered good; 40 percent a bit high). William C. Douce, then chairman of the company, wryly described himself as a "born-again debtor."

4. September 21, 1987 Legal Times Article, "State Takeover Laws Work Well," by Steven Wallman and Ellen Ranard:

In fact, recent economic studies not only undercut the supposed economic justifications for hostile takeovers in the first instance, but also make it abundantly clear that hostile takeovers may well be harming this country's long-term competitiveness.

For example, an economic study by Edward Herman of the Wharton School and Louis Lowenstein of the Columbia University School of Law found, contrary to the assertions of hostile-takeover proponents, that many of the targets of recent hostile-takeover attempts are among the best-run U.S.

corporations. A 1987 study by Andrei Shleifer of the University of Chicago Business School and Lawrence Summers of Harvard University concluded that hostile takeovers, when they do occur, represent mere transfers of wealth from employees, bondholders, communities, and even acquiring company shareholders.

Employees are frequently laid off or required to accept lower wages. Bond credit ratings are reduced, resulting in lower values. And, most interestingly, Ellen Magenheim of Swarthmore College and Dennis Mueller of the University of Maryland found that the share price of acquiring firms frequently falls after the takeover.

In a study to be published later this year, David Ravenscraft of the University of North Carolina Business School and F. M. Scherer of Swarthmore concluded that target company performance is not improved but worsened after a takeover, thus belying the assertion that takeovers are resulting in improved operating companies. And studies of the long-term effects on target-company shareholder wealth have found that these shareholders do not benefit in the long term from accepting the tender offer premium.

In fact, according to a study by Donald Margotta of Northeastern University and Felicia Marston of Boston College, over the long term these shareholders do just as well by defending the tender offer and holding the stock of their company as they would have had they sold out for the offered premium.

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Enormous economic risks are created by the conversion of equity into debt and by the shortening of planning horizons that accompanies most hostile takeover attempts today. Investment banker Felix Rohatyn -- when reviewing the oil company restructurings prompted by T. Boone Pickens, Jr.'s raids -- called the results "a scenario about how to get the U.S. into trouble."

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The arguments in favor of "raiders," who merely attempt to put a company in play in order to force a recapitalization or greenmail, are even fewer. In these instances, there is only the slightest pretense of replacing "inefficient managers," because the management does not change in the recapitalization. Pickens has engaged in numerous such "raids" -- never once taking over a company and never once replacing entrenched management, but nevertheless walking away with hundreds of millions of dollars.

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Proponents of hostile takeovers also cite certain studies, like the study of the Ohio law by the Security and Exchange Commission's Office of Chief Economist, to prove the undesirability of state takeover statutes. Even disregarding the theoretical flaws in such an "event" study, Professor Margotta found that, by simply extending the study period by one day, all the negative findings were contradicted.

5. March 5, 1987 <u>The Christian Science Monitor</u> Article, "Big Business Urges Legislation To Tame The Takeover Tycoons," by Barbara Bradley:

Mr. Roderick (Chairman of the Board of USX) has had to fend off four takeover artists -- Robert <u>Holmes-a-Court</u>, <u>T. Boone Pickens</u>, <u>Irwin Jacobs</u>, and, finally, <u>Carl Icahn</u> -- in the last six months. To do so, USX has undergone drastic restructuring, including spinning off its industrial chemicals business, selling its US Steel supply division, and refinancing its Marathon Oil notes.

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One Senate Banking Committee aide notes that $150 billion was spent on mergers, acquisitions, and leveraged buyouts last year, while $140 billion was spent on new plant and equipment. "The way the rules are shaped favors hostile takeovers whether or not a takeover is aimed at good management," he says.

6. January 16, 1987 Financial Times Article, "Independence Comes At A Punitive Cost," by William Hall:

> But most important, it focused attention on the apparent conflict between Wall Street's short-term share performance requirements and Unocal's longer-term objectives, which the company argues would be reflected in its share price, given time. Did Pickens's takeover bid force the company to take a number of short-term decisions which impaired its long-term future?
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> By all accounts, Unocal was a well run oil company -- albeit conservatively financed -- on the eve of Pickens's arrival on the scene in February 1985. It had made a profit every year since 1901 and had paid a regular cash dividend for 70 years. Unlike most takeover candidates in the depressed oil industry, Unocal had a fairly successful oil exploration record and did not have much obvious fat to shed.
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> In addition, long-term investors in Unocal stock had done considerably better than investors in some of the company's bigger rivals. Unocal says that Dollars 10,000 invested in its stock in 1960 would have been worth Dollars 127,000 by the beginning of 1985, while a similar investment in Exxon, Chevron, Mobil and Texaco would have been worth about Dollars 37,000.
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> "Interest charges are crippling their earnings," says Petroleum Analysis, which argues that Unocal's challenge is to keep its operations on as even a keel as possible until oil and gas prices improve. At Dollars 15 a barrel "that can probably be accomplished without dramatically damaging the company's long-term future." However, if prices were due to fall below Dollars 12 a barrel, the company would probably have to begin selling its core assets to survive. Several of its stronger competitors, such as Standard Oil and Amoco, are known to be interested in acquiring some of

> Unocal's plum assets if it is forced to sell. Unocal's geothermal properties, its large truck stop fuel operations, its downstream refining and marketing business in the US and its overseas concerns could all easily be sold.
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> He does not deny that Unocal has paid a high price for its independence. Because of the huge debt burden, it will no longer be able to exploit its previous financial strength to move quickly into exploration, or buy assets when attractive profit opportunities appear.
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4. <u>What does the proposed legislation do about the problems?</u>

<u>Section 203 does not prohibit takeovers.</u> It discourages only those highly leveraged transactions designed to exploit the assets of the target company for the private benefit of the acquiror. The fact that an acquiror, if he gets only 50% + 1 of a company's stock, can thereafter expropriate the remaining shares at a price, in either cash or debt, picked soley by the acquiror, "stampedes" investors into the tender offer to avoid becoming subject to the acquiror's coercive power to take away their stock in the "back-end" merger at a price which may even be lower than that paid to those who tender, or may be for risky debt instead of cash. Many of these takeover attempts are geared to harass or rattle management into repurchasing the raider's stock to avoid the company being carved up and thus are illusory and never serious offers. This whole mechanism for coercing stockholders into accepting less than fair value for their stock flows from

a quirk in the Delaware Corporation Law, first introduced in 1969, which permits a 51% stockholder to cash out the 49% minority. All the amendment does is limit the ability of the raider to utilize this mechanism for three years, unless he pays a full price in a tender offer to all stockholders or subsequently meets criteria which assure that his "freeze-out" will be fair to all stockholders.

The proposed legislation promotes serious, fully-financed and fully-priced offers for all or most of the stock of the corporation and discourages those underfinanced and underpriced offers which serve primarily as vehicles for compelling "greenmail" or for permitting acquirors to otherwise benefit at the ultimate expense of the small, less sophisticated shareholder.

5. Will this legislation have a negative effect on market prices of stocks of Delaware corporations?

No -- it will encourage, not discourage, fully priced tender offers which permit all stockholders to obtain a greater value for their stock than they can presently get given the ability of an acquiror with only a 50% ownership to force out the remaining minority. Under new § 203, all stockholders will have a better chance to have their shares purchased at a price higher than market by virtue of tangible, fully-financed offers rather than ephemeral deals that are never consummated. The only transactions that will be discouraged are those in which acquirors seek to seize for themselves an unfair portion of the spread between market price and the longer term value of a company.

Professor Donald G. Margotta, Professor of Finance at Northeastern University, has studied the effect of the adoption of the New Jersey takeover statute -- a more restrictive statute than the one proposed here -- on the stock prices of New Jersey corporations during the period from January 23, 1986, when the legislation was introduced, to April 1, 1987 when the act had been in effect for approximately 8 months. Margotta's study examined five critical dates in the history of the legislation and determined that there were no statistically significant effects on the stock prices of the affected companies. The study concluded:

> The New Jersey legislation had no effect on stock prices of companies incorporated in New Jersey.

Professor Margotta did a similar study of the Ohio anti-takeover laws -- again, statutes far more "anti"-takeover than the proposed Delaware legislation -- and concluded that neither of two successive enactments significantly affected the long-term shareholders of Ohio corporations. Professor Margotta's study notes -- with respect to the Ohio, New Jersey and New York takeover statutes -- that while there do appear to be small drops in stock prices around the date of passage, they are generally statistically insignificant and are followed by rebounding stock prices.

6. Will this legislation protect the average stockholder who winds up among the minority in the "back-end" of a hostile acquisition?

Yes it will. The legislation encourages acquirors to make fully priced offers to all stockholders so as to achieve the adjusted 85% threshold. Obviously, more must be paid to all stockholders to reach this goal than must be paid to achieve only 50% + 1. Further, the practice of making offers only to a small percentage of stockholders is discouraged, reducing the risk that the less sophisticated stockholder will be left holding the bag as a minority stockholder.

7. Will pension benefits be affected if this legislation is passed?

No. The claim that this legislation will reduce pension benefits is scandalous and without foundation. Even if the legislation did have some effect on stock value -- which is unlikely -- the amount of a retiree's pension benefits is established by an individual plan, in most cases years before his retirement. Those benefits are required by federal law to be funded in trust funds not subject to the claims of the employer's creditors. Employers are obligated to fund promised pension benefits by yearly contributions in prescribed minimum amounts as set forth in a federal law known as ERISA (Employment Retirement Income Security Act). ERISA requires that the sufficiency of this funding be monitored by independent actuaries, so that if the value of the common stock segment of a pension fund drops, the employer has to make up any shortfall by increased contributions, so that the plan remains actuarially sound. And the payment of pension plan benefits are unconditionally guaranteed by a federal corporation which receives annual contributions from employers, the Pension Benefit Guarantee Corporation. As a result of all this, pension benefits are not affected by day-to-day swings in the market for common stocks (which make up only a part of most pension fund portfolios) since they are guaranteed under the law. In fact, the legislation may actually help employees who look forward to future pension benefits because it is intended to regulate the takeover of corporations by raiders who eliminate jobs by selling corporate assets and frequently dip into overfunded pension plans to repay their acquisition debt.