

MERGER TACTICS AND PUBLIC POLICY

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Carolyn Kay Brancato  
Specialist in Commerce and Industry  
Economics Division



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#### ABSTRACT

This report describes the merger process, including types of mergers, motivation for merger and acquisition activity, and offensive and defensive tactics used to implement or thwart a takeover. The Federal oversight functions of the Securities and Exchange Commission, the Federal Trade Commission, and the Antitrust Division of the Justice Department are discussed. Finally, the report briefly raises public policy questions concerning how takeover activity relates to equity, efficiency, and concentration of power within the economy and within the firm.

#### ACKNOWLEDGEMENT

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## CONTENTS

ABSTRACT.....	iii
LIST OF TABLES AND CHARTS.....	vii
INTRODUCTION.....	1
I. TYPES OF MERGERS AND ACQUISITIONS.....	7
A. Generic Types of Mergers.....	7
B. Methods Used to Merge or Take Over.....	9
C. Waves of Merger and Acquisition Activity.....	11
1. Mergers During the Early 1900s.....	11
2. The Late 1960s Conglomerate Merger Wave.....	12
3. Comparisons Between the Current and Previous Periods of Merger Activity.....	14
4. Current Motivations to Merge.....	22
II. THE TAKEOVER PROCESS: OFFENSIVE TACTICS.....	27
A. Structuring the Deal.....	27
1. The Offeror Considers a Range of Issues.....	28
2. The Special Role of Arbitrageurs.....	29
3. The Offeror Buys an Initial Block of the Subject's Stock....	32
B. Mergers and Acquisitions: Securities Regulations.....	33
1. SEC Jurisdiction Over an Initial Purchase of a Block of Stock.....	33
2. The Offeror Makes a Tender Offer and Triggers Additional SEC Oversight.....	34
3. A Tender Offer May Be Subject to State Takeover Laws and to State Court Review and Is Subject to Federal Court Review...	38
C. Mergers and Acquisitions: Federal Reserve Oversight.....	41
1. Margin Requirements.....	41
2. Credit Policies and Foreign Investors.....	42
D. Mergers and Acquisitions: FTC and Justice Department Oversight..	44
1. The FTC and the Justice Department Will Scrutinize the Proposed Merger for Possible Antitrust Violations.....	44
2. Merger Guidelines.....	45
3. Premerger Notification Is Required.....	51
4. Does the Reagan Administration Propose to Change Antitrust Enforcement Relating to Mergers and Acquisitions?.....	53
III. THE TAKEOVER PROCESS: DEFENSIVE TACTICS.....	59
A. The Responsibilities of Management.....	59
B. Evaluating a Takeover Bid.....	61
C. Structuring a Defense in Advance of a Takeover.....	62
1. Elements in the Overall Strategy.....	62
2. Shark-Repellent Tactics and Porcupine Amendments.....	63
D. Structuring a Defense Once the Tender Offer Has Been Made.....	65
IV. THE BOTTOM LINE: WHOSE INTERESTS ARE AT STAKE?.....	69



TABLES AND CHARTS

Table 1	Distribution of Assets Acquired in Large Mining and Manufacturing Mergers by Type for Selected Years: 1948-1979.....	17
2	Large Acquisitions in Manufacturing and Mining, by Year, 1960-1979.....	18
3	Total Assets of All Large Manufacturing and Mining Companies Acquired as a Percentage of Total Assets of All Manufacturing and Mining Corporations, 1960-1979.....	20
Chart 1	Large Manufacturing and Mining Firms Acquired, 1948-1979.....	19
2	Sources of Law Affecting Tender Offers.....	40





## MERGER TACTICS AND PUBLIC POLICY\*

### INTRODUCTION

Debate on the public policy implications of merger and acquisition activity in the U.S. economy has recently intensified in response to several takeover attempts involving large corporations. For example, one of the largest merger battles in recent U.S. corporate history was fought over Conoco, with contenders Mobil Oil and Seagram losing to Du Pont. Seagram attempted to take over St. Joe Minerals Corporation, but Fluor Corporation, a "white knight" more amenable to St. Joe's management, was the victor. Mobil Oil lost to U.S. Steel in its joust over the prized oil reserves held by Marathon Oil. LTV's attempt to take over Grumman was widely publicized, and congressional interest in acquisitions broadened to defense-related firms.

While currently there are not as many mergers and acquisitions as occurred in the prior merger wave of the late 1960s, the character of merger activity has changed; there are more mergers among very large blue chip companies in an increasingly hostile atmosphere. A reason frequently cited for the recent merger and acquisition activity is that, with sustained inflation, many corporate

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\* This report is based in part on a CRS Member Breakfast Seminar, held on October 21, 1981, at which three nationally prominent panelists involved as counsels in notable merger and takeover cases spoke. The panelists were: Ira Millstein of Weil, Gotshal & Manges, who discussed the antitrust implications of merger activities; Martin Lipton of Wachtell, Lipton, Rosen & Katz, who discussed management's point of view in attempting to implement or block merger attempts; and Melvyn Weiss of Milberg, Weiss, Bershad & Specthrie, who discussed concerns of shareholders and non-controlling interests. While this report attempts to reflect the panelists' varying points of view, they are not responsible for its overall content.

securities become undervalued compared with the intrinsic value of the company's underlying assets. 1/ This fact, combined with persistently high interest rates and the risk premium associated with new business ventures, may provide more incentive to purchase existing business entities than to invest in new plant or in new enterprises. Notwithstanding the current economic climate, however, which may be intensifying corporate takeover bidding, a certain degree of merger and acquisition activity is to be expected in the normal functioning of the marketplace. Mergers and acquisitions can provide financing, management, and access to resources or to markets which might not otherwise be obtainable, or an opportunity to profit from better utilization of existing resources that are inadequately managed by current management. In addition, an entrepreneur who has built up a company may seek an opportunity to sell it, and shareholders may have an opportunity to receive a substantial premium return on their investment.

On the other hand, merger and acquisition activity may not necessarily produce successful business combinations. Barron's reports that numerous mergers and acquisitions--such as Exxon's purchase of Reliance Electric Co. and Mobil's acquisition of Marcor (itself a combination of Montgomery Ward and Container Corporation of America)--have been disappointing because the acquired companies have not performed as well as anticipated. 2/ There is also considerable debate about whether mergers and acquisitions occurring as a result of market forces lead to beneficial and efficient allocation of resources

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1/ Drucker, Peter F. The Five Rules of Successful Acquisition. Wall Street Journal, October 15, 1981.

2/ See Bleiberg, Robert M. Too Far Afield? ...Some Big Oil Company Takeovers Have Come to Grief. Barron's, August 10, 1981. p. 7. See also Wayne, Leslie. Joys of Fleeing the Corporate Stable ...Conglomerates find they often can't profit from the acquisitions of the last merger wave, so they sell the units to the people running them, who thrive. New York Times, November 15, 1981. p. 26.

in society or whether resulting corporate entities will be in a better position to thwart competition in the economy. Of particular concern is the question whether the acquiring company in a takeover situation provides "synergistic" benefits or improved management for the acquired company such that the value of the new entity, and thus the value to society, is greater than the value of the separate companies. Also of interest to legislators is the question whether merger and takeover activity leads to a diversion of capital for "non-productive" uses such as buying existing entities rather than for investment in new plant and equipment, deemed more "productive."

These considerations about the role of merger and acquisition activity in the economy as a whole are present whether the takeover bid is friendly--that is, acceptable to the selling company--or whether the bid is hostile and opposed by the subject or "target" company. But when the merger process and tactics employed result in dispute between various interested parties (such as management, shareholders, labor, pension fund holders, etc.), another dimension of public policy is exposed. The merger battle itself gives rise to issues which relate not only to economic efficiency and concentration of power throughout the economy as a whole, but also to equity, economic concentration, and efficiency issues within the individual firm. Several major questions arise in this connection:

- (1) To what extent should management be free to implement or block a merger? In rejecting a takeover bid--which may be at a substantial premium for shareholders--is management motivated, as many commentators contend, only by a desire to stay in office or has management, as other commentators contend, rejected the bid for sound business planning reasons?

What if management simply wants to operate independently for business judgment reasons or because it fears that a parent company will be less concerned about employees or the community in which the company operates? What if these reasons only transparently mask management's self-interest?

- (2) Can various subgroups within a corporation (such as shareholders, employees, and pension fund recipients) protect their interests if they conflict with the plan of defensive tactics instituted by management?

For example, does the shareholder who wishes to tender his shares to a bidder and thus receive a premium have adequate means to make sure he is not denied the ability to tender and protect his economic interests if they conflict with management's decision to block a tender offer?

What recourse do groups such as pension fund recipients have if management arranges for the use of pension fund money to buy company stock to keep it from a bidder's hands? The purchase of this stock is obviously intended to thwart the takeover, and if this defensive tactic is successful, the company's stock and the value of the pension fund may drop. 3/

In another example, in a situation where a bidding company gains control of a target by receiving 51 percent of its shares through the means of a tender, are there adequate means to protect the economic interests of the remaining minority shareholders who did not tender and are then "frozen out" by the controlling company and obliged to accept unfavorable terms for their shares? 4/

Another issue related to "freeze-outs" is the trend in "going private" transactions, whereby a group of controlling shareholders "freeze" or "squeeze" out minority shareholders in order to take the company private at what many believe are inadequate prices--prices which if offered to management or these controlling shareholders in a tender offer situation might well be rejected. How can the competing interests of controlling and minority shareholders be resolved in these circumstances?

- (3) Are the tactics employed by management to defend itself against a hostile takeover bid so influenced by self-interest as to result

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3/ This was reported to have been one of Grumman's defensive tactics to defeat the LTV takeover attempt. See Carley, William M. Grumman Pension Plan Buys More Stock in Effort to Block LTV, Which Plans Suit. Wall Street Journal, October 13, 1981. See also Carley, William M. Grumman, by Acquiring Its Own Shares, Seems to Be Gaining in Bid to Block LTV. Wall Street Journal, October 14, 1981.

4/ This is reported to be at issue in the U.S. Steel tender offer for Marathon. U.S. Steel offered 125 dollars per share for 51 percent of Marathon's shares, and then proposed to offer debentures the stock market has valued at less than 80 dollars per share for the remaining 49 percent of the shares. See O'Boyle, Thomas. U.S. Steel Faces Rising Dissent Over Bid to Swap 12.5% Notes for Rest of Marathon. Wall Street Journal, February 17, 1982. While Marathon employees owning stock were urged to tender to U.S. Steel, there are instances where management may urge employees not to tender so as to defeat the tender offer. In this case, employees could be in a similar "frozen out" position along with the minority shareholders.

in "unproductive" use of resources, or is the public interest served by allowing management to conduct tactical maneuvers in a takeover situation?

This report discusses types of mergers and acquisitions, motivations for merger and takeover activity, and offensive and defensive tactics used to implement or thwart a merger or takeover. The role of the various Federal oversight bodies, such as the Securities and Exchange Commission (SEC), the Federal Trade Commission (FTC), and the Antitrust Division of the Justice Department, is explored. Finally, public policy issues raised in connection with takeover activity are very briefly summarized, including equity, efficiency, and concentration of power within the economy and within the firm as various competing groups (management, shareholders, employees) struggle in the takeover process to protect their economic interests.



## I. TYPES OF MERGERS AND ACQUISITIONS

Merger and takeover activity has tended to come in waves and has been accomplished in a variety of forms, some of which have recently evolved in response to changing market, regulatory, and judicial conditions. There have been four major waves of merger and acquisition activity since the turn of the 20th century. Each period has emphasized different types of mergers and in recent periods the predominant legal form used to effect merger and takeover activity has varied. This section describes the generic types of mergers, the predominant features of each of the waves, and the contrast between the current wave and prior waves.

### A. Generic Types of Mergers

Briefly, the generic types of mergers can be classified into three groups:

- (1) Horizontal merger - the merger of two or more competitors. The companies must produce one or more of the same, or closely related, products in the same geographic market. 5/ Products which are sufficiently interchangeable in their end uses or for which there exists cross elasticity of demand may be held to be within the same product market.
- (2) Vertical merger - the amalgamation of two firms that previously functioned at different vertical levels of distribution, i.e., in a customer-supplier relationship. The acquisition is designated forward vertical integration when a seller acquires an actual or potential customer and as backward vertical integration when a customer acquires an actual or potential supplier. 6/ Vertical integration may be complete, which occurs when the entire supply source or outlet system is contained within the new enterprise; it is partial when some purchasing or selling continues to be conducted with outside firms. 7/

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5/ von Kalinowski, Julian O. Antitrust Laws and Trade Regulation. Volume 161, Business Organizations, §73.01. See also Federal Trade Commission. Statistical Report on Mergers and Acquisitions, July 1974. p. 162.

6/ von Kalinowski, op. cit., §73.01.

7/ von Kalinowski, op. cit., §73.03.

(3) Conglomerate merger - all mergers and acquisitions that are not horizontal or vertical. Within this non-homogeneous class of mergers, there are four distinct subcategories:

(a) Product extension merger - the merger of companies that manufacture or sell products which, although different, are so complementary that they can be produced with similar facilities, marketed through the same channels, and advertised by the same media. <sup>8/</sup> An example would be the merger of a liquid bleach with a liquid starch manufacturer; in this case production and distribution facilities may be shared.

(b) Geographic market extension merger - a merger in which the acquired and acquiring companies manufacture or market the same products but in different geographic markets, or, what may amount to the same thing, to different customer classes. An example of a geographic market extension merger is the acquisition by a local food chain in New York of a local food chain in Chicago; in this manner, large national or regional dairy and retail grocery industries have developed. Since geographic market extension mergers closely resemble horizontal mergers, they are frequently referred to as "chain" horizontals, <sup>9/</sup> except that the participating firms are not in direct competition with one another since they are in different geographic locations.

(c) Reciprocal dealing or leverage merger - acquisition of a firm which is a supplier or customer of a third firm which sells to or buys from the acquiring firm. The merger may create an opportunity to engage in "reciprocal dealing," a term which refers to the use of buying power to secure an advantage in the sale of products. The acquiring company may seek to create sales outlets for its acquired firm or it may seek to secure a source of supply if it conditions its purchases from a third party on the latter's agreement to sell the acquired firm's products or to secure a firm supply for the acquired firm. <sup>10/</sup>

(d) Pure conglomerate merger - a merger in which there are no discernable economic relationships between the acquiring and acquired firms.

In addition to these generic types of mergers and acquisitions, there are joint ventures, whereby companies join together to form a new corporate entity

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<sup>8/</sup> A complementary relationship between similar products exists when a rise in the consumption or purchases of one causes a rise in the demand for the other. Boulding, Economic Analyses, as cited in von Kalinowski, §73.04.

<sup>9/</sup> von Kalinowski, op. cit., §73.05.

<sup>10/</sup> von Kalinowski, op. cit., §73.06.



without losing their own separate identities. For example, in the energy industry, utility and mining companies and interstate gas pipeline companies have recently formed joint ventures for certain specific projects.

#### B. Methods Used to Merge or Take Over

The term "merger" is often loosely used to describe a variety of acquisition and takeover transactions. A merger, however, refers specifically to "the case in which the assets and liabilities of the selling company are transferred to and absorbed by the buying corporation." <sup>11/</sup> The selling company thus disappears as a separate entity. In a consolidation or amalgamation, on the other hand, it is not specified who is buying whom.

Mergers are subject to State law provisions applicable to publicly held companies requiring approval of the selling company's board of directors, and issuance of Federal SEC-approved, and in some cases State-approved merger proxy materials to shareholders. Shareholder approval is also required; in some States a two-thirds vote is necessary, although in many States only a majority of the stockholders need approve. Consolidations require approval of boards of directors as well as approval of either two-thirds or a majority of shareholders for both companies.

The traditional merger or negotiated acquisition might be accomplished in consideration for a variety of terms including cash, shares in the buying company, convertible debentures (bonds issued by the buyer which are convertible into stock), or other debt instruments such as non-convertible debentures. The negotiated acquisition process is more lengthy and generally less direct than

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<sup>11/</sup> Brealey, Richard, and Steward Meyers. Principles of Corporate Finance. New York, McGraw-Hill, 1981. p. 671.

the much publicized tender offer takeover process. But, "although much of the attention in recent years has been directed to contested takeovers--now a permanent and noisy part of the acquisitions scene--most acquisition transactions are still of the negotiated variety with only two players, a seller, and a purchaser, acting voluntarily." 12/

A takeover bid or tender offer is:

...a method of acquiring shares of a "target" or "subject company" in which a "bidder" makes an offer to purchase shares directly to the target's shareholders. Although such offers may be for any percentage of the target's outstanding stock and for a variety of purposes, they are usually designed to obtain control of the target. Since the offer is made directly to the target's shareholders, a takeover bid enables

a bidder to acquire [control of] the target without approval of the target's board of directors and without the approval of the target's shareholders... 13/

For a variety of tactical reasons discussed subsequently in Section II A, the takeover and merger process now frequently involves a two-step and sometimes even a three-step process whereby a bidder acquires a block of a subject's stock, makes a tender offer for a portion or all of the remaining stock, and then follows up with a formal acquisition to acquire the remainder of the shares which were not tendered in the prior stage.

Merger transactions, in many cases, [are] used to "mop up" the deal, i.e., to pick up the shares not tendered after control of the seller [has] passed to the purchaser. The multistep transaction was born as a means of securing for the purchaser control of the seller (or at least a leg up on any competition which might emerge once the negotiated deal was announced) much faster than through traditional merger transactions, thus helping to assure that the deal would ultimately go through. 14/

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12/ Freund, James C. and Edward F. Greene. Substance Over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions. The Business Lawyer, v. 36, July 1981. p. 1485-6.

13/ Katcher, Richard D. Takeovers: Seminar on Business Acquisitions, Tender Offers and Stockholder Litigation. Illinois Institute for Continuing Education, Chicago, Illinois, June 12-13, 1980. p. 4-1.

14/ Freund and Greene, op. cit., p. 1486.

### C. Waves of Merger and Acquisition Activity

Four periods of increased intensity in mergers and acquisitions have occurred since just before the turn of the 20th century:

- (1) 1896 to 1904, characterized by horizontal mergers to achieve dominant firms and near monopolies;
- (2) 1919 to 1929, characterized by horizontal mergers of less than dominant firms to form oligopolies;
- (3) 1960s, peaking in 1968, characterized by conglomerate mergers to achieve large amalgamations of generally unrelated businesses;
- (4) late 1970s and continuing to intensify in 1981, characterized by mergers among large, well-established firms in an increasingly hostile atmosphere, primarily to purchase existing undervalued business entities.

#### 1. Mergers During the Early 1900s

The first wave, estimated to have involved 15 percent of all U.S. manufacturing plants and employees, is considered to have begun as the Nation recovered from the depression of 1893 and to have continued until the recession of 1904. <sup>15/</sup> The predominant feature of this period was the use of horizontal mergers to consolidate a number of small firms in an industry into a single near-monopolistic dominant firm. Companies such as Du Pont, American Tobacco, and U.S. Steel (formed from 785 separate plants) epitomized this trend.

Oddly enough, this activity went on despite passage of the Sherman Act in 1890. One argument is that the Sherman Act encouraged monopolization since

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<sup>15/</sup> See Nelson, Ralph L. *Merger Movements in the United States*. Princeton University Press, Princeton, 1959. p. 29, 53; Markham, Jesse W. *Survey of the Evidence and Findings on Mergers*. National Bureau of Economic Research Conference Report; Business Concentration and Price Policy. Princeton University Press, 1955. p. 28, 29, 53; Moody, John. *The Truth About Trusts*. Moody Publishing, 1904. p. 486, 487; as cited in U.S. Library of Congress. Congressional Research Service. *Antitrust Policy Towards Mergers*. Report 77-26E, by Howard Useem. Washington, 1977.

it made collusion illegal (but not mergers) and put an end to the trustee device, thereby forcing industrialists seeking market control to resort to complete fusion of their separate companies. 16/

The second wave occurred from 1916 and ended abruptly in 1929 with the collapse of the stock market. In this period, firms secondary to the dominant firms frequently undertook mergers which transformed some industries from dominance by a single large firm to oligopoly, dominance by a few large firms. 17/ Merger activity was especially intense in the following industries: primary metals, petroleum products, food products, chemicals, and transportation equipment.

## 2. The Late 1960s Conglomerate Merger Wave

The third wave--the "conglomerate" wave--peaked in 1968. It was characterized by practical application of the theory that managerial talent was more important than knowledge of any particular line of business and that extremely capable managers could take over any business and improve it. The notion of "synergy"--that a new entity is worth more than the sum of its separate parts--was applied not only to combinations based on extending lines of business into profitable areas but also to well-publicized managerial talent attributed to such people as James Ling of Ling-Temco-Vought, whose transactions epitomized the era.

Some analysts contend that stricter interpretation of antitrust laws applicable to horizontal and vertical acquisitions was a factor in the growth of the conglomerate trend because it would be difficult under existing antitrust

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16/ See Useem, op. cit., p. 29-31.

17/ Stigler, George. Monopoly and Oligopoly by Merger. American Economic Review, May 1950.

statutes to contest a merger on grounds of market concentration where separate markets are involved. But accounting techniques were also reported to have fueled the late 1960s merger wave; these provided incentives in several ways. "Pooling-of-earnings" techniques permitted companies to add their balance sheets and income statements together as if the two companies were one. If investors then compared the resulting pooled earnings with earnings prior to pooling, this would create a distorted growth trend which only the more sophisticated investors might discern. 18/ Another distortion occurred with the sale of assets that were thought to be "undervalued" (i.e., the book value--assets shown on the company's balance sheet divided by the number of shares--was less than the market value). "Goodwill" or intangible assets were created if payment for the company exceeded the book value of its shares. Failure to amortize this goodwill by annual charges to income inflated earnings, thereby creating a distorted earnings trend, which in turn required further "chain letter" mergers to maintain the trend. Finally, an artificial boost to earnings under pooling accounting arose through use in the takeover of preferred stock or convertible debentures (bonds convertible into common stock which enabled the investor to share in appreciation of stock prices without the risk of a fall in the conversion rate). Under accounting rules in effect prior to 1969, earnings per share of common stock could artificially increase with fluctuation in the debenture rate. 19/

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18/ As an example, when Leasco acquired Reliance Insurance, it acquired an investment portfolio of stocks carried on Reliance's books at a cost which was substantially lower than market value. After the acquisition, Leasco sold the securities, making it appear that the merged entity had realized greatly increased earnings when in fact it was merely liquidating securities at the same prices that existed on the date of acquisition. (Telephone communication from attorney Melvyn Weiss to CRS, February 12, 1982.)

19/ See Steiner, Peter O. Mergers, Motives, Effects, Policies. University of Michigan Press, 1975. p. 109-117; and Briloff, A.J. Accounting Practices and the Merger Movement. Notre Dame Lawyer, vol. 45, Summer 1970. p. 604-628.

In an attempt to eliminate these kinds of distortions in earnings, the SEC has since required either retroactive pooling (to insure continuity of earnings comparisons) or purchase accounting, whereby acquired assets are valued at their market price, eliminating the distortions arising from use and amortization of goodwill. Also, more stringent accounting for earnings fluctuations arising from conversion from preferred stock and debentures has been instituted.

### 3. Comparisons Between the Current and Previous Periods of Merger Activity

The current merger wave, which began in the late 1970s and intensified in 1981, differs in several ways from that of the late 1960s. Although friendly deals are still the dominant form, an increasing number of combinations are now the result of hostile actions. More large blue chip companies and "old line" investment bankers and banks now view the process as acceptable. <sup>20/</sup> While most of the deals involve small companies, <sup>21/</sup> an increasing proportion of deals tends to be larger in dollar value and to be characterized by a higher frequency of bidding wars, which raise the stakes between competing companies; examples are the bidding wars of the Mobil-Conoco-Du Pont and the Mobil-Marathon-U.S. Steel contests.

W. T. Grimm & Co., which tracks merger announcements, reported that 1981 merger activity increased 27% to 2,395 transactions, compared with 1,889 a year earlier. This rate does not yet approach the peak of the last wave, when over

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<sup>20/</sup> Phalon, Richard. The Takeover Barons of Wall Street. G.P. Putnam's Sons, New York, 1981. p. 90.

<sup>21/</sup> For a more complete discussion of the composition of recent tender offers by size and for all industries (beyond the limited manufacturing and mining sample the FTC provides), see U.S. Library of Congress. Congressional Research Service. Corporate Mergers Through Tender Offers: Measurement and Public Policy Considerations. Report No. 81-260 E, by Kevin F. Winch. Washington, 1981. (Hereinafter cited as Winch, Corporate Mergers.)

6,000 transactions were reported in 1968. The 1981 transactions, as measured in current dollars, have grown substantially in dollar volume. According to the Grimm data, the total current dollar value paid for acquisitions set a new record for the third consecutive year: \$82.6 billion for 1981, almost double the \$44.3 billion for all of 1980 22/ and the \$43 billion for 1968. While the dollar volume of deals increased dramatically between 1981 and 1980, however, after adjusting for inflation, the 1981 total was actually 17% less than the 1968 dollar value (in 1981 the transactions were valued at approximately \$43 billion in 1972 constant dollars, compared with the 1968 total of approximately \$52 billion in 1972 constant dollars).

There were twelve transactions during 1981 valued at more than \$1 billion--Grimm refers to these as "mega-deals." Together they contributed \$38.4 billion to the \$82.6 billion total. These transactions included the following widely publicized deals:

1. the \$8 billion cash and stock acquisition of Conoco, Inc. by the Du Pont Co., one of the largest corporate takeovers in recent U.S. history;
2. the \$4.3 billion purchase of Texasgulf, Inc. by Société Nationale Elf Aquitaine of France;
3. the takeover of St. Joe Minerals Corp. by Fluor Corp. for \$2.7 billion in cash and stock;
4. the \$2 billion cash acquisition of Kennecott Corp. by Standard Oil Co. of Ohio; and
5. the \$1.8 billion merger between Nabisco, Inc. and Standard Brands, Inc.

But Grimm also reports that "while mammoth takeovers reached record-breaking levels, acquisitions of small privately held companies remain the focal point" of mergers and acquisition (M&A) activity. Of the 2,395 transactions

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22/ Press Release, "W.T. Grimm & Co. Announces Record Year in Mergers," W.T. Grimm & Co., Chicago, Illinois, January 2, 1982.

tabulated for 1981, 1,332 or 56 percent involved the sale of a closely held firm. This figure actually represents an increase from 52 percent in 1980. The second most active segment of M&A activity involved divestitures. According to Grimm, the sale of divisions, subsidiaries, or product lines in 1981 accounted for 830 transactions or 35 percent of all acquisition activity. <sup>23/</sup>

Data compiled by the Federal Trade Commission (FTC) are not as current as the Grimm data, nor are they comparable. Most recent FTC data are preliminary for 1979, and they are only for publicly held manufacturing and mining companies with an acquisition value of \$10 million or more. Thus, they do not include service companies, which have been important participants in M&A activity. (By comparison, Grimm data are current and include all merger transactions with no restriction as to value or industry.) Nevertheless, the FTC data permit detailed historical comparisons between the current and last merger periods. The following tables show:

- conglomerate mergers predominate in both periods (See Table 1);
- there were fewer acquisitions in 1979 than in 1968, but the average current dollar value per acquisition was greater in 1979 (See Table 2 and Chart 1);
- when adjusting merger activity to take inflation into account, both the 1979 total value of assets and the average size of the acquisition remain smaller in constant dollars than during the peak of the prior merger wave, but the recent trend toward "mega-deals" has probably increased the average size of acquisitions since 1979 (see Table 2);
- when adjusting merger activity to account for growth in assets for the manufacturing and mining sector as a whole, data in 1979 show that merger and acquisition assets accounted for a smaller percentage of the total assets of all manufacturing and mining companies than in 1968 (See Table 3).

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<sup>23/</sup> According to Grimm, "persistent high interest rates and dwindling cash flows have led to an increase in both divestitures and sales of private concerns. Divestitures permit large corporations to redirect assets into the most productive areas of their business. Sales of private concerns are increasingly motivated by a desire for liquidity on the part of selling stockholders." See release, "Merger Upturn Persists: Third Quarter Up 25%." W.T. Grimm & Co., Chicago, Illinois, October 21, 1981.



TABLE 1  
 Distribution of Assets Acquired in Large a/  
 Mining and Manufacturing Mergers by Type  
 For Selected Years 1948-1979  
 (percentages) b/

	1948-51	1952-55	1956-59	1960-63	1964-67	
Horizontal	38.8	36.6	27.3	13.3	11.4	
Vertical	23.8	11.5	20.1	23.8	8.9	
Conglomerate	37.5	51.9	52.6	62.9	79.7	
Product extension	37.5	45.7	33.5	37.8	49.9	
Market extension	NA	2.7	5.0	8.0	8.7	
Other	NA	3.6	14.2	17.1	21.2	
	1968	1969	1973	1974	1978	1979 <u>c/</u>
Horizontal	4.2	19.4	18.8	30.7	28.5	2.3
Vertical	7.2	7.7	15.9	1.1	15.1	7.3
Conglomerate	88.6	72.9	65.3	68.2	56.4	90.4
Product Extension	39.0	31.7	13.3	22.6	28.0	35.9
Market Extension	5.9	3.1	15.3	7.6	.0	.0
Other	43.6	38.1	36.7	38.0	28.4	54.2

Source: Federal Trade Commission.

a/ Acquired firms with assets of \$10 million or more for which data are publicly available.

b/ Percentages may not sum to 100 percent because of rounding.

c/ Figures for 1979 are preliminary.

Note: It is possible that in any one year a small number of acquisitions of companies with large asset values could distort the data, however, the general trends observed are probably reasonably accurate.

TABLE 2  
Large Acquisitions in Manufacturing and Mining, By Year, 1960-1979

Year	Number of Acquisitions (1)	Assets (in millions of current dollars) (2)	Assets (in millions of constant 1972 dollars) (3)	Average Size of Acquisition (in millions of current dollars) (4)	Average Size of Acquisition (in constant 1972 dollars) (5)
1960	51	1,535.1	2,224.6	30.1	43.6
1961	46	2,003.3	2,902.9	43.6	63.1
1962	65	2,251.9	3,194.2	34.6	49.1
1963	54	2,535.8	3,541.6	47.0	65.6
1964	73	2,302.9	3,192.4	31.5	43.7
1965	64	3,253.7	4,379.1	50.8	68.4
1966	76	3,329.1	4,337.0	43.8	57.1
1967	138	8,258.5	10,453.8	59.8	75.7
1968	174	12,580.0	15,235.6	72.3	87.6
1969	138	11,043.2	12,737.0	80.0	92.3
1970	91	5,904.3	6,462.7	64.9	71.0
1971	59	2,459.9	2,561.9	41.7	43.4
1972	60	1,885.5	1,885.5	31.4	31.4
1973	64	3,148.8	2,979.0	49.2	46.5
1974	62	4,466.4	3,887.2	72.0	62.7
1975	59	4,950.5	3,942.7	84.0	66.8
1976	82	6,301.8	4,770.1	76.9	58.2
1977	101	9,166.6	6,555.5	90.8	64.9
1978	111	10,724.3	7,147.2	96.6	64.4
1979 <u>b/</u>	97	12,867.1	7,905.1	132.7	81.5

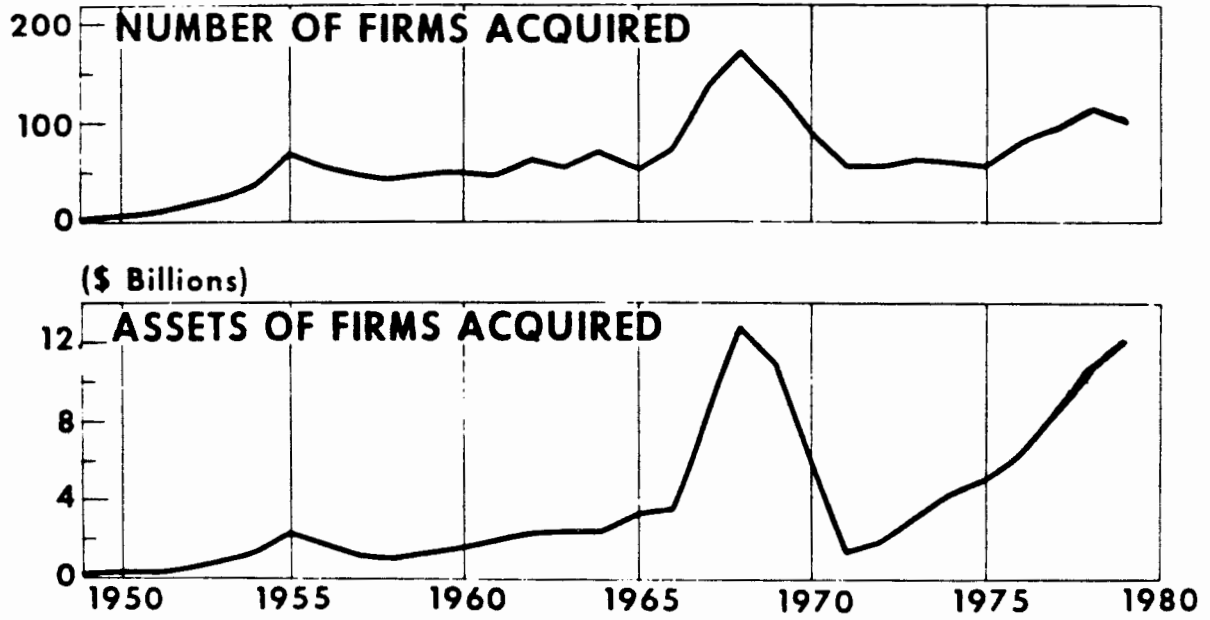
Source: Bureau of Economics, Federal Trade Commission. Columns 3-5 calculated by CRS.

a/ Acquired firms with assets of \$10 million or more.

b/ Figures for 1979 are preliminary.

Note: Not included in above tabulation are companies for which data are not publicly available. The data are only for large mining and manufacturing companies and therefore do not include service industries, which have been quite active in mergers and acquisitions. The W.T. Grimm data, on the other hand, cover all types of mergers and acquisitions and are more current than the FTC data. The Grimm data show a dramatic increase in the average size of acquisitions since 1979, primarily because of the increase in "mega-deals." In 1981 there were 12 such deals of over \$1 billion each (equivalent to \$530 million in 1972 dollars), compared with only 4 such transactions in 1980.

# CHART 1 LARGE\* MANUFACTURING AND MINING FIRMS ACQUIRED 1948-1979



\*Firms with assets of \$10 million or more.

SOURCE: Bureau of Economics, Federal Trade Commission.

TABLE 3  
 Total Assets of All Large Manufacturing and Mining Companies  
 Acquired as a Percentage of Total Assets  
 of All Manufacturing and Mining Corporations, 1960-1979

Year	All Manufacturing and Mining Corporations a/ Total Assets (\$ Millions)	Large b/ Manufacturing and Mining Acquisitions Total Assets (\$ Millions)	Percentage
1960	265,030	1,734.1	0.65
1961	275,658	2,234.9	0.81
1962	292,774	2,660.7	0.91
1963	307,136	3,187.1	1.04
1964	323,311	2,576.5	0.80
1965	346,639	3,721.9	1.07
1966	386,640	4,380.2	1.13
1967	427,133	8,955.7	2.10
1968	468,711	13,759.2	2.94
1969	526,129	12,219.2	2.32
1970	578,019	6,601.1	1.14
1971	610,296	3,140.5	0.51
1972	653,751	2,670.8	0.41
1973	718,768	3,558.8	0.50
1974	738,913	5,118.9	0.69
1975	791,892	5,528.0	0.70
1976	858,588	6,926.0	0.80
1977	933,613	10,129.5	1.08
1978	1,031,577	11,770.4	1.14
1979 c/	1,177,639	16,033.6	1.36

a/ Figures for Manufacturing and Mining Corporate Assets have been revised to reflect the use of First Quarter Quarterly Financial Reports.

b/ Acquired firms with assets of \$10 million or more.

c/ Figures for 1979 are preliminary.

Source: Corporate Manufacturing Assets obtained from Quarterly Financial Reports. Totals for Mining derived from IRS Statistics of Income for 1966 through 1974, and from Quarterly Financial Reports thereafter. Bureau of Economics, Federal Trade Commission.

There are other differences between the current period of increased merger activity and the preceding one. In the late 1960s, rising stock prices, which many analysts regarded as "inflated," precipitated the purchasing of companies in exchange for stock and convertible debentures with such speculative enthusiasm that these stocks and debentures were euphemistically referred to respectively as "Chinese trading stamps" and "Castro Convertibles." 24/ By comparison, in the current wave of merger and takeover activity, a significantly greater proportion of the deals are for cash, whereby stock is purchased by the bidder on a tender offer basis. 25/ This enables the hostile offeror to make his offer quickly and directly to the target's shareholders rather than having to get approval from the company's board of directors, which would have to put the matter to a shareholder vote.

While the accounting devices which reportedly boosted merger activities in the late 1960s have largely been revised, some accounting incentives remain. There is still a potential "bootstrap" effect on earnings per share when mergers occur, although this may be less important in an atmosphere where an increasing number of institutional investors participate in the market and have the capacity to analyze this information. Some incentive to buy at least a partial interest in another company, however, comes from the equity accounting method, whereby a company owning 20 percent of another can include a pro rata share of the latter's earnings in its own profit statement.

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24/ Phalon, op. cit., p. 66.

25/ According to W.T. Grimm, for the first nine months of 1981, among the deals for which payment data are disclosed, cash acquisitions comprised 42%, exchange of stock 35%, and combinations of cash/stock and/or debt 22%. Data for 1968 show that, at the height of the last conglomerate merger wave, 29% of the deals were for cash, 62% were for stock, and 9% were for a combination of cash and securities.

#### 4. Current Motivations to Merge

It appears that the major impetus for takeover activity now comes from a series of events related to high inflation and high interest rates. First, inflation has tended to make depreciated asset values, as set forth on the books of corporations, less than their fair market or replacement values. Absence of robust growth in the stock market frequently means that the market price per share is less than the intrinsic value of the assets and even less than their depreciated book value. For the Standard and Poor's 400 industrials, the average ratio of market to book value was roughly 2 in 1969; it hit a high in 1972 of 2.3 and then declined to 1.1 in 1974. 26/ The average ratio for 1980 was still only 1.2.

During the mid 1970s weakness in the U.S. dollar relative to foreign currencies such as the Deutschmark and the Swiss franc made foreign purchase of U.S. securities, and therefore foreign takeovers of U.S. companies, relatively more attractive. While higher U.S. interest rates have since somewhat moderated this trend, high inflation rates have brought corporate reluctance to risk new ventures and a preference for purchasing ongoing businesses or proved reserves.

With the current soaring inflation and high cost of building new facilities, the final completion cost is not known... Because of the current situation--i.e., the high yield from bonds and the double tax on dividends--common stocks are selling at much less than their true value, sometimes even less than their book value. Therefore, it is generally more attractive to acquire a going business than to attempt to build additional capacity. 27/

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26/ Comments by Joseph H. Perella at the 1979 American Bar Association Annual Meeting. The Urge to Merge--Where Has It Come From and Where Is It Going? The Business Lawyer, April, 1980. p. 1419-1421. (This meeting and publication hereinafter cited as ABA Meeting.)

27/ Comments by Thomas M. Evans, ABA Meeting, op. cit., p. 1424-1425.

This situation was especially evident in Mobil Oil's quest for Marathon Oil. The Wall Street Journal reported comments from two Wall Street analysts:

A takeover of Marathon would be simply "a very good purchase" for Mobil... Marathon's shares recently had traded at such low levels relative to their underlying value...that a takeover "is an opportunity..." The cost of finding oil is \$12 to \$15 a barrel. By buying Marathon at \$85 a share, Mobil can buy it at about \$3 to \$3.50 per barrel. 28/

This is not to suggest the total absence of more traditional motivations to merge or acquire, such as:

- a desire to achieve a large enough size to realize an economical scale of production and/or distribution;
- a desire to diversify to reduce the risks of business;
- a desire to utilize certain tax benefits which may be available with mergers or corporate reorganizations;
- a desire to overcome critical lacks in one's own company by acquiring the necessary complementary resources, patents, or factors of production;
- a desire to achieve sufficient size to have efficient access to capital markets or inexpensive advertising;
- a desire on the part of managers to increase their domain and their profits;
- a desire to respond to shrinking opportunities for growth and/or profit in one's own industry because of shrinking demand or excessive competition. 29/

Indeed, the variety of types of mergers reported by the FTC and Grimm undoubtedly indicate diversity of purpose. But what differentiates the present merger wave from prior waves is a set of market conditions which have encouraged large and established companies to engage in an unprecedented number of hostile acquisitions. Grimm data indicate that tender offers for publicly traded

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28/ Blustein, Paul. Mobil's Bid for Marathon Reflects Lessons from Conoco Offer, Urge to Gain Reserves. Wall Street Journal, November 4, 1981.

29/ See Steiner, op. cit., p. 30 et seq.

companies in 1981 rose 42% to 75 from 53 a year earlier. This increase was accompanied by a rise in takeover battles. Among the 75 offers attempted during 1981, 28 or 37% were contested by the subject company's management, compared with 12 or 23% in 1980. This reflects the highest number of hostile tender offers that Grimm's research department has ever recorded. Of the 28 target companies resisting takeover attempts, Grimm notes that 15 were able to ward off their hostile suitors. But not all 15 remained independent-- 9 were taken over by "white knights." The period can best be summed up by the following statement by a prominent merger and acquisitions specialist at First Boston, a leading investment firm:

...if you start with the premise that capital generally travels to areas of highest return where the smallest amount of attendant risk exists, and put that in the context of the figures [regarding the market price to book value ratios and the relative value of the dollar] ... perhaps you can better understand the explosion in cash merger and acquisition activity since 1974. ...a tremendous gap developed and still exists between the stock market value for 100 shares of stock and the underlying commercial value of an enterprise. ...you have the stock market down and lots of bargains around. The accountants passed rules making pooling more difficult, but no one really cares about pooling any more, with stocks selling way below book. Analysts used to be very nervous about goodwill, but that was pretty much reevaluated, and people began to care less about goodwill if they were paying more than book for stocks. When cash built up in the coffers of your so-called blue chip companies, they looked around and noticed that there was a Williams Act written that said if you want to make a takeover bid, this is how to do it.

So you had the large, well-established, so-called AAA buyers looking not for the turn-around situations, but for quality, well-managed target companies. Therefore, [in] the last five years, you saw companies like Cargill, Ciba-Geigy, International Nickel, Mobil Oil, Schlumberger, and Standard of Indiana launch unsolicited takeover efforts. 30/

In the current hostile atmosphere, few companies faced with an unsolicited tender offer survive as independent companies 31/ even though companies are

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30/ Perella, op. cit., p. 1420.

31/ The survival rate for domestic companies faced with a takeover via a tender offer is small, but it is even smaller when foreign companies make tender offers for U.S. companies. See Winch, Corporate Mergers, op. cit., p. 14.



employing a variety of defensive tactics to thwart raiders. Often the only possibility is to secure the protection of a "white knight," a company willing to purchase the target on terms arguably more favorable to it and usually with a provision to retain existing management. Yet, characteristic of this merger wave, shareholders may benefit greatly from premiums paid which are well above market price. <sup>32/</sup> But the spectacle of large Fortune 500 companies attacking each other, counter-attacking and maneuvering as if engaged in war games has raised public policy questions which go beyond the traditional antitrust and economic concentration questions raised in prior merger periods.

In a somewhat skewed notion of the survival of the fittest, it is the well-managed firms which are frequently the targets. <sup>33/</sup> At a time of concern over the competitive position and the rate of investment of U.S. industry, some cash-rich firms are moving to acquire in order to avoid being acquired. Questions of "fairness" arise at least as often as the traditional questions of whether a merger or acquisition will impede competition. When the tactics are so hostile, fairness--to management, shareholders, labor, pension fund recipients, the community--is not easily defined but seems to be at the crux of the public policy debate.

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<sup>32/</sup> J.A. Morgan & Co., an Oak Brook, Illinois, member consulting firm, reported that the average price paid for profitable manufacturing companies increased to 13.9 times their earnings for the 12-month period ending in the 3rd quarter of 1981. This compares with a 13.7 price-earnings ratio paid in the second quarter of 1981 and a 10.3 ratio in the 1980 third quarter. (To illustrate the magnitude of the premium, the P/E for the Dow Jones Industrials was 7.2 on December 4, 1981.) Buyers were willing to pay the highest premiums ever above net worth. The median premium was 100% more than net worth, up from 40% in the preceding quarter and 50% in this year's first quarter. Wall Street Journal, October 21, 1981.

<sup>33/</sup> Perella, op. cit., p. 1420.



## II. THE TAKEOVER PROCESS: OFFENSIVE TACTICS

### A. Structuring the Deal

A series of innovative transactions has been used in recent years to acquire control of public companies. Some examples are:

...Edper's acquisition of 25 percent of the stock of Brascan on the floor of the American Stock Exchange for the solicitation of between 30 and 50 institutional holders of the stock. The second, and even more controversial, was Sun's midnight raid, pursuant to which they acquired 35 percent of the stock of Becton, Dickinson, Third was the highly unusual offer recently made by J.P. Fuqua to acquire control of the Hoover Company....he made an offer only to members of the Hoover family, who were spread throughout the country and controlled approximately 42 percent of the Hoover stock. 34/

While takeovers may be pursued by a limitless variety of techniques, this section explores some of the basic and well-known offensive tactics used by a hostile offeror (sometimes pejoratively known as a "raider") to acquire control of a subject or "target" company through an unsolicited tender offer. Any takeover situation is dynamic, with many moving parts, including actions by:

- the offeror's management and its investment banking, legal, bank, and public relations advisors;
- the subject's management, with its battery of investment banking, legal, bank, and public relations advisors;
- the investment community, including institutional investors, the directors of stock exchanges on which involved securities are traded, the arbitrageurs, and the shareholders of the offeror and subject companies;

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34/ Comments by Edward F. Greene, ABA Meeting, op. cit. p. 1443-1444.

- the regulatory authorities, including those at the SEC, the FTC, the Justice Department, the Federal Reserve Board, the Committee on Foreign Investment in the United States, and other regulatory agencies, as appropriate; 35/
- the Federal and State courts;
- the Congress and State and local legislators; and
- other interested parties, such as labor unions and pension fund representatives, as well as public interest groups such as consumer groups.

While there is no "typical" takeover--each instance may evoke a change in tactics or the evolution of a new method--the following sections provide the mechanics of a simplified takeover example, noting the roles of these different parties.

1. The Offeror Considers a Range of Issues

A company's management may form the idea to initiate a takeover of another company from a variety of sources, including its investment banker, personal friends of management, its legal counsel, or the internal corporate research

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35/ This report deals with jurisdiction exercised by the SEC, FTC, and Justice Department over all mergers generally, but it does not cover individual agency oversight in the merger area. It should be noted that additional specialized scrutiny is required by certain agencies for particular industries: e.g., the Nuclear Regulatory Commission must approve acquisitions of companies in the energy field; the Federal Energy Regulatory Commission must approve combinations of interstate electric and gas utilities; and the Federal Communications Commission must approve acquisitions in the communications field. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency body established by the executive branch and led by the Treasury Department, is charged with guarding against foreign investments which are not in the national interest. Its oversight powers are limited, however, as evidenced by the fact that its July 1981 request to the French government to delay the acquisition of an American firm (Texasgulf) by a state-owned French firm (Societe Nationale Elf Aquitaine) was ignored.

efforts of its own in-house financial advisory staff. The deal is researched and structured to take into consideration such matters as:

- the tax and accounting effects of various means of effecting the combination;
- the best strategy for accomplishing the takeover (e.g. negotiated acquisition, unsolicited tender offer, quantity of stock needed to assure control, terms of the deal needed to ensure that the arbitrageurs will provide liquidity for the deal);
- the appropriate instruments to use in the deal (e.g., tender for stock, cash, debt, or some combination of these);
- the cost of the merger in terms of investment advisory, legal, and public relations fees;
- the premium necessary to ensure that the tender offer goal is met (e.g., that investors such as shareholders and arbitrageurs will enter into the deal);
- the risk and financial implications of a bidding war with a rival;
- the methods of meeting the financial requirements for the deal (e.g., from internally generated funds from bank loans or from newly issued securities);
- the opportunity cost of making the acquisition as opposed to using the funds for alternative investment purposes; and
- the legal ramifications of the proposed deal (e.g., the risk of violating antitrust or SEC or State disclosure laws).

## 2. The Special Role of Arbitrageurs

Among the considerations affecting these diverse parties, some mention should be made of the role of risk arbitrageurs, 36/ whose participation

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36/ "Risk" arbitrage differs from the more classic "riskless" arbitrage in that the latter involves the purchase of a security and the simultaneous or nearly simultaneous sale of an equivalent or related security at a slightly higher price. See definitions in Welles, Chris. Inside the Arbitrage Game. Institutional Investor, August 1981. p. 41-57.

can affect the outcome of a proposed takeover deal; describing their role also affords insight into the overall strategy of the deal. In its most simple form, risk arbitrage involves the outright purchase of securities in a company that is the subject of a planned reorganization, most commonly a merger, exchange offer, cash tender offer, or liquidation. A relatively small group of highly professional specialists called the "professional arbitrageurs" dominates this field, although an increasing number of "amateur arbitrageurs," made up of the investing public and retail stock brokers, has joined in the sphere of merger speculation surrounding "deal stocks," which are the subject of announced or anticipated takeovers. According to the Institutional Investor, in the relatively small number of billion-dollar deals, the arbitrageurs' role may be minor, but in the much more common \$100 million to \$500 million deals, especially those involving rival bidders, arbitrageurs (arbs) often come to control 30 to 40 percent of the stock.

Once a stock becomes a deal stock, says one m&a (merger and acquisition) chief, the regular institutions get out of the stock and the arbitrage community takes their place. The arbs then set the market. So you have to cater to their tastes. 37/

The offeror must gauge what "premium"--the difference between the market price of the shares in a company it wishes to acquire and the merger offering price--is necessary to motivate a sufficient number of investors, including arbitrageurs, to tender their shares to the offeror. After an announcement of a tender offer, the arbitrageurs may buy stock in the subject company, depending on their assessment of the value of the deal, which is based on a combination of the potential premium if the deal is consummated and the risk that the deal will fall through. Also, generally speaking, the more arbitrageurs there are in the deal, the more likelihood of success, since they are much more likely to tender

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37/ Welles, op. cit., p. 51.

their shares than certain classes of investors such as management and employee groups that may own considerable blocks of stock. The value of their participation stems from the fact that, unless the targeted amount of shares needed to gain control is actually tendered, the deal will collapse. The arbitrageurs' motivations may be summed up:

The profits in risk arbitrage, of course, derive from the differential or spread between the price of the stock following the announcement of a reorganization and the value ultimately realized by shareholders when the transaction is completed. The risk in risk arbitrage derives from the possibility that the transaction will not be completed. Between the announcement and the completion of a deal, the stock will tend to trade somewhere between its pre-announcement price and the estimated value of the deal to the shareholders. If the deal is terminated, the stock will usually drop precipitously to pre-announcement levels [emphasis theirs]. 38/

Thus, structuring the deal so as to be attractive to the arbitrageurs, especially the professional arbitrageurs, can be important. The arbitrageurs value more highly deals in which there is likelihood that all the shares they purchase will be able to be tendered, although some deals are, for other financial reasons, structured so as to put a ceiling on the number of shares an offerer will exchange. In this case, tendered shares are pro rated. (For example, U.S. Steel made a tender offer for 30 million shares or 51 percent of Marathon's shares. Ninety percent of Marathon's shares were tendered, so for each share tendered, the shareholder received 51/90ths, or the value of approximately 56 shares for each 100 tendered.) When an offeror offers terms other than cash, such as convertible preferred stock or bonds, the arbitrageurs will value the deal differently. Their role in influencing the structure and the success or failure of a deal should be noted.

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38/ Welles, op. cit., p. 42.

### 3. The Offeror Buys an Initial Block of the Subject's Stock

Assuming that the offeror decides conditions are favorable for going forward with an acquisition, he may begin the multi-step process already referred to: the offeror first buys a block of stock, then makes a tender offer and finally follows up with a negotiated acquisition to "mop up" the deal. Of course, the offeror may skip the first stage and go directly to the tender offer stage, but since the offeror almost always wants 100 percent of the target, which is virtually impossible to obtain through a tender offer, a mop-up deal is generally required. A company contemplating a takeover may first buy a block of stock for a number of reasons, including: 39/

- (1) to utilize equity accounting, which enables a company purchasing 20 percent of another company's stock to include in its earnings a pro-rata share of the latter's earnings (although purchase of 5 percent or more requires an SEC beneficial ownership 13D filing or, if a tender offer is the intent, an SEC tender offer 14D-1 filing; see following section for details);
- (2) to gain a foothold, possibly even a seat on the board of directors, and thus achieve more standing in negotiating with the subject's management about an acquisition;
- (3) to test the market to get a feel for the appropriate offering price;
- (4) to provide "negative control," whereby, as a large stockholder, the potential offeror could attempt to block management from employing a variety of defensive "shark-repellent" tactics such as:
  - issuing more shares to dilute the potential offeror's holdings;
  - merging with another company referred to as a "white knight";
  - buying a company which will present the potential offeror with antitrust conflicts, etc. (Note: defensive tactics will be discussed further in a subsequent section); and
- (5) to provide some insurance against losses in the event that the potential offeror does make a tender offer but that the subject goes to a rival higher bidder (in this case, the offeror's stock will be tendered at a profit).

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39/ See Phalon, op. cit., p. 33, 78, 92.



B. Mergers and Acquisitions: Securities Regulations

1. SEC Jurisdiction Over an Initial Purchase of a Block of Stock

Section 13(d) of the Securities and Exchange Act of 1934, as amended by the Williams Act of 1968, requires that a Schedule 13D form be filed with the SEC, with the subject or target company, and with each exchange on which the subject's securities are traded, within 10 days after any person or group acquires "beneficial ownership" of 5 percent or more of a class of registered equity securities. <sup>40/</sup> The Schedule 13D must disclose, among other things, the source of funds for the acquired securities, the purpose of the acquisition, and the purchaser's future plans with respect to control of the subject or target. If the purchases are to strengthen the acquiror's position in anticipation of merger negotiations, it must be disclosed that a possible merger will be considered. If the purpose of the purchase is to frustrate a takeover by a third party, disclosure of that fact must also be made. <sup>41/</sup>

Section 13(d) of the Williams Act has been criticized on the grounds that some companies have made large additional accumulations of the subject's stock during the 10-day "window" period prior to filing the required Schedule 13D, and have thus increased their leverage over the subject company despite SEC filing requirements, which are intended to disclose such actions. Early in 1980, SEC

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<sup>40/</sup> Requirements are outlined in Katcher, op. cit., p. 4-7 et seq.

<sup>41/</sup> See Katcher for beneficial ownership filing requirements for institutional investors and members of the securities profession such as broker-dealers and risk arbitrageurs who take positions in a stock with no intention of gaining control. Certain of these (as well as beneficial owners who had acquired not more than 2 percent of a class of securities within a 12-month period) may file a Schedule 13G which is an abbreviated Schedule 13D. Op. cit., p. 4-10, et seq.

Commissioner Harold Williams proposed amendments to the Williams Act to correct these perceived abuses. <sup>42/</sup> These amendments, which have never been enacted, would, among other things, "close the 10-day window period by requiring that shareholders owning 5 percent of a company make public announcement within 1 business day after reaching the 5 percent level, file a Schedule 13D within 5 business days, and refrain from making further purchases until 2 business days after the filing is made." <sup>43/</sup> Opponents of the proposed amendments argue that delays in ability to purchase securities and more cumbersome reporting requirements will interfere with smooth functioning of the securities markets.

In the fast-moving merger process, the timing for amending Schedule 13D may be important. Amendments are required to be made "promptly" (no time interval specified) if any "material" change occurs in the facts set forth in the Schedule and/or if changes occur in beneficial ownership equal to one percent or more of the class. Proposed amendments would have required the disclosure to be filed within 5 business days of these changes and would have required purchasers to refrain from making additional purchases until two business days after filing the amendment.

## 2. The Offeror Makes a Tender Offer and Triggers Additional SEC Oversight

The next step in the takeover process occurs when a potential offeror finalizes his plans to make a takeover bid. The following discussion assumes

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<sup>42/</sup> In response to a request from members of the Senate Banking Committee SEC Commissioner Harold Williams transmitted a letter on February 15, 1980, and shortly thereafter sent a draft of a proposed bill to amend the Williams Act. Both the letter and the proposed bill were reprinted in Securities Reg. & L. Rep. (BNA) Spec. Supp. 2, February 17, 1980, and Spec. Supp. 20, February 27, 1980. See Fogelson, James H., Joanne R. Wenig and Brian P. Friedman. Changing the Takeover Game: The Securities and Exchange Commission's Proposed Amendments to the Williams Act. Harvard Journal on Legislation, Vol. 17, Winter 1980. (Hereinafter cited as Fogelson et al.) p. 410.

<sup>43/</sup> Katcher, op. cit., p. 4-9. See also Fogelson, et al.

he has chosen to follow up his initial purchase with an unsolicited tender offer for all or a controlling portion of the subject's securities.

The Williams Act regulates takeover bids in four ways; it:

- (1) requires disclosure through statements filed with the SEC and circulated to investors;
- (2) prescribes substantive requirements as to the form and content of offers;
- (3) places controls over recommendations as to tender offers; and
- (4) contains a broad antifraud provision. 44/

Tender offer rules have been revised a number of times. Current rules which became effective January 7, 1980, are grouped into two categories, Regulations 14D and 14E. Both regulations apply to tender offers for any class of equity security issued by a registered public company. If the tender offeror seeks securities other than that of a registered company, only Regulation 14E applies. Briefly, these are the main provisions: 45/

#### Regulation 14-D

Rule 14d-3 requires the bidder to file with the SEC and disseminate to the subject company, any other bidder, and any national securities exchange or the National Association of Securities Dealers, a Tender Offer Statement on Schedule 14D-1 five days after the commencement date of the offer.

This 14D-1 filing requires much more information than was required by Schedule 13D (used to report beneficial ownership of 5 percent of a class of securities). Items on Schedule 14D-1 call for disclosure of the bidder's financial statements and any arrangements between the bidder and the target company and their officers and directors, and the applicability of the antitrust laws and margin requirements. These must be disclosed if they are material to a decision by a security holder whether to sell, tender or hold securities being sought in the tender offer. Also, information such as loan agreements to finance the tender offer must be provided.

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44/ Wander, Herbert S. The Effect of the Securities Laws on Various Acquisition Methods, Part 2, ALI-ABA Course Materials Journal, Vol. 5, February 1981. p. 86.

45/ The following description of Regulations 14D and 14E is largely excerpted from Wander, op. cit., p. 87-90, but includes references to Katcher op. cit., as well.

Rule 14d-2 defines the commencement date for the tender offer, a key concept under the new rules. An offer is commenced by press release, newspaper advertisement or other public statement made by the bidder or on his behalf which (i) identifies the bidder and the subject company and (ii) states the amount and class of securities being sought in the tender offer and the price or range of prices being offered. But no tender offer will be deemed to have commenced if, within five business days, the bidder issues an announcement that it is not continuing with the offer.

Rule 14d-1 deals with the scope of the regulation of tender offers and provides a definitional framework to clarify terms.

Rule 14d-9 states that no solicitation to security holders may be made by any person other than the bidder specified in the rule with respect to a tender offer unless that person files with the SEC a Tender Offer Solicitation-Recommendation Statement on Schedule 14D-9 on the date such solicitation is first sent to security holders. Minimum information requirements are stipulated by this rule and disclosure requirements are covered by Rule 14d-6.

#### Regulation 14E

Rule 14e-1 requires any tender offer to remain open for a minimum of 20 business days from the date it is first published or sent to security holders. Also, the offer must remain open at least ten days following notice of an increase in either the offered consideration or the dealer's soliciting fee. The consideration for the tendered securities must be paid or the securities returned "promptly" after the termination or withdrawal of the offer.

Rule 14e-2 interrelates with Rule 14d-9 and requires the target company to publish or send notice of its position concerning the offer to security holders within ten days of the offer's commencement. This position should take one of several forms: a recommendation to accept or reject the bidder's offer; a statement that the target company is expressing no opinion and is remaining neutral toward the bidder's offer; or a statement that the target company is unable to take a position with respect to the bidder's offer.

When the Williams Act was passed, Congress declined to define the term "tender offer." Many have argued that the dynamic nature of tender offers and the need for the SEC to interpret the Williams Act in a flexible manner preclude precise definition. In terms of conventional usage, one commentator notes that a tender offer may be considered to be "a publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale

at a specified price." 46/ But, given the innovative nature of the securities industry, with its wide variety of open market and private purchase methods to acquire securities (with or without public announcements), there would have to be considerable ambiguity concerning when a transaction is a tender offer. Currently, a combination of judicial precedent and SEC rulemaking produces an evolving definition of a tender offer.

The February 1980 proposed amendments to the Williams Act also included a definition of "tender offer" that would make the formal tender offer provisions of the Williams Act generally applicable to acquisitions of ten percent or more of a company's equity securities and to most acquisitions by persons, including officers and directors, who have previously acquired a 10 percent portion. The proposed definition of tender offer would involve a two-tier approach and an offer would constitute a tender offer if it were to meet the test in either tier: 47/

- (1) Under the first tier, the term "tender offer" would consist of:
  - one or more offers to purchase, or solicitations of offers to sell, securities of a single class
  - during any 45-day period
  - directed to more than ten persons and seeking the acquisition of more than five percent of the class of securities.
- (2) Under the second tier, one or more offers to purchase, or solicitations of offers to sell, securities of a single class would be a tender offer if:
  - the offers or the solicitations are disseminated in a widespread manner;
  - the price offered represents a premium in excess of the greater of 5 percent or \$2 above the current market price of the securities being sought; and
  - the offers do not provide for a meaningful opportunity to negotiate the price and terms--thus truly negotiated purchases of securities would not be regulated as a tender offer under the second tier.

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46/ See discussion in Fogelson et al., p. 429, note 101.

47/ Excerpted from Wander, op. cit., p. 91.

Debate in Congress on these proposed amendments was vigorous, proponents arguing for the need to clarify the definition to prevent abuses and opponents arguing that other abuses would result from an approach which allegedly removes flexibility from the SEC. While consideration of the merits of the various arguments for and against these proposed amendments is beyond the scope of the present report, the proposals are aired to provide a sense of the complexity and controversy surrounding current SEC monitoring of the merger and takeover process.

3. A Tender Offer May Be Subject to State Takeover Laws and to State Court Review and Is Subject to Federal Court Review

The trade journal Mergers and Acquisitions reported that, as of mid-1981, 37 states had enacted tender offer laws. <sup>48/</sup> Some State statutes define a "tender offer" as any offer for more than a specified percentage (usually five percent but sometimes as much as twenty percent) of any class of equity securities. <sup>49/</sup> The typical State statute does not apply to "friendly" mergers or takeovers, requires notice of a takeover bid prior to its commencement, and requires pro rata purchases, which may differ from the amounts set forth by the SEC. <sup>50/</sup> There is a serious legal question whether these State statutes are preempted by Federal law. (The February 1980 proposed amendments to the Williams Act would have resolved this question by making explicit Federal preemption of State takeover laws.)

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<sup>48/</sup> Bowers, Thomas L. Tender Offers: A Guide for the 1980s. Mergers and Acquisitions, Summer 1981. p. 28.

<sup>49/</sup> Katcher, op. cit., p. 4-91.

<sup>50/</sup> Wander, op. cit., p. 93-94.

State takeover laws play a role in the merger process, although recently most tender offer challenges have taken the route of seeking a Federal court injunction. But, since the waiting periods between filing and commencement of an offer are frequently longer at the State level, this may give the subject time, if not to avoid a takeover, at least to find a "white knight." Wander offers the following comment on State laws: "because these laws tend to favor management and work against the party making the tender offer, they provide the most effective defensive tactics available to management." 51/ Bowers notes that, "although packaged as investor protection statutes, many state laws preempted the shareholder protection provisions of the Williams Act." 52/

The interrelationship between Federal and State court jurisdiction is outlined in Chart 2. Federal courts review determinations by the SEC and have devoted considerable attention to defining tender offers. They may enjoin the activity of tender offerors or subjects which have violated Federal and State tender offer statutes. Federal courts also judge whether State tender offer law is constitutional, applying the Commerce Clause and the Supremacy Clause of the United States Constitution. Of particular concern is whether the State laws obstruct interstate commerce and whether they conflict with Federal tender offer law. Several State statutes, including those of Illinois, New Jersey, and North Carolina, have been held unconstitutional on one or both of these grounds. 53/

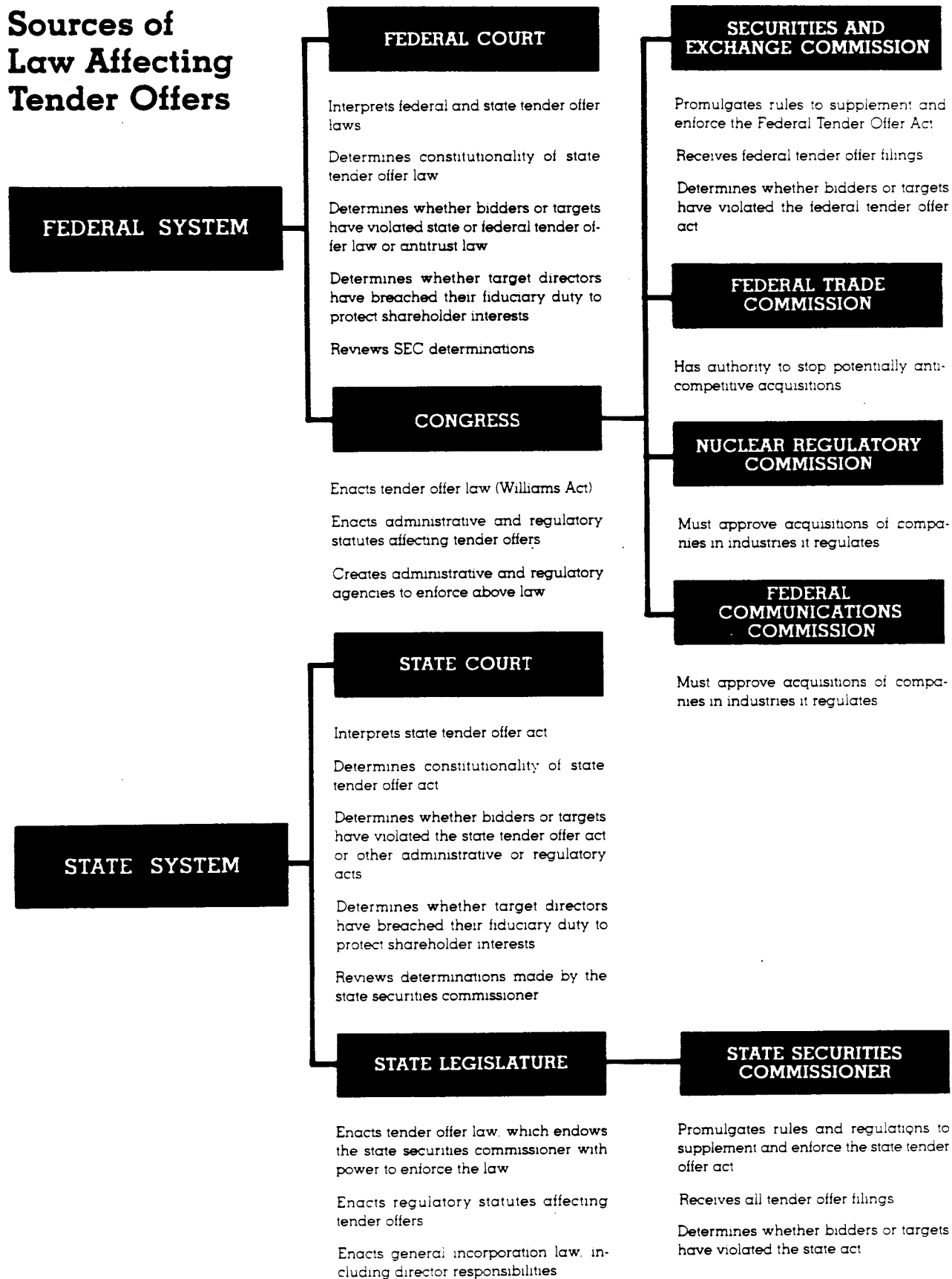
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51/ Wander, op. cit., p. 94.

52/ Bowers, op. cit., p. 28.

53/ Bowers, op. cit., p. 29. A case currently pending in the Supreme Court (Mite Corp. v. Dixon was decided in the 7th Circuit Court of Appeals, and the Supreme Court noted jurisdiction in Edgar v. Mite Corp. on May 4, 1981) may determine the constitutionality of State takeover laws.

# Sources of Law Affecting Tender Offers





State courts consider a set of issues similar to those considered by Federal courts:

Like the federal courts, which interpret the Williams Act, courts in a given state system interpret their state's tender offer act and determine its constitutionality. In relation to congressional rulings, they determine whether tender offerors or targets have violated state tender offer statutes or any administrative or regulatory acts which the statutes have yielded....the state courts (also) review determinations made by the state securities commissions. 54/

An extremely important question in court actions concerning proposed takeovers is the determination of whether target company directors have fiduciary duties to the target company shareholders and whether such duties, if any, have been breached. Such fiduciary responsibility suits are common, but few are successful, since the courts are reluctant to second-guess the business judgment of the target's directors, unless they act "egregiously contrary" to the shareholders' best interests. 55/ (Application of State law to uphold the business judgment of management to reject a takeover bid will be discussed in the Defensive Tactics Section below.)

### C. Mergers and Acquisitions: Federal Reserve Oversight

#### 1. Margin Requirements

Section 7 of the Securities Exchange Act of 1934 authorizes the Board of Governors of the Federal Reserve System (the Fed) to regulate margin requirement terms under which credit can be extended when securities are used as collateral for a loan in connection with financing an acquisition. 56/ The Fed

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54/ Bowers, op. cit., p. 29.

55/ Bowers, op. cit., p. 31.

56/ For a more comprehensive treatment of this subject, see U.S. Library of Congress. Congressional Research Service. The Role of Secured Bank Credit in Corporate Acquisitions. Report No. 81-186 E, by Kevin F. Winch. Washington, 1981. (Hereinafter cited as Winch, Secured Bank Credit.)

has issued a series of regulations which apply to tender offer loans including:

- (1) Regulation U - establishes margin requirements which restrict the amount of bank credit which may be used for the purpose of purchasing or carrying "margin securities," (defined to include, among other things, stock registered on a national securities exchange and over-the-counter securities) where securities are used as collateral stock.
- (2) Regulation T - prohibits broker-dealers from extending credit or arranging for credit extension in violation of the margin requirements established by the Fed.
- (3) Regulation G - governs margin rules for lending by persons other than broker-dealers and banks.
- (4) Regulation X - prohibits, among other things, the borrowing of money which is lent in violation of the Fed's margin rules and thus governs borrowers who obtain securities credit, as opposed to lenders, as in regulations U, T and G.

Margin requirements have ranged from 25 to 100 percent but have been set at 50 percent since January 3, 1974. This means that banks and broker dealers may not extend or arrange credit for the purpose of purchasing securities in excess of 50 percent of the value of such securities.

Margin provisions serve several functions:

Historically, their primary function has been to protect the nation's economy by preventing the excessive use of credit resources for securities speculation, rather than for the purposes of commerce, industry and agriculture. Their secondary historical purpose has been to provide one means of preventing instability in the securities markets. Such instability can occur when margin requirements are inadequate, because securities held as collateral for margin loans must be sold when they decrease in value and when customers are unwilling or unable to provide additional collateral. Such forced sales can accelerate the decline of securities prices. Third, margin requirements provide a measure of investor protection by preventing the extension of credit beyond what is reasonable for investors to carry. 57/

The need for regulation of margin requirements in the area of corporate acquisitions may be regarded as similar to that more traditionally applicable to the retail investor. Like individuals, corporate entities can also

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57/ U.S. Congress. House. Uniform Margin Requirements. Report No. 97-258, 97th Congress, 1st Session. Washington, U.S. Govt. Print. Off, 1981. p. 2.

overextend themselves, especially in an atmosphere where tender offers can create an inflated price for the stock of a target company. Rumors of takeover can promote sharp market fluctuations, which margin requirements may temper. But, perhaps most important, the corporate takeover can involve diversion of credit to the stock markets of far greater magnitude than the financing of individual speculation. 58/

For any stock-secured bank loan, including the few used in tender offers, the Fed requires the filing of a statement of purpose of the loan; thus such loans are commonly referred to as "purpose credit" or "purpose loans." 59/ While charges that an offeror failed to make adequate disclosure in connection with these loans may be used as a defensive tactic, this has rarely, if ever, been a successful defense.

## 2. Credit Policies and Foreign Investors

Substantial public attention has recently been focused on credit policies associated with acquisitions of U.S. corporations by foreign investors, especially because a larger proportion of takeovers of domestic companies by foreign companies involves bank financing than domestic takeovers by domestic companies. 60/ In this connection, the discrepancy between margin requirements applicable to U.S. persons and to foreign investors spurred congressional inquiry in 1981 by the Subcommittee on Telecommunications, Consumer Protection, and Finance of the U.S. House Energy and Commerce Committee.

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58/ Lipton, Martin. Some Recent Innovations to Avoid the Margin Regulations. *New York University Law Review*, Vol. 46, March 1971. p. 13.

59/ Winch, *Secured Bank Credit*, op. cit. p. 11.

60/ Winch, *Secured Bank Credit*, op. cit. p. 11-12.

The Subcommittee found that foreign investors enjoy an advantage over U.S. persons in the takeover process. U.S. persons, whether they receive margin credit from domestic or foreign sources, are subject to the Fed's margin requirements, but foreign purchasers of U.S. securities, using foreign credit sources, are not. H.R. 4145, passed by the U.S. House of Representatives on December 16, 1981, amends the Securities Exchange Act of 1934 to provide uniform margin requirements in transactions involving the acquisition of certain U.S. corporations by non-United States persons where such acquisition is financed by non-United States lenders. A companion Senate bill, S. 1436, has been marked up in committee but has not, at this writing, been further acted upon.

D. Mergers and Acquisitions: FTC and Justice Department Oversight

1. The FTC and the Justice Department Will Scrutinize the Proposed Merger for Possible Antitrust Violations

The initial antitrust law, the Sherman Act of 1890, prohibits existing firms from entering into a contract, combination, or conspiracy in restraint of trade (Section 1) and makes it illegal to monopolize, attempt to monopolize, or combine or conspire to monopolize trade (Section 2). But the primary antimerger statute is Section 7 of the Clayton Act of 1914, which is directed against any acquisition which may have an anticompetitive effect. Section 7, as amended by the Celler-Kefauver Act of 1950, makes it illegal to acquire the stock or the assets of any corporation where the effect of that acquisition may be substantially to lessen competition, or to tend to create a monopoly in any line of commerce in any section of the country. The Clayton Act was further amended in 1980 to cover non-corporate acquisitions and to cover companies "affecting"

but not necessarily "engaged in" interstate commerce. Two agencies, the Federal Trade Commission (FTC) and the Department of Justice, have concurrent jurisdiction to enforce Section 7 of the Clayton Act and, under the Hart-Scott-Rodino Act, which added Section 7A to the Clayton Act, large mergers and acquisitions require filing with both the FTC and the Justice Department. <sup>61/</sup> Antitrust attorney Ira Millstein describes the principal merger and acquisition antitrust issues as those concerning the definitions of the relevant product and geographic markets and whether the effect of the merger or acquisition may be substantially to lessen competition in those defined markets. <sup>62/</sup>

## 2. Merger Guidelines

The Justice Department has issued guidelines and the FTC has issued rules <sup>63/</sup> to indicate their enforcement policies in the merger area. The Justice Department's 1968 merger guidelines set forth standards which the Department has employed in determining whether or not to challenge in the courts a merger or acquisition under Section 7 of the Clayton Act, as well as more general expressions of its enforcement policy. The Guidelines are currently being revised so that, according to William Baxter, Assistant Attorney General, Antitrust Division, they more accurately reflect market realities. The revised guidelines are expected to be available by spring of 1982 and, until such time

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<sup>61/</sup> After a filing is made, an informal FTC and Justice Department liaison committee meets to decide which agency will take jurisdiction over the transaction. Prior jurisdiction over a company or industry does not necessarily indicate whether it will be the FTC or Justice which will exercise jurisdiction in a new matter.

<sup>62/</sup> Prepared statement by Ira M. Millstein, CRS Merger Tactics and Public Policy Seminar, October 21, 1981. p. 3.

<sup>63/</sup> The FTC's rules are embodied in special industry guidelines issued in 1967-1968 (some of which have since been repealed), which are applicable to a limited number of industries: food distribution, cement, grocery products, manufacturing, textile mill products and dairy. von Kalinowski, op. cit., §74-3.

as they are available, participants in merger/takeover transactions have been advised to utilize the 1968 guidelines.

But it should be emphasized that these guidelines are merely intended to acquaint interested parties with the policies and methods of the Department of Justice generally, and should not be solely relied on to predict the Department's response to a particular merger or acquisition. Millstein notes that factors not considered in the guidelines may lead the Department to challenge a merger which appears on its face to fall within the range of permitted mergers. Furthermore, compliance with the guidelines does not constitute a defense to a Department of Justice, FTC, or private challenge under Section 7 of the Clayton Act. <sup>64/</sup>

The Guidelines focus principally on the structure of the market and are intended to identify those mergers that "alter market structure in ways likely now or eventually to encourage or permit non-competitive conduct." The concept of market structure is key, since, according to the Guidelines:

the conduct of the individual firms in a market tends to be controlled by the structure of that market, e.g., by those market conditions which are fairly permanent or subject only to slow change (such as, principally the number of substantial firms selling in the market, the relative sizes of their respective market shares, and the substantiality of barriers to the entry of new firms into the market).

The current guideline standards vary according to whether the proposed merger is classified as horizontal, vertical, or conglomerate. They rely on four-firm-concentration-ratios (the sum of the market shares of the four largest firms in the industry) and on the market shares of the acquired and acquiring

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<sup>64/</sup> For a detailed discussion of private Section 7 actions, see American Bar Association Section of Antitrust Law, "The Private Enforcement of Section 7 of the Clayton Act, 1977."

firms to evaluate the likely anticompetitive effects of horizontal mergers and acquisitions. Certain exceptions exist for firms considered to be "failing." <sup>65/</sup>

(1) Horizontal acquisitions. The Guidelines focus primarily on market structure criteria:

- a. In highly concentrated markets (the four largest firms occupy over 75% of the market, as defined by an appropriate measure such as sales or shipments for a manufacturing company or deposits for a bank), a merger would ordinarily be challenged if it involved the following percentage shares of the market:

Acquiring Firm	Acquired Firm
4%	4% or more
10%	2% or more
15% or more	1% or more

- b. In less highly concentrated markets (the four largest firms occupy less than 75% of the market), a merger would ordinarily be challenged if it involved the following market shares:

Acquiring Firm	Acquired Firm
5%	5% or more
10%	4% or more
15%	3% or more
20%	2% or more
25% or more	1% or more

- c. In a market with a trend towards concentration (the aggregate market share of any grouping of the largest firms in the market from the two largest to the eight largest has increased by approximately 7% or more of the market over a specified and representative period of time), a merger would be challenged if any of the eight largest companies in the market wished to merge with any firm occupying 2% or more of the market.

Acquiring Firm	Acquired Firm
any of the eight largest	2% or more

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<sup>65/</sup> To fall within the parameters of the failing company doctrine and to make a prima facie case that a company is a "failing company," it must show, at least, that (1) it is facing business failure and its prospects of reorganization are dim or nonexistent, and that (2) it has no other reasonable alternatives less detrimental to competition; e.g., it must show that there are no other available purchasers with whom a merger would have had a less anticompetitive effect. See U.S. Library of Congress. Congressional Research Service. A Legal Overview of the Antitrust Aspects of Mergers. Report No. 78-247 A, by Janice Rubin. Washington, 1978.

d. In cases where there are no specific market share standards, a merger would ordinarily be challenged in the following circumstances:

1. acquisition of a competitor which is a particularly "disturbing," "disruptive," or "otherwise unusually competitive factor" in the market; and
2. merger involving a substantial firm and a firm which, despite an insubstantial market share, possesses an unusual competitive potential or has an asset such as a patent that confers an unusual competitive advantage.

(2) Vertical Acquisitions. <sup>66/</sup> The Guidelines focus on three criteria: (a) the market share of the supplier firm; (b) the market share of the buyer firm; and (c) conditions of entry in the buyer firm's market.

The types of vertical mergers likely to be challenged are those where a significant adverse competitive effect is considered probable in either of the two markets when measured by the following standards:

a. Adverse effect in the market of the supplying partner is assumed where:

1. the supplying partner to the merger accounts for approximately 10% or more of the sales in its market, and
2. a merging firm that purchases the products of the supplying partner accounts for approximately 6% percent of the purchases in that market, unless it clearly appears that there are no significant barriers to entry into the business of the merging (i.e., purchasing) firm.

b. Adverse effect in the market of the purchasing partner is assumed where:

1. the supplying partner to the merger accounts for approximately 20% or more of the sales in its market, and
2. a merging party uses what the other supplies and accounts for approximately 10% or more of the sales in the market in which it sells, and
3. the product sold by the supplying partner and its competitors is either a complex one in which innovative changes have been made or is a scarce raw material, and
4. the product sold by the supplying partner is a significant feature of the end-product manufactured by the consuming partner and its competitors.

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<sup>66/</sup> Vertical acquisitions such as those which occur when the firms are in a buyer-supplier position; forward vertical integration occurs when a firm purchases a buyer and backward vertical integration occurs when a firm purchases a supplier.



c. Adverse effect is assumed in the following non-market share cases:

1. if a customer or supplier is acquired by a major firm in an industry with a significant trend toward vertical integration, if such a combination would raise barriers to entry, and if it does not promise to cut the costs of production, or
2. if a customer or a supplier is acquired for the purpose of barring competitors from the market or otherwise putting them at a disadvantage.

(3) Conglomerate Acquisitions. The Guidelines vary according to the type of conglomerate acquisition.

a. Mergers involving potential entrants (deemed to have the technological and financial resources and economic incentive to enter a market) will ordinarily be challenged if the proposed merger is one between one of the most likely entrants into the market and

1. any firm with approximately 25% or more of the market;
2. one of the two largest firms in a market in which the shares of the two largest firms amount to approximately 50% or more;
3. one of the four largest firms in a market in which the shares of the eight largest firms amount to approximately 75% or more, provided the merging firm's share of the market amounts to approximately 10% or more; or
4. one of the eight largest firms in a market in which the shares of these firms amount to approximately 75% or more, provided the merging firm's share of the market is not insubstantial and there are no more than one or two likely entrants into the market, or the merging firm is a rapidly growing firm.

b. The Guidelines state that mergers may be challenged on the grounds that they create a danger of reciprocal buying, 67/

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67/ Mergers creating danger of reciprocal buying (favoring one's customers when making purchases of a product which is sold by the customer) will ordinarily be challenged if 15% or more of the total purchases in a market in which one of the merging firms sells is accounted for by firms which also make substantial sales in markets where the other merging firm is both a substantial buyer and a more substantial buyer than all or most of the competitors of the selling firm. That the merger will result in economies is not considered to be a valid defense to an otherwise unlawful merger that creates the danger of reciprocal buying.

that they entrench market power or raise barriers to entry, 68/ or that they affect aggregate concentration. 69/ As a practical matter, however, Millstein notes that these theories have rarely, if ever, been relied upon to challenge a merger or acquisition.

- (4) Joint Ventures. Neither the Department of Justice nor the FTC has promulgated guidelines relating to joint ventures. The courts have indicated that the joint creation by two or more corporations of a third corporation may evoke serious problems under Section 7 of the Clayton act in either of the following situations: 70/
- a. two of the joint venturers would have entered the market alone but for the joint venture, or one would have entered and another was and would have remained a substantial potential competitor; the industry is an oligopoly such that a few companies occupy most of the market; and the joint venturers, or at least two of them are industry leaders in other markets; or

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68/ Mergers that entrench market power or raise barriers to entry will ordinarily be investigated where the possibility of anticompetitive consequences exists, especially where an acquisition of a leading firm in a relatively concentrated or rapidly concentrating market may serve to entrench or increase the market power of that firm or raise barriers to entry in that market. Examples are:

1. a merger which produces a very large disparity in absolute size between the merged firm and the largest remaining firms in the relevant markets;
2. a merger of firms producing related products which may induce purchasers, concerned about the merged firm's possible use of leverage, to buy products of the merged firm rather than those of competitors; and
3. a merger which may enhance the ability of the merged firm to increase product differentiation in the relevant market.

69/ Mergers that affect aggregate concentration. In 1969, the Department of Justice announced that it might "very well" or "would probably" bring actions against these types of mergers, although no significant case has been brought under these guidelines. The Guidelines affect:

1. any conglomerate merger among the top 200 manufacturing firms or firms of comparable size in other industries, and
2. any conglomerate merger by one of the top 200 manufacturing firms of any leading producer in any concentrated industry.

70/ von Kalinowski, op. cit., §74.05

- b. the joint venturers have the power to transfer substantial market power to the joint venture. The joint venturers may have such power if together they account for a substantial portion of the market outlet for companies in the business of the joint venture, or if they control a substantial supply of the raw material needed by companies in the business of the joint venture.

### 3. Premerger Notification Is Required

Under the provisions of Title II of the Antitrust Improvements Act of 1976 (the Hart-Scott-Rodino Act), 71/ parties, including foreign interests, involved in a transaction such as a merger, acquisition, or even a joint venture, must file a premerger notification form with the Federal Trade Commission and the Antitrust Division of the Justice Department. Only transactions among companies of certain sizes are covered. (The basic criteria are that one company must have \$100 million in total assets or annual net sales and the other company must have \$10 million in total assets or annual net sales, and the transaction must involve \$15 million or more in stock or assets or 15% or more of the outstanding voting stock.) The filings before the FTC and Justice are intended to elicit specific information from the parties to a transaction relating to the transaction, including the purchase price, each company's source of revenues, and other financial and marketing information.

The timing for review of the antitrust implications of a merger is in many cases critical to the deal, since delay may give the subject company increased opportunity to find a "white knight." Substantial investigation by the FTC or the Justice Department may result in arbitrageurs pulling out of the deal, reducing

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71/ Millstein notes that the premerger notification scheme is created by the Hart-Scott-Rodino Antitrust Improvements Act of 1976, amending Section 7 of the Clayton Act by adding Section 7A, 15 U.S.C. §18A, and by the FTC Rules and Regulations promulgated pursuant to Section 7A(d) of the Act and found in 16 CFR Parts 801, 802 and 803.

the likelihood the offeror will attain the requisite number of tendered shares, thus causing the deal to collapse. This happened when the Justice Department announced in the summer of 1981 that it wanted more information about Mobil's proposed acquisition of Conoco. Also, early in 1982, the FTC blocked, at least temporarily, Mobil Oil's proposed acquisition of 15 to 25 percent of U.S. Steel's common stock, a purchase considered by many analysts to be an attempt to use U.S. Steel shares as a wedge to pry loose all or part of Marathon Oil's assets which are being purchased by U.S. Steel. (Mobil had lost its bid for Marathon in the courts on antitrust grounds.)

Once the basic information concerning the transaction is submitted, the Government has thirty days to study a proposed merger transaction (fifteen days for a cash tender offer--see footnote 72) and the transaction cannot be closed during this time period. Millstein describes the procedure as it relates to a merger transaction:

If the Government feels that the transaction does not raise significant antitrust problems, the thirty day waiting period will pass and the parties can consummate the transaction. On the other hand, if the Government is suspicious that the transaction does raise antitrust problems, it will, within the thirty day period, request additional information from the parties. As a result of a request for additional information, the transaction cannot be consummated until twenty days after the date on which the parties fulfill the Government's request for additional information. Moreover, the parties can consummate the transaction only if the Government takes no successful steps in that second twenty day period to challenge the acquisition--such as by seeking a preliminary injunction.

Thus, in effect, before most mergers or acquisitions can be transacted, the Government will have at least fifty days--the initial thirty day waiting period plus the twenty day waiting period after a request for additional information is fulfilled--to study the transaction. It is during this period that the Administration's enforcement policies come into play. 72/

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72/ Millstein, op. cit., p. 4-5. The initial waiting period for a cash tender offer is 15 days; a request for additional information to the offeror extends the period for 10 days subsequent to compliance with the request. The offeree must comply with such a request in a "reasonable" period of time, but cannot extend the waiting period (and thereby delay the tender offer) by delaying its response to the request.

4. Does the Reagan Administration Propose to Change Antitrust Enforcement Relating to Mergers and Acquisitions?

Because of the delicate timing involved in merger and acquisition activity, the Government's ability to delay a deal can have a vitally important deterrent effect and can actually substitute for a more lengthy monitoring effort involving litigation. There is considerable controversy, however, about how vigorously the current administration is monitoring antitrust activities in general and the antitrust aspects of merger and acquisition activity in particular. The recent proposed settlement of the American Telephone & Telegraph Company suit, the dismissal of the lengthy IBM suit, and other actions by the current administration have prompted commentators to say that these developments mark a radical relaxation of antitrust enforcement. While comments about how antitrust policy in general is changing are beyond the scope of this report, some brief comments on possible changes in antitrust policy as it relates to mergers are relevant.

Some contend that the FTC's and Justice Department's current enforcement actions with respect to mergers does not appear to be a dramatic departure from past policies, at least so far. <sup>73/</sup> Thus, in 1981, the Justice Department effectively blocked the Mobil-Conoco merger by requesting additional information about the deal, the Justice Department announced it would oppose on antitrust grounds a merger in the beer industry between Jos. Schlitz Prewing and G. Heileman Brewing, and the FTC announced it would ask the court to bar LTV from buying Grumman (LTV later backed out of the deal). In December 1981, the FTC announced opposition to Mobil Oil's takeover of Marathon Oil and in January 1982 the FTC delayed Mobil's purchase of a large block of U.S. Steel stock, presumably since Mobil was attempting to acquire indirectly some of Marathon Oil's assets. These actions do indicate some continuation of prior enforcement trends.

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<sup>73/</sup> Millstein, op. cit. p. 5-7.

On the other hand, the FTC has been criticized as giving the appearance of assisting in the Mobil-Marathon deal by detailing terms--Congressmen John Dingell and Albert Gore Jr. have charged that the FTC thus provided a "blue-print"--under which Mobil could sell certain downstream operations to Amerada Hess to avoid antitrust problems and gain approval. It is not unusual, however, for parties to a merger to meet with FTC staff (or, for that matter, with Justice staff) and to arrive at informal agreements leading to a stipulation--which could conceivably incorporate such actions as a hold separate order. But the FTC's method of disclosing its terms, by unilaterally issuing terms of approval, was unusual and did give the appearance of unprecedented assistance.

The Wall Street Journal reported that Tyler Baker, special assistant to Antitrust Division chief William Baxter, briefed a conference of attorneys in November 1981 on proposed changes in the Justice Department's merger guidelines. Baker is quoted as saying: "There is a high degree of consistency in merger enforcement...there won't be a great deviation from the past at all, once the new guidelines are published." <sup>74/</sup> Among the changes alluded to was the possible replacement of indicators of market share. Existing guidelines define a market as varying more or less in concentration depending on how many companies command what portion of sales; various percentages of market share are then used to provide one indicator of permissible mergers. A measure called the Herfindahl index <sup>75/</sup> is expected to replace existing guidelines to determine

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<sup>74/</sup> Lawyers See Planned Merger Guidelines of U.S. as Little Softened from the Past. Wall Street Journal, November 16, 1981.

<sup>75/</sup> The Herfindahl index was named for Orris C. Herfindahl's 1950 work on concentration in the U.S. steel industry. Apparently there is some dispute as to the author of the index since Albert O. Hirschman claims to be the originator by virtue of his having first computed the index for a large number of countries in his 1945 book National Power and the Structure of Foreign Trade. (See Hirschman, Albert O. The Paternity of an Index. American Economic Review.

(continued)

permissible mergers at varying levels of market concentration. Millstein argues that use of the index indicates the Administration still intends to scrutinize market share numbers and the index method will not yield dramatically different results from use of the guidelines. <sup>76/</sup> Furthermore, since Baxter

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(continued) October 1964, p. 761-2.) In any event, the so-called Herfindahl Index expresses market concentration as the sum of the squares of the market share percentage of each firm in the relevant industry. Thus, the index for an industry with four equal-size competitors is 2,500 ( $25^2 + 25^2 + 25^2 + 25^2$ ). If one of these firms were to control 70% of the market and each of the other three only 10%, the index would be 5,200 ( $70^2 + 10^2 + 10^2 + 10^2$ ). As the examples demonstrate, the Herfindahl index not only measures the extent of concentration within an industry, but also reflects the distribution of market share among the major firms of the industry. Since many economists believe that an industry which is both concentrated and dominated by one or two very large firms is less competitive than one which is merely concentrated, the Herfindahl index is thought to be a superior indicator of market competitiveness than the four-firm-concentration-ratio more commonly employed. Thus, while in the two examples above the Herfindahl index ranges from 2,500 to 5,200, the four-firm-concentration-ratio test would not distinguish among them at all, since in each instance the four-firm-concentration-ratio is 100%.

According to the Justice Department, mergers or acquisitions in an industry with a Herfindahl index of more than 1,600 would very likely be challenged, if the merger or acquisition raised the index by 50 to 75 points. Mergers that raised the index by at least 100 points would typically be challenged, where the industry's index was between 1,000 and 1,600. And mergers in industries with an index of below 1,000 would usually not be challenged. A change in the Herfindahl index is equal to twice the product of the market shares of the firms involved. For example, if one firm with a market share of 10% proposed to acquire another firm with market share of 5%, this would raise the index by 100 points, and the acquisition would typically be challenged. (Discussion of Herfindahl index excerpted from a January 25, 1982, memorandum sent by Ira M. Millstein to CRS.)

<sup>76/</sup> According to calculations made by Millstein, the proposed Herfindahl index standards are more lax for industries with several large competitors. But in industries dominated by one or two large firms but with relatively low four-firm-concentration-ratios, the proposed standards are actually stricter. For example, in an industry with firms having market shares of 40%, 10%, and 3%, and numerous smaller firms, a merger between the firms with 10% and 3% market shares would not be subject to challenge under the existing standards but would be under the proposed standards. Even where the proposed guidelines are less strict, the change from the existing standards is moderate. For example, in an industry with a four-firm-concentration-ratio of between 50% and 75%, under the existing standards a firm with a market share of 10% may acquire a firm with a market share of less than 4%. Under the proposed Herfindahl index standard, it could acquire a firm with a market share of less than 5%. (January 25, 1982, memorandum, op. cit.)

has indicated he will not permit a failing company defense, he may be tougher than his predecessors on this issue. In the area of conglomerate mergers, where numerical guidelines are not established, Baxter has stated that, in general, he does not believe conglomerate mergers pose an antitrust problem. Millstein notes that while prior administrations had from time to time challenged conglomerate mergers under Section 7 of the Clayton Act, the Government has recently lost virtually every case, and the Supreme Court has seriously circumscribed the potential competition theories that underlie these cases. Thus, it is argued, no dramatic change in enforcement in the merger area has thus far occurred. 77/

On the other hand, public statements made by Administration officials have not inspired confidence in a strict enforcement policy. For example, press accounts report statements by Antitrust Chief Baxter (he doesn't believe that "conglomerate mergers, or mergers generally, have increased economic concentration to dangerous levels"), Attorney General William French Smith (the Government "must recognize that bigness in business does not necessarily mean badness"), and FTC Chairman James Miller (the Commission's past enforcement of antitrust laws barring price discrimination were "misdirected" and he has "strong reservations" about certain long-standing FTC requirements and about the role of the FTC itself). 78/ Thus far, however, the only significant evidence of relaxation of merger policy has been the FTC's issuance of the "blueprint" for the Mobil-Marathon merger. Most other major merger policies to

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77/ Millstein, Prepared Statement, op. cit., p. 9.

78/ See Antitrust: More Boom Than Bust. Washington Post, August 23, 1981; and FTC Chief Miller Questions Agency Role in Consumer Protection, Antitrust Areas. Wall Street Journal, October 27, 1981. See also Big Shift in Antitrust Policy. Dun's Review, Vol. 118, August 1981. p. 38-40; and Baxter at Antitrust: Can the Professor Succeed on Brains Alone? American Lawyer, Vol. 3, July 1981. p. 25, 28-31.



date support the Millstein thesis that formal enforcement in this area is not changing very much.

Finally, the courts, the ultimate forum for resolving questions concerning the antitrust implications of proposed mergers, seem to be supporting a reasonably strict interpretation of antitrust laws, as illustrated by the recent series of rulings on Mobil's attempt to take over Marathon Oil. Thus, on November 30, 1981, Federal Judge John Manos in Cleveland issued a preliminary injunction barring Mobil's acquisition of Marathon, holding there was a substantial likelihood that Mobil's proposed takeover would be found to violate antitrust law, especially because of overlaps in gasoline marketing and refining in the Midwest (Marathon Oil Company v. Mobil Corp., No. 81-2193). The injunction was upheld on December 23rd by the U.S. Court of Appeals for the Sixth Circuit. (Nos. 81-3704, 81-3713). Finally, early in January 1982, Chief Justice Warren Burger of the U.S. Supreme Court denied Mobil's emergency application to enjoin U.S. Steel's takeover of Marathon pending an appeal to the full court of the Sixth Circuit's ruling that Mobil could not acquire Marathon. Mobil had based its appeal partially on the ground that Judge Manos had refused to reconsider his original ruling in light of Mobil's subsequent proposal to sell Marathon's U.S. marketing and refining assets to Amerada Hess.



III. THE TAKEOVER PROCESS: DEFENSIVE TACTICSA. The Responsibilities of Management

Management of a company which is the object of a hostile takeover attempt, or which believes itself to be vulnerable to such an attack, may engage in certain defensive tactics to thwart what it considers to be an undesirable "raid." In a wide variety of instances, management may evaluate the bid and reject it under what has come to be known as the business judgment rule. For example, in Panter v. Marshall Field & Co. (decided in 1980), stockholder actions were brought, attacking the board of director's rejection of a takeover proposal and the defensive measures (which included a lawsuit and an acquisition program) taken by the board to foreclose the takeover. The court held that the business judgment rule governs the consideration of a takeover bid by the board of directors of a target; where the directors reach their decision after full consideration of all of the interests affected by the proposal and after receiving antitrust and securities law advice from outside counsel, they cannot be held to have breached their fiduciary duties. <sup>79/</sup>

On the other hand, a board may reject a bid not on the merits of that bid, but rather to retain control over the company and to keep management in office. Courts have held that, under the primary purpose rule, defensive tactics are improper if they are for the primary purpose of keeping management in office. In addition, certain other tactics used by management during the takeover process may be challenged in the courts. For example, in a ruling in January 1982 against U.S. Steel, the U.S. Court of Appeals for the Sixth Circuit in Cincinnati held illegal certain agreements designed to "lock up" the friendly merger

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<sup>79/</sup> Lipton, Martin. Takeover Bids in the Target's Boardroom; an Update After One Year. *Business Lawyer*, v. 36, 1981. p. 1018.

between U.S. Steel and Marathon. The agreements gave U.S. Steel two options ("poisoned well options") from Marathon: one granted U.S. Steel the right to buy Marathon's interest in the Yates oil field in Texas for 2.8 billion dollars regardless of whether U.S. Steel won Marathon; the other granted U.S. Steel the right to buy 10 million new Marathon common shares, about 17 percent of the total outstanding for 90 dollars a share.

The court might have questioned whether the granting of such options breached the fiduciary duty of Marathon directors to their shareholders but refrained from doing so. Instead, the court attacked the agreements on the grounds that they constituted "manipulative" behavior under the securities laws. The court reasoned that, by rendering the Yates fields unavailable to other companies and increasing the number of shares other companies would have to obtain to get control, the agreements effectively created an artificial ceiling on the price of Marathon shares, the 125 dollar per share price that U.S. Steel offered public shareholders. The "poisoned well options," according to the court, not only artificially affect, but for all practical purposes completely block, competitive bidding for Marathon shares. 80/

While commentators view the court's ruling as a setback for certain bidding tactics, the creativity with which offensive and defensive tactics have recently evolved in the dynamic merger process almost certainly insures that if these lock up agreements are no longer useful, some other tactic will replace them and the courts will have to rule on how the defense's new variation meshes with the fiduciary responsibility of management in evaluating takeover bids.

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80/ Court Rulings on U.S. Steel and Mobil May Change Merger Game, Slow Oil Takeovers, Wall Street Journal, January 7, 1982.

B. Evaluating a Takeover Bid

When a company makes an unsolicited tender offer for another, despite the time restrictions relating to SEC, FTC and Justice Department merger oversight detailed above, the action can take place rapidly--much more rapidly than for a negotiated acquisition. The subject's board of directors may have little time to study the ramifications of the deal; indeed, that is part of the offensive strategy. Also, a certain momentum may be built up because, once a tender offer is announced, shareholders may feel compelled to tender their shares, or else face the prospect of becoming minority shareholders in a company controlled by the offeror--in this event they may be "frozen out" and lose both liquidity and value.

A subject company may view the deal from a variety of perspectives and it may seek to resolve at least the following questions:

- What will control by another company mean to management? Will they lose their jobs?
- Is the offering price fair? Is there another company--a "white knight"--which would offer more or be a more compatible match in other respects?
- What is the quality of the offeror's securities if an exchange is involved? Are all shareholders provided for equally by the terms of the offer?
- Is the timing right or would conditions be more favorable to various interested parties such as management and shareholders at another time?
- What will a change in control mean to employees, suppliers, customers, and other constituencies of the company such as the community in which the subject company is located?
- What is the risk that the deal will not be consummated? Are there potential antitrust problems? Are other regulatory approvals required? Has the offeror failed to make material disclosures?

### C. Structuring a Defense in Advance of a Takeover

The National Association of Accountants conducted a survey, published in the Spring of 1980, of corporate defense strategies among 177 of the 1,000 largest industrial companies. The survey indicated that 40 percent of the companies consider themselves to be vulnerable to a takeover. The principal reason they gave for their vulnerability is the low price-earnings ratio of their stock; other major factors that contribute to their perceptions of vulnerability are undervalued or hidden assets, a book value higher than the market price of their stock, high borrowing capacity, and above average return on net worth. <sup>81/</sup> The questionnaire used in this survey provides insight into some of the major types of defense strategies.

#### 1. Elements in the Overall Strategy

These primarily involve amassing a team of defense experts and making some changes in the company's image and dealings with its employees, its major shareholders, and the public at large. According to the survey, actions might include: <sup>82/</sup>

- establishing a permanent in-house defense committee
- arranging for a specialized law firm on standby retainer (indeed, hiring on retainer from among the relatively few top legal specialists would mean this legal talent won't be used against the company)
- arranging for a proxy solicitation firm on standby retainer (should management wish to wage a proxy battle for its own shares to prevent too many shares from falling into the hands of the offeror)

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<sup>81/</sup> Takeovers: A Survey of Corporate Defense Strategies, Mergers and Acquisitions, Spring 1980, p. 21.

<sup>82/</sup> The following actions (but not the parenthetical commentary on these actions) are excerpted from the National Association of Accountants Survey, *ibid.*

- arranging with an investment banker to be available for emergency action (an investment banker can assist in evaluating the deal, or in finding a "white knight")
- maintaining a list of all larger stockholders to be contacted by telephone immediately after a tender offer (to assist management in keeping a substantial portion of the stock from being tendered or from being sold to arbitrageurs who would undoubtedly tender)
- preparing in advance statements asking shareholders not to act until management has had time to evaluate the offer
- preparing in advance a text stating why the company would be more successful operating independently rather than as a unit of a larger corporation
- arranging with an outside public relations consultant to be available for emergency action (public relations specialists can be invaluable in stirring up public reaction against a takeover, including possible legislative action to block the takeover)
- arranging for a variety of schedules for placing advertisements in the media and establishing a media list for distribution of news releases
- establishing or intensifying an investor relations program to strengthen loyalty of existing stockholders and gain additional support for its stock
- establishing or intensifying employees' stock purchase plan to create more support for the company and to create more insider holdings
- establishing a system for tracking stock transfer records to detect any suspect new share ownership which might signal an attack.

## 2. Shark-Repellent Tactics and Porcupine Amendments

These can involve a series of changes in the company's capitalization or changes in charter and bylaw provisions to make a takeover attempt more difficult. Briefly they may include: 83/

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83/ See National Association of Accountants Survey, op. cit.; and Lipton, Martin. Takeover Bids in the Target's Boardroom, The Business Lawyer, v. 35, November 1979.

a. changes in capitalization

- arranging for placement of common stock in friendly hands
- making new offerings of convertible or other equity issues that disperse voting power or place more voting power in friendly hands
- buying the company's own stock on the open market to reduce public ownership
- changing dividend policy to encourage shareholder loyalty
- instituting a dividend reinvestment plan.

b. charter amendments

- incorporating in another state where the takeover laws are more stringent
- reorganizing the election or composition of the board of directors (this might involve amendments to increase the number of board members and stagger their terms in order to dilute the vote of a new member of the board placed there by the offeror which has purchased a substantial block of the subject company's stock)
- reorganizing the company's voting procedures (which might include requiring more than a majority vote by the board or by shareholders to approve any business combination)
- instituting compensation provisions for shareholders who do not tender their stock to a raider (a company's board might vote an amendment giving shareholders who do not tender shares during an offer the right to submit them for redemption at the offer price or the highest market price during the previous 18 months)
- implementing retirement and severance pay terms for management or other employment compensation terms which might discourage a takeover
- devising statements that the board of directors has a company policy not to engage in merger discussions or that the board is required to consider the interests of employees, customers, suppliers and others when considering a merger or takeover bid (these may have only minimal effect, but may be useful when the courts apply the business judgment rule to the board's rejection of the bid).



D. Structuring a Defense Once the Tender Offer has been Made

Assuming a board of directors is faced with a hostile unsolicited tender offer, it may engage in a number of actions to fend off the attack. State courts have been quite liberal in approving defensive actions under the business judgment rule, unless it can be shown that the primary purpose for the defensive action is to keep management in power. The latter is generally difficult to prove, since courts have held that the premium price alone does not constitute the sole determination of whether the bid should be accepted and the subject company will have a battery of investment advisors, experts to evaluate its worth, and perhaps even a committee of independent directors who will testify about the shortcomings of the deal. The courts generally have been extremely reluctant to second-guess the "business judgment" sense of managers who run large corporations. The recent ruling against the U.S. Steel "lock-up agreements" may cause merger strategists to rethink their tactics, but it is not likely that this ruling will substantially reverse a widespread trend of employing complex defensive actions. The following actions provide a sense of the range of possibilities--and there inevitably will be more variations as situations change. A subject company may try to defend itself by:

- finding a "white knight" to buy it on terms more favorable either with respect to the premium or with respect to management arrangements such as an agreement to allow the the company to operate autonomously and with current management
- acquiring another company which would create an antitrust or regulatory problem for the offeror
- making a "standstill agreement" with a "big brother" who buys a substantial block of the subject company's stock to make it harder for the offeror to gain a majority of the shares in the tender offer
- purchasing at a premium shares the offeror has acquired prior to making the tender offer

- purchasing at the going market price the company's own shares in the market to tie up enough shares to reduce the possibility that the offeror will gain control (because of the premium generally offered, the stock would, however, be at a price higher than before the tender offer was announced, and if the offeror is defeated, the stock may sink to the pre-tender offer level)
- instituting a suit against the offeror on the grounds that adequate disclosure was not made under the securities laws.
- entering into long-term employment contracts with existing management to make the target company less desirable
- selling key assets or divisions perceived to be those aspects of the target company most wanted by the offeror.

Merger tactics are clearly innovative and still evolving. An interesting new defensive tactic--the "royalty trust"--is apparently under consideration by some oil companies worried about Marathon Oil's kind of vulnerability to takeover. Although tax questions concerning this tactic are as yet unresolved, <sup>84/</sup> the method involves spinning off directly to shareholders a company's oil and gas reserves. The shareholders become direct owners of the oil flows and they receive monthly distributions of the production profits. At the same time, the company shrinks its reserve base, lessening the risk of takeover. New discoveries then have greater impact and some analysts claim that the combined effect of the value of the common stock and the royalty trust can be an improvement over the common stock alone. On the other hand, management may reject the idea on the grounds that spinning off reserves would deplete cash flow and reduce the company's ability to develop properties. But for a company whose reserves

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<sup>84/</sup> The Wall Street Journal reports that the uncertain tax status of the royalty trust has made companies wary. Mesa, Southland, and Houston Oil all set up trusts between late 1979 and the end of 1980, and have been waiting for a definitive ruling from the Internal Revenue Service on whether the trusts' monthly distributions are subject to taxation only on the individual level, or whether, like dividends, they will be taxed on both the corporate and individual levels. See Thurow, Roger. Royalty Trusts Seen as Possible Defense for Oil Firms Worried About Takeovers. Wall Street Journal, November 24, 1981.

are generating more cash than can be used in current operations, some analysts contend the royalty trust is preferable to risking a takeover or spending that cash on investments outside the energy field. The evolutionary process of merger tactics thus proceeds, although the return to the trust, from whence anti-trust policy emanated, does appear to be an ironic development.



IV. THE BOTTOM LINE: WHOSE INTERESTS ARE AT STAKE?

Those making public policy concerning mergers and acquisitions must contend with a variety of competing interests including those represented by:

- management which may wish to retain control over the company either to exercise prudent business judgment or merely to preserve their jobs;
- shareholders who may want to tender their shares at the higher premium price an offeror will bid;
- shareholders who are "frozen out" by virtue of not tendering or by virtue of a limited tender offer for only a portion of the shares who find themselves with a minority interest, less than fair value, and little liquidity for their shares;
- employees who may view a change of management as either a positive or negative development (frequently employees will oppose a takeover if they believe a more distant central corporate headquarters will be less responsive to their needs);
- the community in which the company under threat of takeover is located which may fear plant closings and related loss of income to the local economy; and
- the public at large which might be affected by:
  - (a) possible changes in the economics of producing goods and services--it is possible that the entrenched management is less efficient than the new management would be and that the acquisition will produce production economies; or
  - (b) possible changes in concentration of corporate power which may have long-run negative implications for competition and the price and availability of goods and services in the economy.

Attorney Martin Lipton, who has developed defense strategies for numerous firms, argues that management has a right to oppose a takeover it deems not in its proper interest and that avoidance of takeover attempts will result in, among other things, a stable long-run environment for firms to develop. This insulation from takeover attempts will free managers from having to worry about meeting short-run profit goals and about having acquired reserves or cash which make it a target. Shareholder representative Melvyn Weiss, on the other hand,

argues that management should not be entitled to interfere with the relationship between a third party who wants to make an offer and the shareholders to whom the offer is directed, or to prevent a shareholder from earning a premium return on his investment; in his view, management is invariably interested in keeping control of the company and retaining employment and the perquisites of the corporate office. Weiss also argues that management's role should be limited to supplying information to the shareholders to assist them in making an informed decision as to whether or not to accept the third party's offer. Furthermore, Weiss argues that, if management's use of defensive tactics does not allow takeovers to occur as part of the normal functioning of the market, then inefficient management may remain in place despite the fact that shareholders and the company in general might be better off with new management.

But Lipton contends that shareholders are generally better off if they do not tender to an offeror and the takeover does not go through, since cases he has studied indicate that the appreciation in stock price after a takeover is blocked is at least as great as the premium offering price. Weiss disputes this since the premium is frequently substantial and there are financial benefits associated with having the use of the premium price funds.

Lipton argues that considering only the premium price benefit to shareholders ignores the fact that shareholders with legitimate long-term interests in the company may give way to arbitrageurs interested only in making a killing and not in the long-run good of the company. Weiss counters that management is not necessarily a friendly "big brother" to shareholders, that the securities market is still a free market, and that part of owning shares in public companies carries with it the right to sell to those who wish to buy. Weiss also points out that a dichotomy frequently exists between management's opinion of the value of a company when faced with a tender offer and when trying to take a company private. Thus, management may attempt to block a tender offer from a

third party as being inadequate when their jobs and positions of power are at stake, but the same management may attempt to take a company private by "freezing" or "squeezing" out the minority shareholders at prices well below what the third party might have used as the basis for the tender offer.

Lipton endorses the current practice whereby courts rely on investment advisors and the findings of a board independent of management to approve the business judgment of management to reject a tender offer. But Weiss says this independence is not possible since it is the incumbent board which chooses the parties to evaluate the offer. Yet Lipton believes that there are so many reasons beyond premium price why a board may properly reject an offer that management should be given wide discretion.

Furthermore, it is Lipton's position that management can and should employ a wide variety of permissible techniques at its disposal to fend off an offeror's attack. Weiss argues that some of these techniques result in an unwarranted shift of power from shareholders to management. For example, Weiss points out that, during the LTV bid for Grumman, Grumman's management replaced the pension fund managers and ordered the new managers to buy substantial amounts of Grumman stock to thwart the LTV tender offer. <sup>85/</sup> Yet, by buying this stock, which had risen in price from the pre-tender offer price, management was willing to pay more for the stock than it would be worth if its efforts were successful and the takeover were blocked--in which case the price could fall to the prior levels. Thus management was seen to be using its office to the possible detriment of the shareholders and the former employees who are pension fund holders.

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<sup>85/</sup> See also Carley, William M. Grumman Pension Plan Buys More Stock in Effort to Block LTV, Which Plans Suit. Wall Street Journal, October 13, 1981; and Carley, William M. Grumman, by Acquiring Its Own Shares, Seems to Be Gaining in Bid to Block LTV. Wall Street Journal, October 14, 1981.

Also, depending on how the deal is structured, a substantial group of shareholders may be poorly treated in the "mop-up" part of the deal by the management of a company gaining control. For example, in the U.S. Steel tender offer for Marathon, the offer was for 51 percent of Marathon's shares at 125 dollars per share. But the remaining 49 percent, comprised of those who either did not tender or those who tendered but were given a pro rata value, are offered U.S. Steel debentures valued at less than 80 dollars per share. The interests of this class of minority shareholders (which could on occasion include employees refusing to tender) who are "frozen out" is the subject of some policy concern in the takeover process.

The role and interests of various branches of the Government should also be noted in the merger process. For example, the Federal government may have considerable latitude to affect the course of merger and acquisition activity even before the issues reach the courts. Informal discussions between FTC and Justice Department attorneys may result in restructuring a merger or breaking off a deal even before a premerger notification is filed. The timing in merger deals is frequently such that requests for additional information by the FTC and Justice Department can effectively kill a deal, as occurred in the Mobil-Conoco proposed merger. On the other hand, some commentators contend that certain regulatory agencies have facilitated hostile takeovers by not enforcing statutory requirements for prior approval of changes in control (this was alleged when the Civil Aeronautics Board approved voting trusts in the Continental Air and Western Air cases). 86/

Actions at the State level can also affect the merger process. An important question of whether Federal or State law should govern tender offers

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86/ Written communication from attorney Martin Lipton to CRS, January 1982.



is currently under review by the Supreme Court. Meanwhile, Weiss has argued that State law--which is frequently more favorable to the defensive tactics of management attempting to thwart a takeover--should not be the binding determinant of tender offer outcomes. The rationale is that shareholders as well as general corporate activities are often dispersed throughout the country, yet a company may charter itself in a State with laws giving management more discretion at the expense of the rights of a national class of shareholders.

And where are the interests of the public at large in this debate? To the extent that struggles between management, shareholders, and employees produce a Darwinian dynamic which leads to efficiency in the production of goods and services, the public will be better off. On the other hand, if takeover activity crowds out healthy competition in the economy, the public will suffer. The struggle is great as it relates not only to concentration of power throughout the economy but also to concentration of power within the firm, since management, shareholders, and employees have varying interests at stake. Devising public policy strategies and tactics to achieve equity and efficiency among all the parties is as complex and dynamic as the takeover process itself.

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