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IMPACT OF CORPORATE TAKEOVERS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

THE EFFECT OF MERGERS ON MANAGEMENT PRACTICES, COST, AVAILABILITY OF CREDIT, AND THE LONG-TERM VIABILITY OF AMERICAN INDUSTRY

APRIL 3, 4, JUNE 6 and 12, 1985

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WITNESSES

nity to see to it that we can fashion a legislative proposal that will be fair to all the shareholders, not impinge upon the free enterprise system as such, but certainly I think we can all agree that permitting these takeovers and greenmail episodes as well as the many other actions that have been taking place in recent weeks and months to continue without our attempting to resolve the issues in this committee where it properly belongs would indicate a failure on our part to meet our responsibilities.

The chairman knows that in the last session I was prepared to go to the floor with some amendments. I would hope that we not resolve the matter in that way, but that this committee can fashion a piece of legislation either mine or someone else's that will meet the challenge and that we not make it a matter of who can gain 51 votes on the floor of the U.S. Senate. I think it's a pressing problem. I think it's a matter of concern to the American economy and to the system as such, and I'm very happy to work with the chairman and grateful to him for his cooperation.

Senator D'AMATO. Let me ask our witnesses—first of all, let me express the thanks of this committee for all of you taking your time to be here. You have come many miles and left important engagements to share your knowledge and your insights with us. If it is possible to summarize your statements in 10 minutes, then we will have more of an opportunity to ask you some of the questions that I know my colleagues will have. So I would ask you to be mindful of the time limit and we'll begin hearing testimony from the left to the right.

Mr. Lipton needs no introduction to this panel from the business community. He's been involved in the corporate takeover area, both offensively and defensively, in more cases than most have been in a lifetime. We are delighted that you're here and look forward to your testimony.

STATEMENT OF MARTIN LIPTON, ESQ., SENIOR PARTNER, WACHTELL, LIPTON, ROSEN & KATZ, NEW YORK, NY

Mr. LIPTON. Thank you, Senator D'Amato.

DISASTROUS EFFECTS

During the past 3 years there has been sharp growth in highly leveraged takeovers by entrepreneurs who are not interested in operating the target companies, but seek the opportunity for profit through greenmail, bustup liquidation of the target or forcing a white knight transaction that usually also results in bustup liquidation of the target. These takeovers are not for the purpose of diversification, expansion, or growth. They are financial transactions for the profit of the takeover entrepreneurs. They do not create jobs. They do not add to the national wealth. They merely rearrange ownership interests by substituting lenders for shareholders and shift risk from equity owners to creditors. They place our banking system and credit markets in jeopardy. They restrict the ability of the affected businesses to grow and provide increased productivity and employment.

The President's Council of Economic Advisers and the Office of Management and Budget, as well as a large number of private economists, argue that hostile takeovers move the assets of the targets into the hands of more efficient management and therefore are economically desirable. This often is correct with respect to soundly financed acquisitions by operating companies that are seeking to diversify or expand. Mergers by successful operating companies have been an integral part of our economic development. They should not be restricted. They improve the economy. But this is not true with respect to bustup liquidation takeovers by takeover entrepreneurs. They do not move assets into more efficient management. They move assets into hands that profit by reducing expenditures for research and development and capital improvements. After a highly leveraged takeover, a very high percentage of the revenues produced by the acquired assets must be diverted from research and development and capital investment to paying the debt incurred to acquire the assets.

The situation can be analogized to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by building fences, planting cover, and creating windbreaks. In the early years our farmer will maximize his return from the land. It is a very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster.

A national policy favoring bustup takeovers is a policy that favors the present at the expense of the future. It is consistent with economic policies and political decisions that result in huge deficits in the national budget. Those deficits also benefit the present at the expense of the future. The reasoning of the Council of Economic Advisers and the Office of Management and Budget with respect to takeovers is apparently the same as that which results in the national deficits. These policies are not sound. Unfortunately, the future has no political constituency.

In addition, our accounting conventions and tax laws favor highly leveraged acquisitions over direct research and development and new product introduction expenditures and capital investments. The ability to defer, over periods as long as 40 years, the amortization of acquisition premiums makes takeovers more attractive from an accounting standpoint than those expenditures which must be charged against income immediately or over a relatively short period. The ability to deduct for tax purposes interest on debt, but not dividends on stock, makes high leverage more attractive than sound balance sheets. These are arbitrary tax and accounting policies which, although in effect for many years, have no fundamental justification. It is time that their serious adverse impact on the economy is recognized and corrected.

We have entered the era of the two-tier, front-end loaded, bootstrap, bustup, junk bond takeover. Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing businesses to forego. The message is clear. If a company wants to avoid being taken over and busted up, it must sacrifice long-term growth and future profits. It must use the maximum amount of leverage and operate with the primary objective of short-term profitability. This may in the short run save it from the liquidator

However, it will ultimately succumb to the advantages enjoyed by its foreign competitors. They are not hindered by outmoded tax laws and accounting conventions. They are not prey to takeover entrepreneurs and the institutional investment managers who encourage takeover entrepreneurs.

As the takeover entrepreneurs have grown more aggressive corporations are being forced to match them. We are faced with escalating offensive and defensive tactics. To meet the threat of the two-tier, front-end loaded, bootstrap, bustup, junk bond takeover, we have developed fair price charter amendments, fair value rights and staggered boards. The takeover entrepreneurs and their academic supporters call them shark repellents, poison pills, and management entrenchment. To us, they are only defensive missiles—never to be fired except in self-defense.

The bustup takeover and the extreme leverage that is being built into the structure of American business have created a pressing national problem. While different in form, what we face today is not different in substance from what happened in 1928 and 1929. Leverage produces great results on the way up, but no economy ever goes up in a straight line and high leverage inevitably produces a crash when an economy turns down.

I have proposed legislation to deal with part of the problem. The legislation I propose is a balanced approach to correcting the abuses of the takeover process. Its net effect is to curb takeover abuses and promote real shareholder democracy. At the same time, unlike some recent legislative proposals, it preserves the traditional role of the States in regulating corporations. However, my proposal is not an overall solution. That can be achieved only by correcting the accounting and tax policies that encourage highly leveraged speculative takeovers. As indicated by the opening statements of some of the Senators this morning, such legislation has been proposed and is now being studied. I believe that all of these proposals are deserving of careful consideration by this committee and the Congress. Thank you.

[The complete prepared statement follows:]

TESTIMONY OF

MARTIN LIPTON, ESQ.

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

APRIL 3, 1985

THE SHAREHOLDER PROTECTION AND ELIMINATION OF TAKEOVER ABUSES ACT OF 1985

INTRODUCTION

In light of the experience in the last session of Congress with H.R. 5693, 5694, 5695 and 5972, and S. 2754, 2782, 2783, 2784 and 2785 (including H.R. 5694 and S. 2783 that I drafted), I recommend a new legislative approach to protect shareholders and eliminate the abuses that have crept into the takeover process.

The new approach, called the Shareholder Protection and Elimination of Takeover Abuses Act of 1985, builds on my personal experience as counsel for both acquirors and target companies in takeover matters, service on the Securities and Exchange Commission Advisory Committee on Tender Offers and the testimony and comments submitted to Congressional committees in connection with pending bills.

The legislation I propose:

° Does not add new regulation, but primarily accomplishes its objectives through deregulation.

° Protects shareholders from takeover abuses by both takeover entrepreneurs and entrenched managements.

° Assures all shareholders of fair and equal treatment and ample time to make reasonable decisions as to their best alternatives in takeover situations.

° Eliminates the universally condemned practice of greenmail.

° Preserves shareholder democracy and gives the holders of common stock a really meaningful opportunity to use the corporate proxy machinery to prevent management entrenchment. A substantial shareholder will have the same right as, and equal opportunity with, management to urge the shareholders to change corporate policy or management.

° Does not deter or handicap takeover bids by companies that are prepared to make fair and equal offers to all shareholders and permits cash and securities tender offers to be made on an equal basis.

° Protects employees, customers, suppliers, pensioners and communities against the disasterous effects of bust-up takeovers.

° Does not in any way interfere with the traditional role of the states in corporate governance and leaves the business judgment rule to evolution in the state courts.

° Eliminates abusive front-end loaded two-tier tender offers and creeping open-market takeovers that were developed to give takeover entrepreneurs the upper hand, and thereby eliminates the need for takeover targets to resort to shark repellents, crown jewel options, pac-man defenses, issuance of blocking preferreds, poison pills, greenmail and other pejoratively named defenses developed to try to counterbalance such takeover tactics.

° Preserves the ability of corporations to raise venture capital, use innovative financing techniques, negotiate desirable mergers and acquisitions and have all the free market acquisition and financing flexibility they presently enjoy.

° Enables corporations to reduce their concern with abusive bust-up takeovers and devote greater time and resources to the long-term planning that is essential to the preservation of the preeminent position of American industry in a worldwide economy.

° Creates an even playing field on which free market forces and the competitive skills of corporate managements can assure that our public corporations and national assets are managed by the best people and are devoted to the uses that are most favored by free market forces.

I believe that it is vital to the national interest to move quickly to eliminate takeover abuses. I think that goal can be accomplished with the legislation I propose.

THE BUST-UP TAKEOVER PROBLEM

"Greenmail" has become part of our everyday vocabulary and takeover abuses have become a pressing national problem. During the past three years there has been sharp growth in highly-leveraged takeovers by entrepreneurs who are not interested in operating the target companies, but seek the opportunity for profit through greenmail, bust-up liquidation of the target or forcing a white knight transaction that usually also results in bust-up liquidation of the target. These takeovers are not for the purpose of diversification, expansion or growth, but are financial transactions for the profit of the takeover entrepreneurs. They do not add to the national wealth. They merely rearrange ownership interests by substituting lenders for shareholders and shift risk from equity owners to creditors. They place our banking system and credit markets in jeopardy and restrict the ability of the affected businesses to grow and provide increased productivity and employment.

The President's Council of Economic Advisers and the Office of Management and Budget, as well as a large number of private economists, argue that hostile takeovers move the assets of the targets into the hands of more efficient management and therefore are economically desirable. This is correct with respect to soundly-financed acquisitions by operating companies that are seeking to diversify or expand. Mergers by successful operating companies have been an integral part of our economic development. They should not be restricted. They improve the economy. But this is not true with respect to bust-up liquidation takeovers by takeover entrepreneurs. They do not move assets into more efficient management. They move assets into hands that profit by reducing expenditures for research and development and capital improvements. After a highly-leveraged takeover, a very high percentage of the revenues produced by the acquired assets are diverted to paying the debt incurred to acquire the assets.

The situation can be analogized to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by building fences, planting cover and creating windbreaks. In the early years he will maximize his return from the land. It is a very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster.

A policy favoring bust-up takeovers is a policy that favors the present at the expense of the future. It is consistent with economic policies and political decisions that result in huge deficits in the national budget. Those deficits also benefit the present at the expense of the future. The reasoning of the Council of Economic Advisers and the Office of Management and Budget with respect to takeovers is not different from that which results in the national deficits. These policies are not sound. Unfortunately, the future has no political constituency.

The shares of most companies that devote a significant part of their cash flow to research and development and capital investment sell in the stock market at a discount from liquidation value. The stock market discounts substantially the profits that will be produced in the future by investment in research and development and capital improvements. The market today prefers immediate shareholder realization of the present value of the investments that would otherwise finance the research and development and capital improvements that would provide long-term growth and future profits to shareholders.

In addition, our accounting conventions and tax laws favor highly-leveraged acquisitions over direct research and development and new product introduction expenditures and capital investments. The ability to capitalize and defer for up to 40 years the amortization of acquisition premiums makes takeovers more attractive from an accounting standpoint than those expenditures which must be charged against income immediately or over a relatively short period. The ability to deduct interest on debt, but not dividends on stock, makes high leverage more attractive than sound balance sheets. These are arbitrary tax and accounting policies which, although in effect for many years, have no fundamental justification. It is time that their serious adverse impact on the economy is recognized and corrected.

Institutional investment managers prefer short-term gains to long-term growth. Institutions will accept any premium over the current stock market price rather than hold a portfolio investment for appreciation in the future. This investment policy is mandated by the competitive necessity for institutional investment managers to show better performance than the market as a whole and other investment managers.

New business flows to investment managers on the basis of their investment performance compared to each other and to the stock market as a whole. Thus, they have a strong incentive to focus on short-term portfolio performance rather than long-term investment. This leads investment managers not just to accept any takeover premium that is available, but to go further and join forces with the takeover entrepreneurs to force companies to effect any takeover that will produce a premium over current market. Takeover entrepreneurs have gained the active support of major institutional investors.

This further exacerbates the bust-up takeover problem. Since most of the large publicly-held companies are effectively controlled by institutional investors, the coordinated activity of takeover entrepreneurs and institutional investors threatens every large public company that sells in the stock market for less than its liquidation value with a bust-up takeover. At a Labor Department hearing on January 15, 1985, Mr. Jesse Unruh, the Treasurer of California, announced the formation of the Council of Institutional Investors to coordinate the actions of institutional investment managers on such matters as takeovers and stated that by banding together the institutions could exert "incredible force" over corporate managements. Subsequently, Mr. Unruh's Council played an active role in the attempt to take over the Phillips

Petroleum Company and supported the takeover entrepreneur who was seeking to force the bust-up of Phillips.

We have entered the era of the two-tier, front-end loaded, boot-strap, bust-up, junk bond takeover. Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing businesses to forego. The message is clear. If a company wants to avoid being taken over and busted up, it must sacrifice long-term growth and future profits. It must use the maximum amount of leverage and operate with the primary objective of short-term profitability. This may in the short run save it from the liquidator but, like the farmer who ravages his land, it will ultimately succumb to the advantages enjoyed by its foreign competitors who are not hindered by outmoded tax laws and accounting conventions and who are not prey to takeover entrepreneurs and the investment managers who encourage them.

The acute problem is not greenmail. It is the bust-up takeover and the extreme leverage that is being built into the structure of American business. While different in form, what we face today is not different in substance from what happened in 1928 and 1929. Leverage produces great results on the way up, but no economy ever goes up in a straight line and high leverage inevitably produces a crash when an economy turns down.

It is clear that abuse of the corporate takeover process has become a serious problem and is a threat to the economic system of the United States. On the other hand, as the takeover entrepreneurs have grown more aggressive, corporations have been forced to respond with defensive mechanisms to match them. While these mechanisms may be necessary to protect against abusive takeover tactics, they can affect the normal voting processes of the corporation's shareholders and may have other regrettable impact on corporate democracy. The net effect of the entire situation is that shareholders are hurt and American business is hurt.

Any successful solution must attack the problem as a whole, rather than focusing on particular symptoms. The legislation I propose is a balanced, cohesive approach to corporate takeover abuses. Its net effect is to curb takeover abuses and promote true corporate shareholder democracy. At the same time, unlike some recent legislative proposals, it preserves the traditional role of the states in regulating corporations. It does not deter takeovers, and it does not encourage management entrenchment. Nor does it add federal or Securities and Exchange Commission regulation. It deregulates rather than adds to regulation. It returns corporate power to shareholders while concurrently giving them necessary protection against speculators who would profit at the corporation's and the shareholders' expense.

PROPOSED LEGISLATION

The proposed legislation would amend the Securities Exchange Act of 1934. First, the legislation would provide that, with certain exceptions, the acquisition of more than 5% of the outstanding shares of voting stock of a publicly held corporation could only be accomplished by an offer for all of the corporation's shares. The offer could be for cash or securities or a combination of cash and securities. In order to allow for legitimate passive investment, an institutional investor would be allowed to acquire up to 10% of the outstanding shares for investment purposes only, but would not be allowed to participate in any way in seeking a change of control until five years after reducing its holdings below 5%. Excepted entirely from the 5% limit would be proxy groups (unless they were seeking a merger, sale of substantial assets or other business combination), existing holders of 5% or more on the effective date of the legislation, acquisitions by or from the corporation, by an employee benefit plan or pension fund of the corporation, by a subsidiary of the corporation or with the approval of the corporation, and intra-family transfers.

By means of this provision, while legitimate investment will be protected, two-tier bids that pressure shareholders and favor market professionals over unsophisticated investors will be eliminated. Greenmail will also be eliminated. The would-be greenmailer will no longer be able to threaten to harm the corporation's shareholders with a creeping, two-tier or partial takeover attempt. In addition, the 5% limit on creeping acquisitions will eliminate the incentive to pay greenmail to buy back a 5% or larger block because larger blocks could no longer be created and a less than 5% block could easily be recreated.

Based on the protection provided by the 5% limit, the proposed legislation will also require shareholder approval before a corporation could repurchase its own shares from a holder of 3% or more of the corporation's voting securities at a premium above market (unless an offer of equal value were made to all holders of shares of the same class). In the current takeover environment, restricting corporations from paying greenmail would simply channel the efforts of creeping-acquiror takeover entrepeneurs into different avenues detrimental to unsophisticated investors. With the protection of the 5% limit, however, the 3% proscription on greenmail is appropriate and will eliminate greenmail without encouraging the takeover entrepeneurs to pursue other abusive tactics.

The proposed legislation will extend the period during which a tender offer must be held open from the present 20 business days to 60 calendar days. In conjunction with this amendment, the present statutory provision allowing securities deposited pursuant to a tender offer to be withdrawn after 60 days would be amended to allow withdrawal after 90 days. Extension of the tender offer period will give shareholders and boards of directors needed time to evaluate fully the merits of an unsolicited tender offer without being subjected to the kind of intense pressure that now often leaves a board with no choice but to act hastily and, in some cases, rashly. Because the time pressure on boards of directors will be lessened, many actions that are justifiable in the pressured context of a 20-day offer period may be found to be inappropriate in the new context of a 60-day offer period. This will permit the state courts to give new content to the business judgment rule as applied to takeover decisions.

Because the 5% limit on creeping acquisitions and extension of the tender offer period to 60 days will, to a great extent, curb abusive offensive takeover tactics and reduce the undue pressures now placed on directors in the takeover context, it becomes possible to mandate a high degree of shareholder democracy without the fear that shareholders will be taken advantage of in the process. To this end, the proposed legislation would provide that a corporation's shares could not be traded on a national securities exchange or through a national securities association unless (a) all of the corporation's common stock has one vote per share and (b) the corporation's common stock represents at least a majority of the voting power for directors of the corporation. This provision would become effective as of December 31, 1986, but the Securities and Exchange Commission would have the power to provide exemptions, in order to accommodate corporations unable to modify their governing instruments by the effective date and otherwise to avoid undue hardship and disruption to the securities markets. In conjunction with this provision, the proposed legislation would allow free and equal access to the corporate proxy machinery for candidates for election as directors who were nominated by shareholders with 3% of the corporation's outstanding voting power or $500,000 in market value of the corporation's shares, whichever is higher. These thresholds will prevent shareholders and corporations from being plagued by proxy statement gadflies but at the same time assure that any substantial shareholder can submit to a shareholder vote any takeover proposal or change in corporate management. It is assumed that in its rulemaking and enforcement activities implementing these provisions, the Securities and Exchange Commission will be able to eliminate or curtail voting trusts, long-term proxies, supermajority charter provisions, staggered election of directors, standstill agreements and other devices that effectively deprive the holders of a majority of the common stock of a corporation from the unfettered ability to elect a majority of the directors and thereby influence corporate policy and management.

Finally, the legislation would amend Section 13(d) of the Securities Exchange Act of 1934 by lowering the threshold level at which a person must report beneficial ownership from 5% to 3% of a public company, and concurrently tightening the reporting exemption for acquisition of no more than 2% of the company's shares in a 12 month period to no more than 1%. This change is necessary in order to facilitate the provisions prohibiting greenmail repurchases from a 3% holder and allowing free and equal access to the corporate proxy machinery for candidates for director nominated by holders of 3% of a corporation's stock. Because of the 5% limit on creeping acquisitions, however, no other changes to Section 13(d) would be necessary.

The proposed legislation, as a whole, would restore control of the public corporation to its shareholders without allowing self-seeking takeover entrepeneurs to take advantage of those shareholders. It would allow direct corporate accountability and responsibility in a context that will promote fair and equal treatment. It is a precise, balanced approach that encourages fair takeover offers and gives shareholders the ability to decide the fate of those offers and the future of their corporations.

By effectively barring the most abusive offensive takeover tactics, the proposed legislation will remove any incentive corporate managements might have to engage in abusive defensive tactics. The new federal approach will thus allow state courts to apply the business judgment rule in a new context. With the shareholder protections and reduction of pressure embodied in this legislation, certain management measures may no longer be necessary or entitled to the protection of the business judgment rule, even as presently interpreted. At the same time, the legislation will not impinge on the states' historical role in fashioning corporate law.

Finally, by restoring shareholder democracy, this proposed legislation will mean that shareholders, once again, are assured of the best deal. This proposed legislation is the answer to the critical policy issues recently cogently summarized by former Securities and Exchange Commissioner Francis M. Wheat in these words:

To sum up, we have a situation in which the hostile takeover, once rare in corporate life, has become commonplace. Clear advantage lies with the raider unless the target company takes radical defensive measures. Only thus can it hope to remain independent if its directors believe the time is not ripe for sale. Accordingly, targets, their lawyers and their investment bankers have been ingenious in devising defenses, only a few of which have a solid chance of success. Alas, those are the very defenses that will inevitably result in loss of important assets, increased vulnerability to recession, partial or complete disenfranchisement of public shareholders, or all three. Meanwhile, large amounts of management time and effort are diverted from management's primary job and, where the focus of management is on the business, short-term results are likely to receive undue attention. It is astonishing to me that these deleterious effects, which the practicing lawyer in the field cannot help but see, are well-nigh invisible to those economists of the Chicago school (and their special friends among law professors) who are in love with takeovers. Before and after market prices (like the pictures of the fat lady who took the reducing pills) appear to be their principal, if not their only, analytical ground.

There is no doubt that most of the defensive measures which companies take are bad. The Commission has sought legislation which would place severe limitations on certain of these defensive measures, although its effort now seems to be running counter to the latest administration position that <u>any</u> legislation on the subject of tender offers is unnecessary and would be an intrusion into the province of state law. Last spring, the head of the Commission's Division of Corporation Finance suggested that the business judgment rule should be modified in the hostile takeover context. He would place the burden of justification for defensive actions on the target's management and board of directors, rather than the reverse. Alas, in my humble judgment, the Commission has focused on the symptoms and not on the disease. As long as the hostile takeover is a growing threat, it will be countered by a growing panoply of defenses. And recent indications are that the business community will not

> stand for the enactment of measures which severely weaken the ability of companies to defend themselves, by whatever means.
>
> It is my suggestion that we cease to wring our hands over the symptoms and consider steps to root out this malady.

The Shareholder Protection and Elimination of Takeover Abuses Act of 1985 is designed to root out the malady.

ANALYSIS OF PROPOSED LEGISLATION

1. Section 1 of The Shareholder Protection and Elimination of Takeover Abuses Act of 1985 (the "Protection Act") adds a new subsection (h) to Section 14 of the Securities Exchange Act of 1934. The new subsection provides that the acquisition by any person of voting equity securities which would entitle that person to cast 5% or more of the votes entitled to be cast in the election of directors of a publicly held company must be by means of a tender offer or exchange offer (or a combination tender offer and exchange offer) that includes an offer for all of the corporation's common stock. This limit does not apply to acquisitions by a proxy group not seeking a merger, sale of substantial assets or other business combination (so long as the individual members of the group comply with the limit), continued holding by a holder of more than 5% of the corporation's voting power on the effective date of the legislation, acquisitions by or

from the corporation, by an employee benefit plan or pension fund of the corporation, by a subsidiary of the corporation or with the approval of the corporation, and intrafamily transfers. In addition, an institutional investor will be allowed to acquire up to 10% of the corporation's shares for passive investment purposes only, provided that such an investor may not change its passive investment intent for a period of five years after reducing its holding below 5%. The definition of an institutional investor used in the Protection Act is derived from Rule 13d-1(b)(1) under the Securities Exchange Act of 1934, which prescribes the requirements for a Schedule 13G as opposed to a Schedule 13D filing. The definition of person includes two or more persons acting in concert or in a coordinated or consciously parallel manner, even if not pursuant to an express agreement.

This provision does not regulate the price at which or the consideration by which the tender offer or exchange offer must be made. Because the threshold for non-tender or exchange offer purchases is set at 5%, shareholders are sufficiently protected without having to require that the offer price be at least equal to the highest per share price paid by the acquiror in purchasing stock prior to the offer. If the limit were higher than 5%, "fair" price protections would have to be included. This provision also allows offers to be made for cash, securities or a combination of cash and securities. There is no requirement that, in a combination offer where shareholders can choose between cash and securities, the cash and securities be of equal value because, by its terms, the same offer must be made for all shares to all shareholders. In the context of a 60 day offer (as is required under Section 3 of the Protection Act) where shareholders will have adequate time to evaluate the alternative forms of consideration, the market force of the alternative elections together with full proration will protect the shareholders' ability to receive equal value for their shares.

In addition, this provision permits any form of acquisition, including partial and two-tier acquisitions, with the approval of the corporation. Under the corporation laws of most states, this power would be exercised by the board of directors of the corporation. In addition, in some circumstances, shareholder approval is required for acquisitions above a certain level. In this manner, the flexibiliy afforded by state law is maintained to allow, among other things, venture capital investments and partial offers that the corporation determines are advantageous to all shareholders. This provision also facilitates saleability of existing large blocks of stock.

2. Section 2 of the Protection Act adds a new sub-

section (i) to Section 14 of the Securities Exchange Act of 1934. The new subsection requires shareholder approval before a publicly traded company may purchase, at a premium over the market price, any of its voting securities from any person who holds more than 3% of the class of voting securities to be purchased, unless such purchase is part of an offer made at the same price to all holders of such securities. The Securities and Exchange Commission is given power to grant exemptions from this provision.

This provision recognizes that with the 5% limit on creeping acquisitions embodied in Section 1 of the Protection Act, there is little incentive for a corporation to pay greenmail (i.e. repurchase a block of shares from a large holder at a premium price). This is because no larger block than 5% may be accumulated (except through an offer for all the shares), and a 5% block could easily be recreated. Without the protections of Section 1, the restriction on repurchase at a premium would not be advisable. With those protections, however, this provision can be expected to eliminate greenmail without encouraging other takeover abuses. Section 2 does not define "market price". It is anticipated that the Securities and Exchange Commission will develop a definition of market price which will take into account the prices of securities as reflected on securities exchanges, or for securities not listed on any exchange, the average bid and asked prices as quoted on a quotation system or as furnished by a professional market maker. It is not intended that this provision restrict the purchase of debt or other nonvoting securities.

3. Section 3 of the Protection Act amends Section 14(d) of the Securities Exchange Act of 1934 to extend the period during which a tender offer must be held open from the present 20 business days to 60 calendar days, and to extend the time after which securities tendered may be withdrawn from the present 60 days to 90 days.

Although extension of the tender offer period might be argued to deter offers, the overall effect of the Protection Act is to remove many deterrents to offers and, within this context, extension of the tender offer period is necessary. Extension of the tender offer period will also allow courts, in applying the business judgment rule, to reject the argument that extreme defensive tactics are justifiable because they are necessary to "buy time" in looking for alternatives to the offer. With sufficient time, defensive tactics that under pressure seem to be the only alternatives available to a corporation may turn out to be the less desirable of a number of alternatives.

4. Section 4 of the Protection Act adds a new sub-

section (j) to Section 14 of the Securities Exchange Act of 1934. The new subsection provides that a company's shares may not be traded on a national securities exchange or through a national securities association unless each share of the company's common stock has one vote, and a majority of the voting power for directors of the company is held by the common stock. The subsection gives the Securities and Exchange Commission the power to grant temporary exemptions from this provision in order to accommodate corporations unable to modify their governing instruments by the effective date and otherwise to avoid undue hardship and disruption to the securities markets. It is assumed that in its rulemaking and enforcement activities under this subsection the Securities and Exchange Commission will be able to secure the elimination of voting trusts, long-term proxies, supermajority charter provisions, staggered election of directors, standstill agreements and other devices that effectively deprive the holders of a majority of the common stock of a corporation from the unfettered ability to elect a majority of the directors and thereby influence corporate policy and management.

This subsection is designed to protect shareholder democracy and corporate accountability. In the context of the protections provided by Sections 1 and 3 of the Protection Act, this subsection removes a number of potential deterrents to those takeover offers that are fair to shareholders. Together with Section 5 of the Protection Act, this provision ensures that Sections 1 and 3 of the Protection Act are purely shareholder protection measures and cannot be used to diminish or insulate managers and directors from responsibility and accountability. This subsection is not intended to interfere with issuance of stock for use in connection with innovative acquisition or financing techniques that do not entrench management or preclude the effective exercise of shareholder democracy.

5. Section 5 of the Protection Act amends Section 14(a) of the Securities Exchange Act of 1934 to provide that a beneficial owner of voting securities of an issuer representing the greater of 3% of the voting power of such issuer or $500,000 in market value is entitled to free and equal access to the corporate proxy machinery for such beneficial owner's nominees for director, on an equal basis with candidates nominated by the issuer's management or board of directors.

As with Section 4 of the Protection Act, this provision encourages director accountability and responsibility. While Sections 1 and 3 of the Protection Act reduce the potential for unfair treatment of shareholders and detrimental pressure on directors, Sections 4 and 5 restore whatever director accountability might otherwise be lost, and remove deterrents to fair takeover attempts. The threshold for access to the corporate proxy machinery is set at 3% or $500,000 of the corporation's voting securities (whichever is higher) in order to protect against abuse of such access by "proxy statement gadflies" but at the same time to assure that any substantial shareholder can submit to a shareholder vote a proposal for a change in corporate management. The access to the proxy machinery provided by Rule 14a-8 under the Securities Exchange Act of 1934 would remain intact and would supplement the new provision.

6. Section 6 of the Protection Act amends Section 13(d) of the Securities Exchange Act of 1934 to reduce the threshold at which a beneficial owner of securities must report such ownership from 5% to 3%, and to tighten the reporting exemption for acquisitions within a twelve month period from 2% to 1%. This lower threshold is necessary in order to facilitate enforcement of Section 2 of the Protection Act, which requires shareholder approval of certain premium repurchases of stock from a 3% holder, and Section 5 of the Protection Act, which mandates free and equal access to the corporate proxy machinery for candidates for director nominated by holders of 3% (or, if higher, $500,000 in market value) of a corporation's stock. No other amendments to Section 13(d) are necessary in light of the 5% limit on creeping acquisitions embodied in Section 1 of the Protection Act.

TEXT OF THE SHAREHOLDER PROTECTION AND
ELIMINATION OF TAKEOVER ABUSES ACT OF 1985

Section 1. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (h):

(h)(1) It shall be unlawful for any person, directly or indirectly, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, to acquire or agree to acquire any shares of any class of voting equity securities of a corporation registered pursuant to section 12 of this title, or any shares of any class of voting equity securities of an insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of this title, or any shares of any class of voting equity securities issued by a closed-end investment compay registered under the Investment Company Act of 1940 if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of voting equity securities which would entitle such person to cast 5 percent or more of the votes that all holders of outstanding voting equity securities would be entitled to cast in an election of directors of the issuer, unless such acquisition shall be by means of a tender or exchange offer (or a combination of a tender offer and exchange offer) which includes an offer for all of the outstanding shares of common stock of the issuer (including all shares of common stock issuable upon conversion or exercise of outstanding securities, warrants, options or other rights issued or granted by the issuer).

(2) The provisions of this subsection shall not apply to:

(A) any person that on the effective date of this subsection beneficially owns voting equity securities of a corporation which would entitle such person to cast 5 percent or more of the votes that all holders of outstanding voting equity securities would be entitled to cast in an election of directors of the corporation unless, subsequent to such effective date, such person increases its beneficial ownership of voting equity securities of the corporation to a percentage in excess of the percentage of outstanding voting equity securities of the corporation beneficially owned by such person on such effective date;

(B) acquisitions of any voting equity security by the issuer of such security;

(C) acquisitions of any voting equity security from the issuer of such security;

(D) acquisitions of voting equity securities pursuant to an agreement with the issuer;

(E) acquisitions of voting equity securities by gift or inheritance or by transfer from an existing holder to an individual related to such holder by blood or marriage;

(F) acquisitions of voting equity securities of any issuer that on the effective date of this subsection and on the date of such acquisition is a subsidiary of any other corporation by such other corporation or any other subsidiary of such corporation;

(G) acquisitions by an institutional investor of voting equity securities of any issuer that would entitle such institutional investor to cast 5 percent or more, but less than 10 percent, of the votes that all holders of voting equtiy securities would be entitled to cast in an election of directors of the issuer; provided, however, that such institutional investor shall not seek, or in any way aid or assist any other person in seeking, to influence or control the management, board of directors or policies of such issuer until at least five years after such institutional investor reduces its ownership to that number of voting equity securities that would entitle such institutional investor to cast less than 5 percent of the votes that all holders of voting equity securities would be entitled to cast in an election of directors of the issuer; or

(H) acquisitions of voting equity securities of any issuer by an employee benefit plan or pension fund of such issuer.

(3) For purposes of this subsection:

(A) The term "person" shall include two or more persons acting in concert or in a coordinated or consciously parallel manner (whether or not pursuant to an express agreement) or as a partnership, limited partnership, syndicate, or other group (whether or not organized) for the purpose of acquiring, holding, or disposing of securities of an issuer, or influencing the management policies of an issuer;

provided, however, that two or more persons acting in concert or in a coordinated manner shall not be deemed a "person" for purposes of this subsection if (A) they are existing holders of voting equity securities of an issuer, (B) they are acting in concert or in a coordinated manner solely for the purpose of soliciting proxies from other holders of voting equity securities of the issuer or otherwise seeking to influence the management policies of the issuer, (C) no such existing holder has acquired any voting equity security of the issuer other than as set forth in paragraph (1) of this subsection, and (D) they have no intent to effect and are not seeking or proposing a merger, sale of substantial assets, or other business combination involving the issuer and themselves or any other person;

(B) the term "voting equity security" means any equity security of a corporation that entitles the holder thereof to vote generally in an election of directors of the corporation;

(C) the term "subsidiary" means any issuer as to which another corporation beneficially owns voting equity securities that would entitle such corporation to cast at least 50 percent of the votes that all holders of outstanding voting equity securities of the issuer would be entitled to cast in an election of directors of the issuer; and

(D) the term "institutional investor" means (i) a broker or dealer registered under Section 15 of this title; (ii) a bank as defined in Section 3(a)(6) of this title; (iii) an insurance company as defined in Section 3(a)(19) of this title; (iv) an investment company registered under Section 8 of the Investment Company Act of 1940; (v) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; (vi) an employee benefit plan, or pension fund which is subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") or an endowment fund; (vii) a parent holding company, provided the aggregate amount of the subject class of voting equity security held directly by the parent, and directly and indirectly by its subsidiaries which are not persons specified in clauses (i) through (vi) of this subparagraph, does not exceed one percent of such class of voting equity security; or (viii) a group, provided that all the members are persons specified in clauses (i) through (vii) of this subparagraph.

Section 2. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (i):

(i)(1) It shall be unlawful for an issuer to purchase, directly or indirectly, any of its voting equity securities at a price above the market price of such securities from any person who holds more than 3 percent of the voting equity securities of the issuer, unless such purchase has been approved by the affirmative vote of a majority of the aggregate voting equity securities of the issuer, or is pursuant to an offer at the same price (or equivalent per share price) made to all holders of securities of such class and to all holders of any class into which such securities may be converted.

(2) The term "voting equity security" has the same meaning as defined in paragraph (h)(3)(B) of this section.

(3) The Commission may, by rule, regulation, or order, in the public interest or for the protection of investors, and subject to such terms and conditions as may be prescribed therein, provide exemptions from the provisions of this subsection.

Section 3. Subsection 14(d) of the Securities Exchange Act of 1934 is amended by deleting the word "sixty" in current paragraph (5) and inserting in its place the work "ninety", and by renumbering current paragraphs (5), (6), (7) and (8) as paragraphs (6), (7), (8) and (9), and inserting the following as paragraph (5):

(5) Any person making a tender offer or request or invitation for tenders shall hold such offer, request or invitation open for a period of at least 60 days from the date on which the statement required by paragraph (1) of this subsection with respect to such offer, request, or invitation is filed with the Commission, except that this paragraph shall not apply to such an offer, invitation, or request by the issuer for the class of securities being sought if such offer, invitation, or request is not make in anticipation of or response to another person's offer, request, or invitation for tenders for securities of the same class.

<u>Section 4</u>. Section 14 of the Securities Exchange Act of 1934 is amended by adding the following subsection (j):

(j) It shall be unlawful for any member, broker, or dealer to effect any transaction after December 31, 1986 on a national securities exchange, or through a national securities association, in any security (other than an exempted security) of an issuer if:

(1) any of such issuer's common stock or any class of such common stock has fewer or greater than one vote per share on any issue to come before such issuer's shareholders (before giving effect to any right of such shareholders to cumulate votes in an election of directors); or

(2) the number of votes which such issuer's common stock, in the aggregate, entitles the holders thereof to cast in an election of directors of such issuer is less than a majority of the total number of votes entitled to be cast in such an election of directors;

provided, however, that the Commission is authorized to promulgate rules providing for exemptions from the operation of this subsection (j) or portions hereof to any issuer for up to three years after December 31, 1986 in those circumstances where the Commission determines that the earlier application of this subsection (j) or portions thereof would cause undue hardship or disruption of the securities markets.

Section 5. Subsection 14(a) of the Securities Exchange Act of 1934 is amended by adding the following provision:

There shall be included in any proxy statement or other communication with respect to the election of directors, sent by any issuer to its shareholders pursuant to this subsection, descriptions and other statements of or with respect to any candidates for election as directors nominated by any person who is the beneficial owner of voting securities of such issuer representing the greater of (1) 3% or more of the voting power of such issuer's securities or (2) $500,000 in market value. Such descriptions and other statements shall be submitted by or on behalf of such candidates, shall receive equal space, coverage and treatment as is received by candidates nominated by the board of directors or management of such issuer, and shall be subject to such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 6. Section 13(d) of the Securities Exchange Act of 1934 is amended by deleting the phrase "5 per centum" in paragraph (1) thereof and inserting in its place the phrase "3 per centum" and by deleting the phrase "2 per centum" in paragraph (6)(B) thereof and inserting in its place the phrase "1 per centum."