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IMPACT OF CORPORATE TAKEOVERS

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FIRST SESSION

ON

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

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Senator D'AMATO. Thank you very much.

Let me see if we can't focus in on some of Mr. Lipton's descriptions of a two-tier takeover. I won't use all of the other adjectives, Marty.

TWO-TIER TENDER OFFERS

Let me ask you this. How would you deal with what you perceive to be that evil—the front-end loaded two-tier tender offer, the greenmail problem as you perceive it—and also I'd like you to comment, if you would, on some of what has been characterized as management's defensive techniques that fly in the face of legitimate shareholder governance? Are we seeing a swing to defend against takeovers to the point where poison pill legislation and other kinds of things are becoming so commonplace that we are depriving shareholders of participation or representation that they are entitled to?

If you would address both of those.

Mr. LIPTON. Yes; the proposal that I submitted to you and this committee on November 20, and which is contained in the written testimony that I submitted, I think, provides the essential means to accomplish those objectives.

There is no question that with the escalation of takeover tactics and the strengthening of the hand of bidders to stampede shareholders into making poor decisions with respect to their investments, there has been an escalation of the attempt on the part of corporate management to try to recreate a level playing field. That has not been successful. Today, the bidders are able to stampede shareholders into selling their shares before the directors of corporations have an opportunity to try to maximize value for shareholders.

There is no question that the takeover entrepreneurs have great objection to the so-called shark repellents, poison pills, and so on. What they are objecting to is a redressing of the imbalance and the taking away of some of their ability to bully shareholders into acting in the interest of the takeover entrepreneur and not the interest of the shareholder and the Nation as a whole.

What I have suggested is that we deescalate the tactics substantially, that we eliminate the partial two-tier tender offer, that we eliminate greenmail, that we eliminate the ability to acquire control without offering a control premium to all shareholders, by essentially providing that a potential acquirer cannot go beyond 5 percent of the outstanding shares of a target company without making an offer to all of the shareholders at a single price.

Senator D'AMATO. That 5 percent is a number that's negotiable. If we were to make it 10 percent, what would you say?

Mr. LIPTON. Well, I would make it 10 percent in the case of a true passive institutional investor but not in the case of the takeover entrepreneur. The true passive institutional investor is someone who would be barred from takeover activity with respect to that company for a period of 5 years. That person could go to 10 percent. I see no need for a higher level of ownership in order to accommodate institutional investors. Most professional institutional investors hold their ownership at that level or below and I see no

need for accommodation of the takeover entrepreneurs who wish to have higher levels of investment.

I would provide exceptions to the 5 and 10 percent level for venture capital, family holdings, transactions approved by management—transactions that are essentially designed to further the capital interest of the company involved but deliberately designed to preclude takeover entrepreneurs from having an advantage.

Senator D'AMATO. If that legislative initiative were approved by the Congress and were enacted into law, what do you think would be necessary, if anything, looking at the argument that Professor Bradley and Mr. Montgomery have put forth in regard to some of the tactics that management is now engaged in and attempting?

Mr. LIPTON. I think those tactics become in large measure academic and meaningless. These are tactics that are designed to deal with the specific abusive takeover tactics, but I do provide——

BUSINESS JUDGMENT RULE

Senator D'AMATO. Should legislation then be directed to deal with, what many perceive, to be an imbalance in the application of the business judgment rule? I, for one, have got to say that I think it's long overdue. I recognize States rights, and I think they are very important. I would like to see some local courts begin to make some decisions that would bring about more accountability. If we are to deal with greenmail, or the two-tier takeovers that's perceived by many as being a problem that Congress should address, what about the other side? And that is the business judgment rule, the poison pill, et cetera.

Mr. LIPTON. I would suggest that it might be well to wait before making a significant intrusion into the business judgment rule to see if the situation would not revert to what it was before. Remember, all of the defensive tactics that have been criticized have been responsive to these takeover tactics. I do think we have a serious problem, one that is developing on a rather escalating basis now of essentially depriving shareholders of the right to vote in the choice of management. And what I have suggested in my proposal is that companies that do not adhere to the principle of one share one vote be barred from the national market, that their securities not trade on the national stock exchanges and not trade in NASDAQ, again, a way of avoiding interference with State governance of corporations, but I think essentially achieving the purpose that all national companies, all major public companies, follow the one share one vote principle and to give the Securities and Exchange Commission rulemaking authority in order to implement that.

I think that with that basic principle that there be one share one vote and a requirement that that be implemented by removing the various charter amendments that are designed to impinge on one share one vote, we would have restored true shareholder democracy.

I go even further than that and suggest that the legislation provide free and equal access to the proxy machinery for any holder of the greater of $500,000 in market value of a company's stock or 3 percent of the outstanding shares of common stock. So that if shareholders are dissatisfied with the way management is tending

to its duties, they have the same opportunity as management on a yearly basis to conduct an election and replace the board of directors.

I think that would create the balance between the right of corporations to protect the entity as a continuing concern and to be able to manage the entity for long-term growth and long-term profit, but at the same time, protect against entrenched management, poor management, and give the shareholders a really meaningful way of influencing the management, of changing the management if that becomes necessary.

Senator D'AMATO. Professor Lowenstein, Some have suggested that a great deal of the problem—and I believe you yourself concurred—would be eliminated if we were to legislatively eliminate greenmail and require additional shareholder approval of all mergers, somewhat like the English system.

Mr. LOWENSTEIN. By that, if the target company is under attack, that any major event proposed by the board at that point—significant purchase of assets, sale of assets, issuance of shares and the like—be subject to shareholder approval?

Senator D'AMATO. Correct.

Mr. LOWENSTEIN. That's the pattern of the British City Code and I think there's a good deal to recommend that, assuming that you keep the playing field level by first reducing the incidence of greenmail, two-tier offers, and the like.

But let me address the primary issue. A proposal that a target company once threatened with or actually faced with a hostile takeover bid could not issue large numbers of shares, buy doggie stores as Marshall Field did when confronted with a takeover bid, paper the walls with shares as Treadway did, and the like—the response to that is sometimes that it intrudes on States rights in the area. I think all of us as we think about legislation in this field are concerned that the Federal Government not intrude in corporate governance matters traditionally left to the States.

ONE SHARE ONE VOTE

The issue it seems to me is whether the States act or do not act, because in the event of default Congress acting at the Federal level would be forced to address it. The one-share-one-vote issue illustrates that. For 60 years the New York Stock Exchange has had a rule mandating one share one vote. It's hard to think of anything more fundamental to corporate democracy.

Under competitive pressures from the NASD, the American Stock Exchange, the big board is contemplating dropping that rule. I don't know of anyone who has thought that the States would then pick up the slack.

Senator D'AMATO. How do we deal with that?

Mr. LOWENSTEIN. I would like——

Senator D'AMATO. I would suggest to you that I find that incredibly offensive, the fact that one shareholder's value of shares is nothing. It is wiped out.

Senator METZENBAUM. It's just gone.

Mr. LOWENSTEIN. I find it offensive as a matter of corporate democracy. I lobbied against it in my city bar association committee

meeting and the only votes I got were those of a former associate in my law firm and inside counsel of Goldman, Sachs, who presumably agreed with the views recently expressed by John Whitehead of that firm. I think that's a mistake for corporate America because if corporate America is not responsible to shareholders, there are those who will think of other less attractive groups to whom they could be made responsible. And I, for one, and I'm sure you, are in favor of keeping the responsibility to the owners of the business.

I worry that we will shoot ourselves in the foot with proposals like this. If the stock exchange cannot be induced or jawboned to keep this, and that essentially means inducing the NASD and the American Stock Exchange to adopt similar provisions, then I see no alternative to Federal legislation that—and my written statement has a paragraph endorsing in substance Marty Lipton's proposal regarding this. There you will have it, you will have Federal intrusion on that most basic aspect of corporate democracy, who votes, how many shares, what the voting rights are, but it will be by default. It will be because Delaware, New Jersey, New York, and the rest of the States would have failed to take up the slack.

Senator D'AMATO. How long do we wait? How do you give a message?

Senator METZENBAUM. I would say to the chairman, as a guest here, that my guess is that if he were to put a bill in barring the New York Stock Exchange—which I would be happy to join him in—I would think that would be enough of a message to the New York Stock Exchange that it would not happen.

Senator D'AMATO. But it's not simply the New York Stock Exchange. It's the competitive interest and those who will leave the New York Stock Exchange and threaten to do just that and that's the problem.

Senator METZENBAUM. That isn't too much of a problem.

Mr. LOWENSTEIN. There is some suggestion, however, that the NASD might prefer to have you do it by legislation rather than antagonizing members, but I know that if we don't get a consensus among the three groups involved most of us think that the ball will be in your court rather than Delaware and New York.

Senator D'AMATO. I'm wondering if I might intrude for just one further question. I have gone over my time.

Professor Bradley, you raised a point when you showed that the companies that have been acquired over a period of time listed in one of your exhibits had increased some $30 billion. What about the future? Have you studied what the effect will be on capacity, in terms of the productivity of those organizations and those companies? Will they be generating the same kind of product, the same kind of return in the area of oil exploration? Will those companies now be impaired as a result of the increasing debt structure? Have we analyzed the long-term run with respect to the economic consequences of those acquisitions?

Mr. BRADLEY. We have in terms of the stock prices. We have looked at the stock prices out for 5 years and we see no significant trend away from that evidenced in the first 80 days. This again illustrates what we in the profession refer to as the efficient market

hypothesis, that the stock price is an unbiased estimate of future long-term value.

To the contrary, if there were tendencies for these data to deviate after the 80 days, either positive or negative, that would evidence what we call a trading strategy which is a poor and inefficient capital market.

So my answer to you is in two parts. One, we have the stock price data and they are not significantly different if you carry those data out for 5 years.

The thing we have not done is exactly what you're suggesting to do, namely, tear apart this combined corporate entity to find out just exactly what synergies are being brought to bear on the issue. We in academics are accused of what might be known as naming our ignorance. We get to a situation where we don't understand something and we hang a fancy label on it and proceed as though we now understand it. Synergy falls into that category.

We talk about synergies as though we really understand what the economic forces are behind them but in fact we don't know and in fact there may be as many different scenarios as there are acquisitions to explain why this particular acquisition has affected long-term value.

Could I interject one point? I find it interesting that, on one hand Mr. Lipton argues for more regulation because the raiders are making so much money and, at the same time, Professor Lowenstein argues that we need more regulation because bidders aren't making any money at all. I find it curious that both positions support a call for more regulation.

Senator D'AMATO. My time has expired. Senator Cranston.

Senator CRANSTON. Thank you very much. I have many questions I'd like to ask but I think it might be more constructive if I use my 10 minutes in the following way: I would like to ask you, Mr. Montgomery, to use 5 minutes to say whatever you would like to say in rebuttal to what you have heard this morning; and then I'd like to ask Marty Lipton to use 5 minutes to rebut whatever he would like to comment on.

Mr. MONTGOMERY. Thank you, Senator.

EFFECTIVE USE OF TAKEOVERS

I was pleased that Marty Lipton made the distinction between the takeover entrepreneurs, the raiders, and the corporate takeovers. It seemed to give more legitimacy to corporations like mine that have effectively used takeovers to build a very strong company and I will submit later for you the record of what we have built over the last 15 years, essentially half from the growth from within and half by being able to make 28 acquisitions over the last 5 years and some of them started off certainly hostile.

I would like to point out that it's very difficult to throw out a very healthy baby just because of some dirty water in the tub and it appears to me that arbitragers do serve a very useful function in pointing out where there is a difference in value between the securities market and transfer prices to third parties. I think to single them out for special restrictions will have some impacts that maybe people haven't thought through.

For example, the ability to identify the disparities, to call attention to the disparities, sometimes has the effect of closing the gap to the benefit of the shareholders and to managements that would prefer to continue to run the companies independently for a while. And I think that anything that restricts the traditional role of the arbitrager probably has long-run economic effects that would not be positive.

I think if you look at the macroeconomic effect, one thing alone would probably close the gap between market price and transfer price to third parties, and that would be what many of you Senators in your opening remarks mentioned; and that is, if you can get interest rates down—high interest rates are at the root of agricultural problems, the root of trade problems, the root of many, many problems—if we can get interest rates down, then you're going to find that the P_E ratios of common stocks are going to soar. They're going to go back to some of the levels they were in the 1950's and 1960's. If you could do one thing to just take the fun away from the corporate carrions and equalize things in favor of the corporate champions, then I feel that would be the one thing I would recommend you doing.

You can't start fiddling with some symptoms when the primary cause here I think is high-interest rates. Thank you.

Senator CRANSTON. Thank you very much. Marty.

Mr. LIPTON. Yes, Senator. Several points. First, one share one vote. I think it's most inappropriate to single out the New York Stock Exchange to try to impose on the New York Stock Exchange the responsibility that Congress should have for establishing uniform national treatment with respect to corporate governance and corporate democracy. It is a matter for Congress. If Congress feels this is a problem, Congress should enact legislation, whether it's the type of legislation that I have proposed or other legislation. But I don't think that the New York Stock Exchange should be singled out as the culprit in the matter. It is not the culprit. They have tried very hard to establish principles of corporate democracy. Again, it has been the escalating takeover tactics and the responses of management to those tactics that have created the present problem.

GREAT DANGER TO THE NATION

Second, I think it's very important to recognize that the abuses of the takeover process are only one of the concerns that Congress must take into account. The process itself does give rise to some of the more fundamental problems such as the creation of additional leverage by the use of debt securities and second step acquisitions and so on, but the fundamental problem goes beyond the process. It goes into the question of whether the kind of leverage that we're building into the economy today is in the long run a great danger to the Nation. It goes far beyond just takeovers.

I think takeovers are a minor aspect of it, but the entire financial system is being leveraged up on a day-to-day basis. Trading today is in options, it's in futures, it's in options on futures. We have junk bonds. We have zero coupon bonds. We have national deficits that aggregate more than $1 trillion. We have a banking

system that in large measure must fund itself every night, overnight and if it's not able to do that it cannot continue to function. That kind of leverage ultimately results in a serious problem. Takeovers are only one aspect of it.

Now that sort of leverage is the product of a number of different problems—national policy, tax policy, accounting conventions, and so on. But to my mind, we have entered a period not dissimilar from that of 1927, 1928, and 1929 and there are apostles of this new era as well—Professors Bradley and Jensen among them—who see absolutely no problem in the kind of leverage that's being introduced into the economy, who find academic justification in efficient market theories, stock prices, and so on.

But fundamentally, we are creating a system which historically has resulted in crashes, panics, and depressions. We can go back to the 17th century to the tulip bubble; to the 18th century, to the South Sea bubble; to the 19th century, with the money panics; and the 20th century, to 1929. I think that we are again approaching a situation which gives rise to that kind of problem. Takeovers are just a minor aspect of it.

As Felix Rohatyn has described the current financial system, it is a great big casino, and when the number doesn't come up you lose your money and the system is in danger.

I think it's important that takeovers be placed in the context of the overall problem. We seem to be losing sight of soundness, sound balance sheet, sound financial practice—for that matter, sound mergers and acquisitions. I am not an opponent of sound mergers and acquisitions, but I think the takeover process that has developed over the past 3 years is leading to unsound practices in the takeover area just as we are falling into unsound practices in most of the other areas of the financial structure of the economy.

Senator CRANSTON. Thank you very much. I have about 2 minutes of my time left.

Claude, do you have any comments to make on what's been said so far?

Mr. BRINEGAR. I'd like to endorse Marty's comments that there's much too much speculation afoot. I sort of describe what is going on in our industry as an effort to stampede shareholders and new shareholders by the entrepreneurs with what I call a phony idea and using junk money—junk money to sell a phony idea. It is a cycle not unlike the South Sea bubble; the idea that you can somehow restructure, a magic term, 10 or 11 oil companies to make everybody better off and forget about tomorrow is nonsense. My table showed, to take Exxon, this idea—and I guess it applies to everybody—would require Exxon to take $25 billion from someplace—I guess from the money markets—and give up $25 billion in equity, and you go right down the line.

That's what the idea amounts to. It's a stampede and the shareholders are not able to understand, in my opinion, what is going on and it goes on too fast. That's an issue I know you dealt with in a number of bills and I believe the Nation needs time to stop and understand it. It needs time to think about what the consequences are in the long run before very serious damage is done to an industry that I know for certain is a vital part of America.

I went through the energy crisis and I know what it means if major oil companies are disabled. I don't think we want that. Mesa will not be looking for another Prudhoe Bay oil field. Mesa will not be looking to deep offshore waters trying to discover new ways to make synthetic fuels. Mesa says this is a sunset business. It is not. It's a matter of working hard and being innovative. This takes a long-term view and it's hard to deal with short-term speculative issues when you're trying to deal with long-term views.

Senator CRANSTON. Thank you very much.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Montgomery, I want to thank you very much for giving us another reason for the Congress to get to work on the deficit. You said that these high-interest rates are largely responsible for the "takeoveritis" we're suffering. There are all kinds of other reasons to get the deficit under control, but it seems to me you add another very persuasive argument.

Mr. Lipton, you have been involved in as many takeover fights as anyone. Can you cite to us any examples that appear of a hostile takeover or raid that forced management into making decisions they might not otherwise have made which have caused damage to the enterprise in their charge?

Mr. LIPTON. I think it's inappropriate for me to speak with respect to specific situations that I've been involved in, but I can say——

Senator PROXMIRE. You're lucky you have a loophole.

Mr. LIPTON. The ethics of my profession limit what I can say.

Senator PROXMIRE. You could say company X.

Mr. LIPTON. There are numerous instances on the public record of companies that have repurchased shares from professional holders and not from the balance of the shareholders and instances of companies that have made acquisitions for the purpose of deterring a takeover attempt, companies that have placed large blocks of securities with so-called friends.

ACTIONS THAT CAUSE DAMAGE

Senator PROXMIRE. My question, Mr. Lipton, was actions that caused damage to the enterprise in their charge—in other words, persuaded them not to spend as much on R&D, and so forth.

Mr. LIPTON. Well, I think that the damage to the enterprise comes in large measure from the restructuring of the capitalization of the business in order to create more leverage.

As you restructure the capital of a company to increase the amount of debt during the short run, you increase the per share price.

Senator PROXMIRE. You've seen that happen in a number of instances?

Mr. LIPTON. We see it happening almost every day. There are a number of reasons why they resort to debt rather than equity to create capital. Accounting and tax policies are the principal reasons, but more and more the pattern of takeovers and the pattern of demand of institutional investment managers for quarter-to-quarter earnings performance, earnings improvement, result in

companies increasing the leverage of their balance sheet using debt instead of equity, and thereby forcing the reduction in capital expenditures, reduction in research and development, in order to have the funds available for the service of the debt. There's a limited amount of cash flow that comes from the productive use of any aggregation of assets.

If all of the financing of those assets is equity, then you have most of the cash-flow available for the long-term improvement of the assets and improvement of the business. If most of it is debt, then a major part of the cash-flow must be diverted from capital improvements and capital reinvestment and into the servicing of the debt.

Senator PROXMIRE. They do it far more commonly in financing the debt?

Mr. LIPTON. Today, most financing is debt.

Senator PROXMIRE. Mr. Montgomery, as you know, Peter Drucker is one of the most respected observers of business practices in this country. He said:

> A good many experienced business leaders I know now hold takeover fear to be the main cause of the decline of America's strength in the world economy and a far more potent cause than the high dollar.

Do you believe that there's truth in that assertion?

Mr. MONTGOMERY. Not really. I believe that a certain amount of fear is very healthy. I think we all have a need for a very high comfort level and if we can entrench ourselves a little bit more firmly in office we all feel that that security will make us perform better. But in fact I think the opposite is true.

I think that I personally work and people that I know work better under the tension and pressures of knowing that if we don't do a good job, if we don't really perform—and that means maximizing value over a reasonable period of time for shareholders—we are going to get thrown out of office. I think that is part of the dynamic tension that's important. I think it makes better politicians and statesmen. I think it makes better business managers to have that kind of pressure.

Senator PROXMIRE. Is that your view, Mr. Brinegar?

Mr. BRINEGAR. No, it's not. I think we tend to be a little loose with words and I think Mr. Montgomery, when he says maximizing value can mean one thing, and when Mr. Pickens says maximizing value can mean another thing, and we are essentially caught in our industry—and I have to speak for that because that's where I am—in this arbitrage between what I consider to be a phony idea of value of what's being sold and stock market idea of value.

I mentioned in my statement some of the reasons for this gap, but I think to look at our entire industry and to say that we are all bad managers, which you have to do when you look at the statement, is nonsense. The entire industry cannot be bad.

What is wrong is some of the data and some of the concepts that are being sold are wrong. I think that by most measures our company is respected and viewed as a well-run company. We have a record of growth. Our shareholders have been with us for 25 years. Just as an example, someone who put $10,000 in 25 years ago now have $135,000 and 15 percent compound growth on investment—a

very fine record. We do not believe we are badly managed. We believe there's a bad idea that is afoot in our case, mainly that appraised value is a value that somehow you should produce. If I could produce a table that says appraised value and label it as such and get it published and copyrighted and create the idea that it's true, then we would be judged by that value. I think that's the wrong idea.

I think the stock market is relatively efficient, but I think at times it can get a speculative mania going based on a bad idea and these speculative manias have gone on in the past and I think quite possibly one is going on right now in our industry. So we have to be very careful.

DEEPER AND DEEPER IN DEBT

Senator PROXMIRE. Dr. Bradley, I'm very concerned with the tendency for this country in all kinds of ways and aspects to get deeper and deeper in debt. We have the Federal deficit. We have the trade deficit. Now we have corporate debt increasing partly as a result of this takeover situation.

Nobody has repealed the business cycle. What happens come the next recession when some of the more highly leveraged companies that have emerged from takeover deals go under?

Mr. BRADLEY. Well, one thing I should point out— there are two things I'd like to respond to. One is that the nature of the Federal Tax Code induces corporate managers to use substitute leverage for equity. The tax deductibility of interest payments leads corporate managers to push the leverage higher and higher and if there are some problems that perhaps could be rectified perhaps you would want to look at the tax deductibility of interest payments.

The other point to reckon with, while corporate bankruptcy is many times a traumatic event on a corporation, bear in mind in the advent and in the wake of bankruptcy these shares and these assets are not burnt or lost forever. Bankruptcy simply is a process in which the bondholders claims are adjudicated in terms of their priorities and we can't think of the notion of corporate bankruptcy or defaults on bonds, while I said it would be traumatic and costly for a corporation, that doesn't mean the end of that corporation or the resources over which it commands. Those resources will be redeployed and still exist in the economy.

So I agree with you that perhaps the concern in terms of eventual bankruptcies is that we may want to reduce or keep constant the level debt, but again we can't overplay this notion of bankruptcy with the idea that the firm will go away and all its assets will be dissolved.

Senator PROXMIRE. Well, I'm not just considering bankruptcy. The fact that as I say our National Government is deeper in debt than ever. We have a trade deficit that's enormous. We are very dependent on foreign borrowing. And now our corporations seem to be getting more and more highly leveraged, which is another way of saying more and more deeply in debt.

Mr. BRADLEY. Well, I think we have to make a distinction between borrowing or debt at the corporate level versus the Government or a personal level. When you think of debt or equity in a

corporate capital structure, the only distinction between the two is which group has the safer part of the earnings produced by the firm. In other words, bondholders just stand in line before equity holders. And what we're doing is in a sense piecing out the risks of the corporation between bondholders and equity holders.

It's not like my personal wealth where I have my personal equity and then I borrow somebody else's money. A corporation exists for the production of goods and services and it gets funds from both bondholders and stockholders. Stockholders and bondholders both lend money to the corporation. What they lend money for is simply a promise for a future payment. Bondholders have a promise of safer dollars and equity holders riskier dollars, but nevertheless, the corporation, if we can use that legal entity, is borrowing both from equity holders and bondholders. So from that perspective, I don't think it has the same concern for the corporation as it would for you or me.

Senator PROXMIRE. My time is up, Mr. Chairman. I wish I could lock horns a little further with Professor Bradley. Unfortunately, I can't and I have some questions for the record for Mr. Lowenstein if he could respond for the record.

Senator D'AMATO. Those questions will be submitted for the record and Professor Lowenstein will have an opportunity to provide this committee with a detailed answer.

[Response of Professor Lowenstein follows:]

Mr. LOWENSTEIN. There's little doubt that our tax system encourages such transactions, but what to do about that is a very complex inquiry. For example, in the study of leveraged buyouts referred to in my written statement to the committee, I mentioned several different tax incentives: The interest deduction, the writeup of assets, the ability then to take accelerated depreciation and ESOP's, or employee stock ownership plans. Some such deductions, at least when considered individually, may be useful. For example, in an inflationary period it is probably useful to permit industry to take depreciation deductions based on current rather than historic value. Similarly, it is probably not wise (and the history of sections 279 and 385 of the Internal Revenue Code tells us that it is probably futile) to try to prohibit interest deductions for merger-related indebtedness. The problem is that the tax distinction between interest on debt and dividends on stock may be counterproductive. But that is a problem of which mergers and acquisitions are but a small part. Perhaps Congress' increasing willingness to look at some of the fundamentals of our corporate tax structure will give us a fresh opportunity to deal with these concerns.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Mr. Chairman, has there been a previous questioning round? I've been in the Commerce Committee.

Senator D'AMATO. This is the first questioning round and we have been attempting to limit it to 10 minutes. Then what I suggest is we will attempt to go back after Senator Metzenbaum if we have an opportunity and limit it to 5 minutes.

Senator RIEGLE. Very good.

Senator D'AMATO. I want to thank our panelists for being so patient.

Senator RIEGLE. Mr. Chairman, I have a great interest in this subject, as you well know, and as I say I happen to be the ranking member of the Science and Space Subcommittee of the Commerce Committee and we had a meeting this morning on the space station which is an $8 billion item and I was required to be there or I would have been here at the outset. I've had a chance to review most of the statements here and I'm going to pose some questions

and I'd like just brief responses to the extent that you can be brief and still meaningful with your responses.

One frequently cited justification for unfriendly takeovers is that these practices serve to discipline entrenched managers who have been lax in their responsibilities and that it is generally poorly run companies that find themselves targets. This is a major argument that's put forward and I would like just a very brief response from each of you as to whether the theory that contested takeovers primarily discipline incompetent managers is for the most part a valid one, especially in the timeframe now when there's a burst of this kind of activity.

TARGETS ARE USUALLY WELL MANAGED

Mr. LIPTON. Senator, in my experience, that's not true. In fact, the direct opposite is true in almost every contested takeover situation that I've been involved in. The management of the target company was good management and indeed if one reflects for a moment on the question it would be a foolhardy bidder who selected a badly managed target to make a hostile tender offer without the ability to examine it or investigate it, audit it and so on. Targets are well managed companies, not poorly managed companies.

Senator RIEGLE. Mr. Montgomery.

Mr. MONTGOMERY. I think an analogy to what the union movement has done for workers in America, even though union numbers are down as a percentage of work force, is a good analogy to use here. The threat of unionization I think, apart from good feelings that people have who treat workers fairly, have served to increase the benefits for all employees, even if not unionized.

I think similarly the threat of takeover, that there is a possibility that somebody may come in some day, whether you've done a good job or not, is the iceberg under a little tip of the public takeovers that we read about. But I think an enormous number of companies operate more efficiently because they never know when that phone is going to ring and I think that's one of the macroeconomic effects that you have to consider when we look at the tip of the iceberg.

I think that it's not—to answer the question specifically, I don't believe that too many of the takeovers are directed solely to mismanaged or undermanaged companies. I think the major difference is the fact that, because of high-interest rates, stock market prices are not reflective of the split-up values of the companies. But let's trust the shareholders. We haven't heard much about the shareholders this morning. The shareholder does benefit greatly by receiving the premiums and we haven't talked about the macroeconomic effects of what happens when that capital is put into use and I think that s another issue.

Senator RIEGLE. Mr. Brinegar.

Mr. BRINEGAR. Senator, until recently, we did not believe we could be a takeover target, and during this period when we believed we could not be a takeover target we were generally considered to be one of the best run companies in the industry.

The discipline of growth and the discipline of our outside directors was plenty of incentive for us to run ourselves well. We think we're being attacked by Mesa because we are well run and because

we have a balance sheet that does not have much debt and gives Mesa perhaps future leverage to continue their adventures.

We try to keep our debt low because we want to have the ability to borrow money to grow in the oil business. We think that's what we're supposed to be doing. But now we're beginning to wonder.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. No, I don't think that that's the primary purpose of tender offers to discipline corporate managers. I think there are many more important and direct checks and balances on corporate behavior within the corporation itself to curb managerial abuses, or malfeasance, or what have you and that we might look at the tender offer perhaps as a court of last resort. There's always that threat out there, as Mr. Montgomery mentioned, but I don't think that that's the primary purpose of the takeover.

Indeed, as Professor Lowenstein pointed out, there are many cases in which the bidding firm sought the target simply because of its management, because it was an excellently managed firm, and indeed that was the resource that was being sought after through the combination.

Senator RIEGLE. Mr. Lowenstein.

Mr. LOWENSTEIN. To paraphrase Mr. Montgomery, for whom does the phone toll? If the stock prices don't accurately reflect management skill consistently and if therefore good companies as well as poorly run companies are caught up in the net, then how does a well-managed company respond to the threat of a takeover bid?

I think we see—and I think Mr. Lipton was suggesting—is that increasingly they respond to the short-term pressures of the market with short-term measures.

I would just illustrate. In 1981, I looked quite closely at a company that happened to be based in Senator Proxmire's State, Giddings & Lewis, which was a target of a hostile bid. It would be hard to find a better managed company than Giddings & Lewis. It had a return on equity in the range of 26 percent and spent a lot of money on R&D but then a Canadian conglomerate, which knew nothing about machine tools, selected Giddings & Lewis because it was well managed. Had it been poorly managed, they would not have used it as a vehicle for entry into the industry.

Senator RIEGLE. It sounds to me as if there's some unanimity on this point; that poor management is not really a very strong argument in any broad sense.

But let me talk about the question of fairness to shareholders, because an underlying concept of our securities laws involves the concept of fairness to all shareholders and some kind of an absolute equity across the board.

EQUAL TREATMENT TO SHAREHOLDERS

I'm wondering to what extent are we finding that certain shareholders are being treated differently from others in some of these takeover deals and how serious a problem in this regard are we faced with if we value the principle that says shareholders ought to be treated equally?

Again, I'd appreciate pointed responses in the interest of time.

Mr. LIPTON. The basic takeover device today is the two-tier tender offer. It's designed to stampede shareholders into tendering. It deliberately creates a situation in which the quick afoot are advantaged at the expense of the slow. The slow are usually the unsophisticated shareholders. The quick are the institutions. And it is that basic unfairness that has given rise to most of the abusive takeover tactics.

Senator RIEGLE. Mr. Montgomery.

Mr. MONTGOMERY. I think that the States increasingly are adopting charter amendment provisions to direct against the two-tier takeover. The Commonwealth of Pennsylvania I believe for one has a provision where if 30 percent of a target's stock has been accumulated a tender must be made for the remaining shares.

I think that there are some things that can be done to equalize the playing field. I think that there should be another look at the securities laws in terms of let's take the so-called section 13(d)—the famous 13(d), which really doesn't do anything any more. I think you should eliminate 13(d) and have instead a simultaneous notice of any purchase or sale of 1 percent or more of the stock of publicly traded companies. I think that that would immediately notify at a very early stage who is interested and let other people judge the motives.

The problem with 13(d) now is that they call for present intentions for statements of purpose, and we all know that any time you want to confuse people you say, "It's my present intention," and it may sincerely be your present intention, but it certainly leaves open a change of purpose later.

So I think there should be a level playing field by simply opening up shareholder lists and have simultaneous notice when a major transaction takes place as to who is making the transaction.

Senator RIEGLE. Mr. Brinegar.

Mr. BRINEGAR. Senator, I believe that there are methods available for raiders who confuse and stampede shareholders that have not been changed, though I won't go into the details now, but I think when a raider comes at you it comes in a stampede, the ability to consider the long-term future of the company in light of this onrush of events is very difficult. Time moves rapidly. And I would refer, as I did in my report, to the article in the January Harper's that described in grizzly detail the proposals to destroy the Gulf Oil Co. and to I believe seriously disadvantage the long-term Gulf Oil shareholders, and I would like to submit part of that for the record because it does describe something that can be done legally today and is a great disadvantage to shareholders and a large group of the public.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. The first thing I'd like to point out is that by far the most frequent form of corporate acquisition by tender offer is the any-and-all tender offer. Over the last 4 years, 228 offers, 70 percent of them, were any and-all tender offers and only 17 percent were two-tier offers, whereas 13 percent were partial offers. So most of these, the vast majority of these takeovers are being effected on an any-and-all offer.

Senator RIEGLE. Let me ask you if you look at the size of the transactions, would that skew that data as opposed to the absolute

number of transactions? Would the smaller percentage represent larger entities so that the dollar volume of the total would be skewed the other way?

Mr. BRADLEY. That's correct. There is a tendency for two-tier offers to be used in larger firms just because of the capitalization and the risk of the investment that would be expected. One thing to keep in mind in the two-tier tender offer is that they are effected on a pro rata basis, which is to say that every tendering portfolio must receive and indeed does receive the same treatment in terms of the acceptance of the offer. So when we see the first and second tier, we are misled if we think that those who tender get the first tier and those who don't tender get the second tier. Rather, through this prorationing, the provisions set out in the Williams amendment, everybody that tenders gets their shares accepted on a prorationed basis. So I think that the current system does have built into it an equality of treatment among target stockholders.

Senator RIEGLE. Mr. Lowenstein.

Mr. LOWENSTEIN. Passing the two-tier bids for the moment, let me turn to greenmail, a more pressing shareholder problem.

Senator RIEGLE. It's a real concern of mine.

Mr. LOWENSTEIN. The bidder says, "Your company or your money," and the target company management turns to its shareholders and says, "It's your money or my job." And the greenmail gets paid. I don't know how to describe that except in terms of shareholder fairness.

Senator RIEGLE. Well, take it to the next point then. I'm wondering about whether, at the bottomline you're concerned that there is an unfairness to all shareholders that is approaching a dimension that has to be treated. That's what I'm asking.

DISGORGEMENT OF PROFIT

Mr. LOWENSTEIN. Well, I think there's a very serious problem of shareholder fairness there and that as a part of my legislative proposals I have a specifically antigreenmail provision which in substance says that anyone who purchases more than 5 percent of the outstanding security voting shares of a company, 5 percent would take care of institutional investors, and holds it for less than a significant period of time would have to disgorge the profit to the company.

Senator RIEGLE. Senator D'Amato and I have been working for some time on greenmail legislation and we hope to eventually be successful with it.

Senator D'AMATO. I might mention that legislation. As you suggested, I believe Stanley Sporkin made a presentation not too long ago in which he talked about disgorgement of those profits and returning them to the company. I might ask these gentlemen to comment with respect to that idea.

Senator Metzenbaum.

Senator METZENBAUM. Thank you, Mr. Chairman.

Vis-a-vis the last comment that my distinguished colleague and friend from Michigan and the chairman was saying about working on the greenmail matter, I just think there's such a great sense of

urgency on that matter, whether or not we fashion a total bill, it may be valuable to accommodate some of these problems on a piecemeal basis and bring them to the floor because every day we read more and more of some of the problems and some of the activities that are taking place.

Mr. Lipton, you propose a mandatory tender offer for all shares of anybody acquiring 5 percent or more of a company's stock.

Now I'm aware of the fact that IBM held 20 percent of Rolm for a period of time without indicating that its desire for an unfriendly takeover and finally did have a friendly takeover, as I understand it. Warren Buffet owns 13 percent of the Washington Post. GEICO has a 30-percent minority owner. I guess I could stay here for the next hour reporting on people who take more than the 5 percent interest and don't have any intention of a takeover.

Don't you believe that that is a problem? As you know, I myself have set a higher figure in the legislation I propose and I'm wondering whether you think 5 percent is enough.

Mr. LIPTON. I do think 5 percent would be an appropriate level, Senator, and you will see on pages 27, 28, and 29 of my submission of the draft bill exceptions to go over the 5 percent for specific situations that are beneficial and where more than 5 percent ownership levels would be appropriate.

POISON PILLS

Senator METZENBAUM. Mr. Montgomery, you talk about the problem of the congressional limit—that you don't look forward to a congressional action with respect to poison pills and that the courts are looking at it.

My question is, that while this takes place, you also, I think, reported how many companies—I think you listed them—have already adopted poison pill modifications of their own charters.

My question to you is: Would you or would you not support Federal legislation to outlaw poison pills, assuming we could agree it's egregious?

Mr. MONTGOMERY. No; I would not favor Federal legislation outlawing poison pills. I believe that either the States can address this issue or, more importantly, I believe that there is still one little glimmer of hope and that is that shareholders can take these issues directly to the shareholders of the company either through precatory resolutions or resolutions that would be binding on companies that outlaw poison pill shareholder rights.

Senator METZENBAUM. Do you know of any situations where shareholders have so acted?

Mr. MONTGOMERY. Well, just by coincidence, my company, Rorer Laboratories, is waging a proxy fight against the Rorer directors adopting poison pill shareholders rights and the shareholder meeting is on the 23d of this month. We feel that that's an appropriate forum, apart from action that we also have taken in the courts.

Senator METZENBAUM. Mr. Lipton, you talk about actions that Congress should take with respect to protecting the corporate management, but I don't think, as I read a summary of your proposal, that you've given any indication of what should be done with respect to management. Let's face it. This is not a one-sided issue.

The chairman has made that clear. There are great advantages to the stockholders in many instances in selling out and I don't think the Congress should be standing in the way. I'm going to get to Mr. Brinegar in a moment. But whether or not the company has a great record or not, there are some values to the company and if stockholders can all get $80 a share instead of $40 a share, I'm not certain that Congress should stand in the way. I do think there are strong reasons why Congress should prohibit some shareholders, usually the poorer ones, or less informed ones, or smaller ones, getting $50 and the others getting $80, as occurred in the United States Steel, Marathon, and some of the others. To me, that's so morally wrong that I have a little difficulty in understanding Mr. Bradley's point of view in not recognizing that there's an element of conscience and decency involved in that kind of thing.

Mr. LIPTON. Senator, I agree with you completely and the proposal I made merely removes the stampede aspects and the unfair aspects of the takeover process and very specifically provides for one share and one vote and total shareholder democracy so that if there is a transaction that the shareholders wish to pursue and the management stands in the way the shareholders have a quick and easy way of changing the management or forcing the management to accept that transaction.

All I propose is that we remove the unfair aspects and abusive aspects of the takeover process, but I have proposed also to keep the playing field level, that the shareholders have the absolute right, without fetter and without interference, to determine the future of the enterprise.

Senator METZENBAUM. Mr. Brinegar, you talked about your company being well run and I take no issue with that, but in the last analysis, I feel—and I was formerly a corporate officer—that the bottom line is the shareholders. It's they who have the right to be protected, not management, and not whether the company was or was not well run. If somebody comes along and says they are willing to pay $80 a share for Unocal and stock market price shows that it's $50 a share, I'm really not that concerned about preserving management's position, nor necessarily even preserving the company. I think that's part of the free enterprise system.

What I didn't hear as I listened attentively to your statement was any concern about how—Congress shouldn't be one-sided. We should try to find some element of balance.

What would you do to protect the shareholders who could get $80 a share for stock that's selling for $50 a share, assuming that all of them can get the $80?

Mr. BRINEGAR. Senator, I can answer that directly. I would probably tender my own stock for $80 a share.

Senator METZENBAUM. I think that's a good answer.

Mr. BRINEGAR. We do not oppose a cash tender for all shareholders. That has never been brought to us.

What has been brought to us—and I'm a director of the company and have a fiduciary role to see that the shareholders are properly represented, and I plan to fulfill that obligation—and if somebody brings a full cash tender, it would certainly be looked at closely and our investment bankers would help us.

OPPOSE STAMPEDE ACTION

What we do oppose is an effort to destabilize the company in any kind of stampede action. For example, this speaks to your 5-percent issue. Mesa with 13.6 percent of the company has proposed that we delay our annual meeting by withholding a quorum while they try to put a deal together. I think that's unfair. I think if they can put a deal together they should do it and bring it forward. They should not deny our shareholders the right to have a meeting. If they had 5 percent they could not, but with 14 percent perhaps they can.

Senator METZENBAUM. Have they made a proposal as to what their price would be to buy them out?

Mr. BRINEGAR. They have not.

Senator METZENBAUM. Have they indicated they would be receptive to such a discussion?

Mr. BRINEGAR. They have not. They have indicated they have some ideas, asking us to delay the annual meeting for 2 months, and asking us and suggesting that if we would not agree they would withhold a quorum if they could solicit it. I think that's unfair to the shareholders. We have had our meeting scheduled for months and we have had our proxy material out and we would like to vote on the director issue, which I think makes the company able to negotiate proper deals.

What I'm objecting to, Senator, is proposals that are not what you would see and I would see as a direct or full-fledged proposal that you can evaluate. But rather—and I don't want to take the time today, but there are proposals that have been made that are not fair to all shareholders because they are so complicated. They offer various kinds of junk money, various kinds of pieces of paper. If you move fast you might get a good piece. If you don't move fast you might get a bad price.

Senator METZENBAUM. Would you agree that we ought to extend the 10-day period to something like 60 days?

Mr. BRINEGAR. Very much.

Senator METZENBAUM. Would anybody take issue with extending the time period for consideration of an offer? Do any of you have any fault about that?

Mr. BRADLEY. There does appear to be a gain in speed in these acquisitions. I think that there should be a delay for the target stockholders to evaluate the parameters of the offer or for competing bids to be made, but perhaps 60 days is a bit long. I think that should be looked at.

Senator METZENBAUM. What would you think?

Mr. BRADLEY. I think maybe 20 days. Isn't it now 20 days as proposed by the SEC?

Mr. LIPTON. It's now 20 business days.

Mr. BRADLEY. Right. I think that is adequate.

Mr. BRINEGAR. Let me say that 20 business days goes by very quickly. Events come at you from all sides.

Senator METZENBAUM. If you can think that goes by fast you ought to see how fast my time has expired.

Mr. BRINEGAR. Senator, when you're deciding the future of a company that has a long-term past and a long-term future, I don't think 20 days is long enough.

Senator METZENBAUM. Mr. Chairman, I know my time has expired and Mr. Bradley is trying to have an opportunity to respond about whether this is a nonconscience position and I think I'd ask unanimous consent that he be permitted to answer or respond, not that I have more time.

Senator D'AMATO. Mr. Bradley.

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

I just wanted to clear up one thing that I wasn't able to do in my opening statement because I was rushed—I rushed myself, I guess. But in this United States Steel-Marathon acquisition, I think this prorationing has to be appreciated for what it is. For example, the front end of that offer was for $125. The back end of that offer was for $90. Now it's a complete misrepresentation of that offer to think that those who tendered got $125 and those in the back end got $90.

What in fact happened was that 95 percent of those shares were tendered. That offer was effected on a pro rata basis, which is to say if you tendered two shares, one of your shares would have been accepted for $125 and the other share would be accepted for $90 for this pro rata or blended price of $107.85. If you tendered 100 shares, 50 of them would have commanded that higher price and the other 50 the lower price. So it's not the case that those that tendered——

Senator METZENBAUM. That isn't always the case, is it?

OFFERS EFFECTED ON A PRO RATA BASIS

Mr. BRADLEY. Yes, it is. According to the Williams amendment in 1968, all oversubscribed offers must be effected on a pro rata basis. Now what has to be done—and this is days we're talking about—if those shares are tendered into pro ratables within that specified time period, then it must be effected on this basis.

My point is that in the Marathon case, 95 percent of those shares were tendered. They actually got into the prorationing pool. So there might be 5 percent of the stock out there unaccounted for, but the bulk of those stockholders got the classic pro rata execution on that particular offer and everybody walked away, large and small stockholder alike, with a per share premium of $107.

Senator METZENBAUM. My time has expired. I want to respond but I don't have the time.

Senator D'AMATO. Professor Lowenstein wanted to respond.

Mr. LOWENSTEIN. For a financial economist, the deal was fair. For the small shareholder, it might not have been. The institutional investors tendered all theirs, some of them trying to double tender. The people who were left out obviously were uniquely and uniformly and entirely small shareholders. So that 5 percent may have been as much as 15 or 20 percent of the mom and pop shareholders out in Nebraska—excuse me—Ohio.

I would add a footnote to what Marty Lipton said before about 5 percent rules and greenmail, and that is that there will always be an exception I think in any proposal for the IBM investment in Rolm and GEICO and the like, that is to say when the investment is made with the investee company's approval. No one intends to disrupt those kinds of arrangements.

Senator D'AMATO. Let me ask you, Marty—you say greenmail is unfair to shareholders of the target corporation. Let me ask you to explain why.

Mr. LIPTON. I don't say that greenmail is unfair to the shareholders of the target company. I see absolutely nothing wrong with a target company that feels that its future should not be determined by extraneous forces at the moment doing whatever is necessary in order to preserve the continuity of the entity.

I think what's wrong is a system that permits takeover entrepreneurs to seek to demand greenmail and I would eliminate it not by foreclosing the payment of greenmail but by foreclosing the ability of greenmailers to obtain greenmail positions.

I think the real vice is not the repurchase of shares in order to prevent the company from being forced into a liquidation mode at an inappropriate time. The real vice is a system that permits takeover entrepreneurs to gain footholds that enable them to profit at the expense of the rest of the shareholders.

Senator D'AMATO. Professor Lowenstein indicated in his legislative proposal that any profits received by those who have taken a short-term position of over 5 or 3 percent, would then be returned to the corporation.

Mr. LIPTON. I think it's an excellent proposal and I think it's deserving of consideration by the committee.

Senator D'AMATO. Would that eliminate your fear of the utilization of the methods?

Mr. LIPTON. Well, again, I think it would be a correction of an abuse. I would still urge on the committee and on Congress that there be a 5-percent limitation on ownership levels of nonpassive investors.

Mr. LOWENSTEIN. Senator, as you know, my proposal includes the best of both worlds, Lipton and Lowenstein, and that 5-percent provision that you talked about, coupled with Mr. Lipton's proposal that if you go over some threshold figure you must bid for all, but I would raise that threshold figure from 5 to 10 percent.

Senator D'AMATO. Mr. Montgomery.

Mr. MONTGOMERY. I take exception to the one-sided accusation as to who is responsible for greenmail. The only people that can authorize the payment of greenmail are corporate managers and I think that is clearly their responsibility and I think that it is a despicable practice and I think it can be corrected by the States adopting appropriate legislation which at least makes directors take payment of greenmail to their shareholders. But the abuse, again, is management's using greenmail as an excuse to entrench themselves further. There's no justification for it.

Senator D'AMATO. Mr. Montgomery, on that issue: What if the States do not move to deal with this greenmail situation? What would be the appropriate course for Congress to undertake then, if any?

Mr. MONTGOMERY. I think that, No. 1, one should give it some time because, again, one of the unloved methods of redress here is the proxy contest and I think we have to get back into elections if we believe in corporate democracy. I like some of Mr. Lipton's proposals to really bring forth a rebirth of corporate democracy.

I would think that if, within a reasonable period of time, the State and shareholders have not acted to outlaw de facto or de jure use of greenmail, then is the appropriate time for Federal legislation. I think it's a very serious and wrong practice.

MATTER OF GREENMAIL

Senator D'AMATO. Do you have a specific legislative proposal that you would endorse dealing with greenmail?

Mr. MONTGOMERY. Not at the Federal level at this time. I think it would be more appropriate, as I say, at the State level.

Senator D'AMATO. Mr. Bradley.

Mr. BRADLEY. Yes. I underscore Mr. Montgomery's statement about who's the culprit in this greenmail. In fact, I'm reluctant to call the transaction greenmail. I call it a targeted repurchase where the target firm repurchases shares from a targeted individual and I agree with Mr. Montgomery in saying who's giving impetus to the greenmail situation.

Senator D'AMATO. That's not really this committee's concern. The concern is if it is identified as an abuse and those who profess both sides of the philosophical point here agree that there's an abuse—how long should we wait and what should our action be? Do you believe that this Congress, absent any legislation or any initiative on the State level, should undertake legislative action?

Mr. BRADLEY. Not at this time. I think the greenmail has been a recent phenomenon and I think we ought to let the capital market and the corporate democracy mechanism take care of that process or see what they do in that regard.

We do see some evidence that firms are adopting antigreenmail provisions in their corporate charters. Moreover, I think there is a tendency and hopefully a tendency of courts to judge these and other issues under corporate control under a duty of loyalty standard as opposed to what they are now doing under a duty of care business judgment standard. And I think the movements at the court level as well as stockholder democracy would go a long way to solve this problem.

Mr. BRINEGAR. Let me make just a comment on trying to define greenmail. You'd better be unusually perceptive and alert because the methods by which it can be put into play are often pretty subtle. I attended yesterday a hearing where both Mr. Douce and Mr. Pickens were there and everyone in the room seemed to agree that Mr. Pickens had received greenmail except Mr. Douce and Mr. Pickens. Mr. Pickens said that Mr. Douce insisted upon it and Mr. Douce said Mr. Pickens insisted upon it. And I think it is a form of greenmail and I don't think it can be easily caught up in a simply drafted piece of legislation. There are very subtle ways of doing it.

Senator D'AMATO. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I have three questions which I think are important ones but I don't want to detain you so I'll try to go through them as fast as I can.

One aspect of this hostile takeover activity that has been brought to my attention is the almost instantaneous availability of very large blocks of credit that seem to be not nearly so readily available for other economic purposes, and I could cite examples. There

are a number which are familiar to all of us that have recently occurred.

But I would like to understand better, starting with you, Mr. Lipton, and you, Mr. Brinegar, to explain how the financing of some of these deals is done and whether or not you think there is anything wrong with a system where billions are raised virtually overnight for this kind of activity?

Mr. LIPTON. Yes I think there's something drastically wrong with a system which permits the kind of leveraged takeovers that are the current vogue and I think it presents a threat to the national economy.

Senator RIEGLE. Why? Explain why you feel that way.

Mr. LIPTON. Because I don't think that the normal investors or lenders prudent investigation and assurance of the soundness of the loan is undertaken with respect to those transactions.

Senator RIEGLE. Well, I'd like you to go a step further because that's a very serious charge to lodge. One assumes that the market system is quite sophisticated and very well developed in our country. Money moves around and people make decisions. This is somebody's money that's being used in these forms. I'd like you to take it a step further and either take a specific example or create a hypothetical example to show why you think that this is really somehow abusing the public interest or somehow threatening to the country in ways that we may not presently understand, but need to understand.

Mr. LIPTON. There's an inverse Gresham's law. The money is collected from very unsophisticated people who either deposit it in savings and loans associations or buy single premium annuities. That money flows up to those people who are able to promise the highest return. In other words, deposits of unsophisticated people are attracted by promising a higher return than is otherwise available in the financial system. Then there are those that provide the securities that provide the return, the bonds that provide interest rates of 16, 17, and 18 percent a year. Some of the institutions or organizations that are collecting the deposits promise 13 or 14 percent, or so on. This is just fine as long as you can keep doing it, as long as you can keep expanding, as long as you can keep liquidity in the market until there's a downturn in the economy. As we all know, that can't keep up forever and when it happens and there is a collapse and the people who get hurt are the most unsophisticated participants in the system. They are the ones least able to protect themselves.

FOUR MERGER WAVES

Senator RIEGLE. Well, along that line, it's my understanding that if you look back through history, there's been essentially four merger waves since the late 1890's. There was roughly a period from 1890–1904, 1919–29, and from 1960–69, and I'm wondering why is this current merger wave any different from the previous ones and why is there anything that attaches to this period of time that suggests——

Mr. LIPTON. Senator, we had a merger wave from 1974–80, but since 1980 we've not had a merger wave; we've had a liquidation wave.

Senator RIEGLE. OK. You term it as a liquidation wave. Who else would like to comment?

Mr. MONTGOMERY. Well, I think we all need to be a little humble about macroeconomic effects and I think that I will try to be humble and maybe Mr. Lipton and others will be.

I think if anybody wants to characterize the last 3 or 4 years as a period of no growth in goods and services and jobs, then I have difficulty holding a discussion on any other basis than the facts. I don't think there is any justification whatsoever for Mr. Lipton's position. I don't think the evidence is in and I don't think the full impact of the macroeconomic effects has been studied by any of us, with all due respect. I think to call junk bonds, which are simply higher priced bonds, the high price reflecting the increased risk, junk bonds is to—it's like hostile takeovers. A hostile takeover certainly isn't hostile to the shareholders who receive the premiums. So I think junk bonds is another one of those terms—probably the people who refer to junk bonds are on the side of defending managements, but there is nothing, again, no way you can stop legitimate leverage buyout that's on a friendly basis. If you take the number of excellent deals that have been done in this country on the divestiture of divisions of large corporations where a young entrepreneurial team or very often it's the management of the divested division have been able to become entrepreneurs by leverage that would make the takeover leverage look like a Sunday school picnic that is quite conventional.

These are the kind of macroeconomic effects we have to be thinking about when we concentrate on essentially trying to protect corporate managers who do not need Federal protection. I assure you we can take care of ourselves. Thank you.

Senator RIEGLE. I think both of you want to comment and I have one other point to raise.

Mr. BRINEGAR. I have to agree with much of what Mr. Lipton said. I do not believe that we should wait until the history of the collapse in order to understand the nature of this collapse. I think there is something apparently going on.

Senator RIEGLE. Would you pull the mike closer?

Mr. BRINEGAR. I said I hope we don't have to wait and write the history of this collapse to understand the collapse. We can learn something from the facts. I believe this is something that you can investigate by discussing it with the savings and loan administrators and others who are head and heels in this. I believe there is something of a pyramiding going in the junk bond business. I believe money is available much too easily and I believe that deals are being promoted on speculative notions that are not true. And all those things tend to lead to a wave that does lead to a collapse.

In the case, as I said earlier, in my own industry, I feel very strongly that the notion is being pursued that we can all be restructured and everybody can win and to hell with tomorrow. I think the idea is wrong and I think in time it will be realized to be wrong. It's being made possible by the easy availability of this new

source of money that has come out of deregulation of much of the monetary system.

Senator RIEGLE. Mr. Lowenstein, it seemed like you were nodding and I want to call on Mr. Bradley too.

Mr. LOWENSTEIN. I think that that question is very complex.

Senator RIEGLE. That's why we need to understand it.

SIGNS OF PYRAMIDING

Mr. LOWENSTEIN. On the one hand, you do see some emerging signs of pyramiding going on. I'm reminded of a large media company which recently sold over 1 billion dollars' worth of so-called junk bonds where the company's income statement shows that it is annually losing money at the rate of $100 million pretax and after tax. But, on the other hand, it kept enough money from the bonds to pay interest for several years and also agreed with some of the bondholders that they wouldn't receive interest for a number of years.

One has to be concerned about the marketplace's willingness to accept bond issues of this kind in any systematic way. If you're old enough to have lived in 1929 or read some of the history of the pyramiding that took place then, the fact that the market would take it does not mean that it's in our long-term interest to sell it.

On the other hand, the debt question gets very complicated because, I agree with Mr. Montgomery, that a number of buyouts are being done that have been quite salutary and yet done with borrowed money, where the entrepreneur buys his division from the perhaps swollen conglomerate.

And when you try to regulate in that fashion, through the Tax Code, I think you end up trying to chase something that's ephemeral. Either you overregulate, in which case you hear very promptly that you're doing too much, or you try to distinguish between people who borrow money to buy assets and people who borrow money to buy stock, and that is a distinction that collapses in practice. Or you end up writing a bill that's so targeted that it becomes meaningless, because the practitioners on Wall Street can work their way around it. That's what happened to the present section 279 of the Internal Revenue Code, an effort to legislate with respect to so-called acquisition debt in the 1960's. Most of us don't even remember what that section contains, because it's no longer relevant.

Senator RIEGLE. Mr. Bradley.

Mr. BRADLEY. Just one point because I think it relates to what Senator Metzenbaum and I were talking about in terms of this capital structure decision between debt and equity.

Again, I have to agree completely with what Mr. Montgomery said about this characterization of junk bonds. Junk bonds are nothing more than risky debt and if you can think of the ultimate junk bond it would be equity. So there's a continuum here and just because bonds are yielding higher rates of return reflecting the underlying bids, there's nothing inherently junky about those bonds. And again, this pejorative connotation that people like to hang on them that gets all these emotional discussions going, when, in fact, an economist just sees that as a very risky instrument that's going

to command a higher price—sure, there's a higher probability of default than it is on a U.S. Treasury bill, but that's reflected in the price.

The other thing I wanted to mention in these takeovers, that why the bidding firm will resort to leverage, as you well know and might expect, is that the need for cash comes up very quickly and the mobilizing cash particularly in a front-end cash offer, the cash has to be amassed very quickly and distributed to the target stockholders and debt through insurance companies and through the intermediaries having this access to the debt market is a very natural way of getting that.

Finally, when the target stockholders get that money they don't burn it. That money goes back into the system. It's a closed system and they might take it from overnight into their pocket or over 20 days but that money goes back into the system. So that money goes back in the system so I think it's erroneous to think that corporate acquisitions somehow are squeezing out other types of investment.

Senator RIEGLE. Isn't there perhaps a concern—and I'm posing the question because Mr. Lowenstein began to nod negatively as you were speaking on your first point here—that a bondholder doesn't necessarily think he's in an equity position, especially if he's at the end of a chain of transactions that he may feel that he's a bondholder but that he may be much more in an equity play situation than he realizes. Obviously, there's a big premium that's hung out there, but I'm a free market person and markets are imperfect, but I'm just wondering if there isn't some confusion that may exist out there where somebody could end up getting burned thinking they're in one category and finding out they're actually in another.

Mr. BRADLEY. That may well be. As we all know, information is a costly good, like any other economic good, and there may not be enough information being produced and, therefore, what might be the remedy would be to disclose information, disseminate information about what these bonds are. But I think that somebody looking at a bond with a 17, 18 percent expected return knows pretty much that that's not a Treasury bill and that there's some risk behind that instrument and it's beyond me to think that people are so naive to think that they can get 18 or 20 percent return on a very safe instrument.

I have faith in the efficiency of the capital market and the rationality of investors, but your point may well be taken that more disclosure might be needed if there is this pyramiding and people don't know where their funds are ultimately being invested.

Mr. LIPTON. I'd just like to point out that while most of the managers of savings and loans and insurance companies and other institutions that buy junk bonds probably do understand what the instrument is, the people who are entrusting their funds to those institutions do not; and it's their funds that are at risk in the junk bond market.

OVERHAUL THE TAX SYSTEM

Senator RIEGLE. I'm going to have you answer for the record because I know we are pressed for time, my question is: There's a

major proposal before us to overhaul the tax system, as you know. It's not in final form but it will be. I think it's very important that we establish whether the tax system today is neutral with respect to hostile takeovers, leveraged buyout, and acquisitions, or does the Tax Code as it now sits somehow impinge on this and either encourage it or discourage it? I want to know the impact of the current Tax Code at either driving this activity or retarding it, if anybody has a clear one-shot answer I'd like to hear it.

Senator D'AMATO. Senator, I don't want to cut off this line of questioning, but we're well over the allocated time.

Senator RIEGLE. Could we have answers in for the record for that because I think it's important that we establish this before we try to relate these things, especially because we're apparently on the verge of major tax changes.

Senator D'AMATO. I see Professor Lowenstein and Mr. Bradley have indicated their willingness to submit that for the record.

[Response to written questions of Senator Riegle follow:]