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PUBLIC HEARING

before

SENATE LABOR, INDUSTRY AND PROFESSIONS COMMITTEE

SENATE BILL 1539

(Enacts "Shareholders Protection Act" to
discourage certain hostile takeovers)

May 12, 1986
Room 334
State House Annex
Trenton, New Jersey

MEMBERS OF COMMITTEE PRESENT:

Senator Raymond Lesniak, Chairman
Senator Christopher J. Jackman, Vice Chairman
Senator Edward T. O'Connor, Jr.
Senator Gerald Cardinale
Senator Donald T. DiFrancesco

ALSO PRESENT:

Senator Richard Van Wagner
District 13

Dale C. Davis, Jr.
Office of Legislative Services
Aide, Senate Labor, Industry and
Professions Committee

* * * * *

Hearing Recorded and Transcribed by
Office of Legislative Services
Public Information Office
Hearing Unit
State House Annex
CN 068
Trenton, New Jersey 08625





New Jersey State Legislature

SENATE LABOR, INDUSTRY
AND PROFESSIONS COMMITTEE

STATE HOUSE ANNEX, CN-068
TRENTON, NEW JERSEY 08625
TELEPHONE (609) 984-0445

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NOTICE OF PUBLIC HEARING

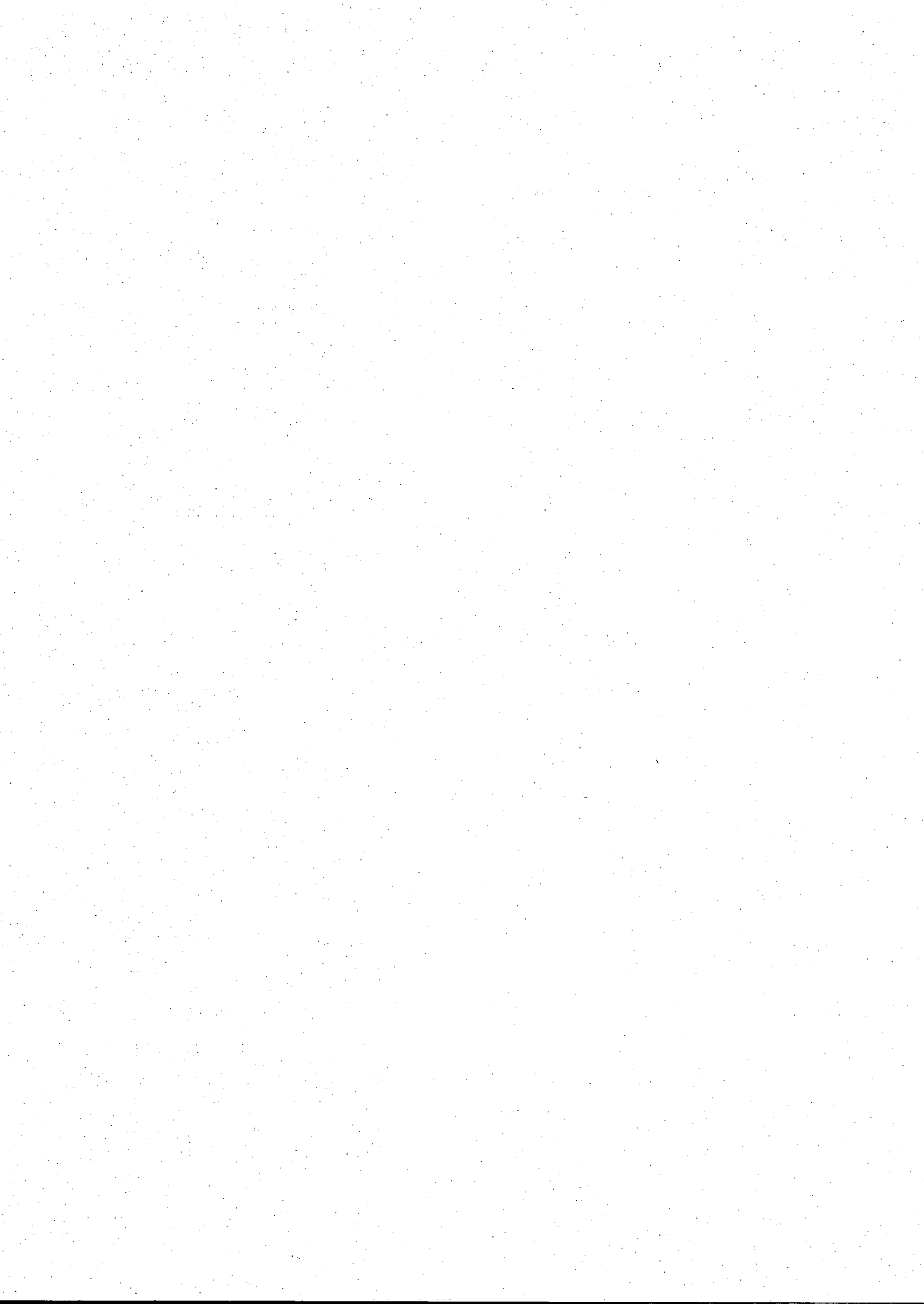
April 28, 1986

The Senate Labor, Industry and Professions Committee will hold a public hearing on Monday, May 12, 1986, at 1:00 P.M., in Room 334, State House Annex, on the following bill:

S-1539
Van Wagner

Enacts "Shareholders Protection Act" to discourage certain hostile takeovers.

Anyone wishing to testify should contact Dale Davis, Committee Staff, at 609-984-0445.



SENATE, No. 1539

STATE OF NEW JERSEY

INTRODUCED JANUARY 27, 1986

By Senator VAN WAGNER

Referred to Committee on Labor, Industry and Professions

AN ACT concerning the protection of shareholder rights, and
supplementing Title 14A of the New Jersey Statutes.

1 BE IT ENACTED by the Senate and General Assembly of the State
2 New Jersey:

1 1. This act shall be known and may be cited as the "New Jersey
2 Shareholders Protection Act." The requirements of this act shall
3 be in addition to the requirements of applicable law, including
4 ***[the "New Jersey Business Corporation Act," P. L. 1968, c. 350**
5 **(C. 14A:1-1 et seq.)]*** **Title 14A of the New Jersey Statutes**
6 and any additional requirements contained in the certificate of
7 incorporation or bylaws of a resident domestic corporation with
8 respect to business combinations as defined herein.

1 *2. *The Legislature hereby finds and declares it to be the public*
2 *policy of this State, the following:*

3 a. *Resident domestic corporations, as defined in this act, encom-*
4 *pass, represent and affect, through their ongoing business opera-*
5 *tions, a variety of constituencies including New Jersey shareholders,*
6 *employees, customers, suppliers and local communities and their*
7 *economies whose welfare is vital to the State's interests.*

8 b. *In order to promote such welfare, the regulation of the inter-*
9 *nal affairs of resident domestic corporations as reflected in the*
10 *laws of this State governing business corporations should allow*
11 *for the stable, long-term growth of resident domestic corporations.*

12 c. *Takeovers of public corporations financed largely through*
13 *debt to be repaid in the short-term by the sale of substantial assets*
14 *of the target corporation, in other states, have impaired local*

EXPLANATION—Matter enclosed in bold-faced brackets [thus] in the above bill
is not enacted and is intended to be omitted in the law.

Matter printed in italics thus is new matter.

Matter enclosed in asterisks or stars has been adopted as follows:

*—Senate committee amendments adopted May 12, 1986.

**—Senate amendments adopted May 15, 1986.

15 *employment conditions and disrupted local commercial activity.*
16 *These takeovers prevent shareholders from realizing the full value*
17 *of their holdings through forced mergers and other coercive*
18 *devices. The threat of these takeovers also deprives shareholders*
19 *of value by forcing the adoption of short-term business strategies*
20 *as well as defensive tactics which may not be in the public interest.**

1 ***[2.]*** *3.* As used in this act:

2 a. "Affiliate" means a person that directly, or indirectly through
3 one or more intermediaries, controls, or is controlled by, or is
4 under common control with, a specified person.

5 b. "Announcement date," when used in reference to any busi-
6 ness combination, means the date of the first public announce-
7 ment of the final, definitive proposal for that business combi-
8 nation.

9 c. "Associate," when used to indicate a relationship with any
10 person, means (1) any corporation or organization of which that
11 person is an officer or partner or is, directly or indirectly, the
12 beneficial owner of 10% or more of any class of voting stock,
13 (2) any trust or other estate in which that person has a substan-
14 tial beneficial interest or as to which that person serves as trustee
15 or in a similar fiduciary capacity, or (3) any relative or spouse
16 of that person, or any relative of that spouse, who has the same
17 home as that person.

18 d. "Beneficial owner," when used with respect to any stock,
19 means a person:

20 (1) that, individually or with or through any of its affiliates
21 or associates, beneficially owns that stock, directly or indirectly;

22 (2) that, individually or with or through any of its affiliates
23 or associates, has (a) the right to acquire that stock (whether
24 that right is exercisable immediately or only after the passage
25 of time), pursuant to any agreement, arrangement or understand-
26 ing (whether or not in writing), or upon the exercise of con-
27 version rights, exchange rights, warrants or options, or other-
28 wise; provided, however, that a person shall not be deemed the
29 beneficial owner of stock tendered pursuant to a tender or ex-
30 change offer made by that person or any of that person's affiliates
31 or associates until that tendered stock is accepted for purchase
32 or exchange; or (b) the right to vote that stock pursuant to any
33 agreement, arrangement or understanding (whether or not in
34 writing); provided, however, that a person shall not be deemed
35 the beneficial owner of any stock under this subparagraph if the
36 agreement, arrangement or understanding to vote that stock (i)

37 arises solely from a revocable proxy or consent given in response
38 to a proxy or consent solicitation made in accordance with the
39 applicable rules and regulations under the Exchange Act, and
40 (ii) is not then reportable on a Schedule 13D under the Exchange
41 Act (or any comparable or successor report); or

42 (3) that has any agreement, arrangement or understanding
43 (whether or not in writing), for the purpose of acquiring, hold-
44 ing, voting (except voting pursuant to a revocable proxy or
45 consent as described in subparagraph (b) of paragraph (2) of
46 this subsection, or disposing of that stock with any other person
47 that beneficially owns, or whose affiliates or associates beneficially
48 own, directly or indirectly, that stock.

49 e. "Business combination," when used in reference to any resi-
50 dent domestic corporation and any interested stockholder of that
51 resident domestic corporation, means:

52 (1) any merger or consolidation of that resident domestic corpo-
53 ration or any subsidiary of that resident domestic corporation with
54 (a) that interested stockholder or (b) any other corporation
55 (whether or not it is an interested stockholder of that resident do-
56 mestic corporation) which is, or after a merger or consolidation
57 would be, an affiliate or associate of that interested stockholder;

58 (2) any sale, lease, exchange, mortgage, pledge, transfer or
59 other disposition (in one transaction or a series of transactions)
60 to or with that interested stockholder or any affiliate or associate
61 of that interested stockholder of assets of that resident domestic
62 corporation or any subsidiary of that resident domestic corpora-
63 tion (a) having an aggregate market value equal to 10% or more
64 of the aggregate market value of all the assets, determined on a
65 consolidated basis, of that resident domestic corporation, (b)
66 having an aggregate market value equal to 10% or more of the
67 aggregate market value of all the outstanding stock of that
68 resident domestic corporation, or (c) representing 10% or more
69 of the earning power or income, determined on a consolidated
70 basis, of that resident domestic corporation:

71 (3) the issuance or transfer by that resident domestic corpora-
72 tion or any subsidiary of that resident domestic corporation (in
73 one transaction or a series of transactions) of any stock of that
74 resident domestic corporation or any subsidiary of that resident
75 domestic corporation which has an aggregate market value equal
76 to 5% or more of the aggregate market value of all the outstanding
77 stock of that resident domestic corporation to that interested
78 stockholder or any affiliate or associate of that interested stock-

79 holder, except pursuant to the exercise of warrants or rights to
80 purchase stock offered, or a dividend or distribution paid or made,
81 pro rata to all stockholders of that resident domestic corporation;
82 (4) the adoption of any plan or proposal for the liquidation or
83 dissolution of that resident domestic corporation proposed by, on
84 behalf of or pursuant to any agreement, arrangement or under-
85 standing (whether or not in writing) with, that interested stock-
86 holder or any affiliate or associate of that interested stockholder;
87 (5) any reclassification of securities (including, without limita-
88 tion, any stock split, stock dividend, or other distribution of stock
89 in respect of stock, or any reverse stock split), or recapitalization
90 of that resident domestic corporation, or any merger or consolida-
91 tion of that resident domestic corporation with any subsidiary of
92 that resident domestic corporation, or any other transaction
93 (whether or not with, or into, or otherwise involving that in-
94 terested stockholder), proposed by, on behalf of or pursuant to
95 any agreement, arrangement or understanding (whether or not in
96 writing) with, that interested stockholder or any affiliate or
97 associate of that interested stockholder, which has the effect,
98 directly or indirectly, of increasing the proportionate share of the
99 outstanding shares of any class or series of stock or securities
100 convertible into voting stock of that resident domestic corporation
101 or any subsidiary of that resident domestic corporation which is
102 directly or indirectly owned by that interested stockholder or any
103 affiliate or associate of that interested stockholder, except as a
104 result of immaterial changes due to fractional share adjustments;
105 or
106 (6) any receipt by that interested stockholder or any affiliate or
107 associate of that interested stockholder of the benefit, directly or
108 indirectly (except proportionately as a stockholder of that resident
109 domestic corporation) of any loans, advances, guarantees, pledges
110 or other financial assistance or any tax credits or other tax
111 advantages provided by or through that corporation.

112 f. "Common stock" means any stock other than preferred stock.
113 g. "Consummation date," with respect to any business combina-
114 tion, means the date of consummation of that business combination.
115 h. "Control," including the terms "controlling" "controlled
116 by" and "under common control with," means the possession,
117 directly or indirectly, of the power to direct or cause the direction
118 of the management and policies of a person, whether through the
119 ownership of voting stock, by contract, or otherwise. A person's
120 beneficial ownership of 10% or more of the voting power of a

121 corporation's outstanding voting stock shall create a presumption
122 that that person has control of that corporation. Notwithstanding
123 the foregoing in this subsection, a person shall not be deemed to
124 have control of a corporation if that person holds voting power,
125 in good faith and not for the purpose of circumventing this section,
126 as an agent, bank, broker, nominee, custodian or trustee for one
127 or more beneficial owners who do not individually or as a group
128 have control of that corporation.

129 i. "Exchange Act" means the "Securities Exchange Act of
130 1934", 48 stat 881, (15 U. S. C. 78a et seq.) as the same has been
131 or hereafter may be amended from time to time.

132 j. "Interested stockholder," when used in reference to any
133 resident domestic corporation, means any person (other than that
134 resident domestic corporation or any subsidiary of that resident
135 domestic corporation **or a bank holding company as defined in the
135A "*Bank Holding Company Act of 1956*," 70 Stat. 133, (12 U. S. C.
135B § 1841 et seq.) as amended, or any subsidiary of a bank holding
135C company**) that:

136 (1) is the beneficial owner, directly or indirectly, of 10% or
137 more of the voting power of the outstanding voting stock of that
138 resident domestic corporation; or

139 (2) is an affiliate or associate of that resident domestic corpora-
140 tion and at any time within the five-year period immediately prior
141 to the date in question was the beneficial owner, directly or
142 indirectly, of 10% or more of the voting power of the then
143 outstanding stock of that resident domestic corporation. For the
144 purpose of determining whether a person is an interested stock-
145 holder pursuant to *this* subsection, the number of shares of
146 voting stock of that resident domestic corporation deemed to be
147 outstanding shall include shares deemed to be beneficially owned
148 by the person through application of subsection d. of this section
149 but shall not include any other unissued shares of voting stock of
150 that resident domestic corporation which may be issuable pursuant
151 to any agreement, arrangement or understanding, or upon exercise
152 of conversion rights, warrants or options, or otherwise.

153 k. "Market value," when used in reference to property of any
154 resident domestic corporation, means:

155 (1) in the case of stock, the highest closing sale price during the
156 30-day period immediately preceding the date in question of a
157 share of that stock on the composite tape for New York Stock
158 Exchange-listed stocks, or, if that stock is not quoted on that
159 composite tape or if that stock is not listed on that exchange, on

160 the principal United States securities exchange registered under
161 the Exchange Act on which that stock is listed, or, if that stock is
162 not listed on any such exchange, the highest closing bid quotation
163 with respect to a share of that stock during the 30-day period
164 preceding the date in question on the National Association of
165 Securities Dealers, Inc. Automated Quotations System, or any
166 system then in use, or if no such quotations are available, the fair
167 market value on the date in question of a share of that resident
168 domestic stock as determined by the board of directors of that
169 corporation in good faith; and

170 (2) in the case of property other than cash or stock, the fair
171 market value of that property on the date in question as deter-
172 mined by the board of directors of that resident domestic corpora-
173 tion in good faith.

174 l. "Preferred stock" means any class or series of stock of a
175 resident domestic corporation which under the bylaws or certifi-
176 cate of incorporation of that resident domestic corporation is
177 entitled to receive payment of dividends prior to any payment of
178 dividends on some other class or series of stock, or is entitled in
179 the event of any voluntary liquidation, dissolution or winding up
180 of the resident domestic corporation to receive payment or distri-
181 bution of a preferential amount before any payments or distribu-
182 tions are received by some other class or series of stock.

183 m. "Resident domestic corporation" means an issuer of voting
184 stock which is organized under the laws of this State and, as of
185 the stock acquisition date in question, has its principal executive
186 offices and significant business operations located in this State.

187 n. "Stock" means:

188 (1) any stock or similar security, any certificate of interest, any
189 participation in any profit sharing agreement, any voting trust
190 certificate, or any certificate of deposit for stock; and

191 (2) any security convertible, with or without consideration, into
192 stock, or any warrant, call or other option or privilege of buying
193 stock without being bound to do so, or any other security carrying
194 any right to acquire, subscribe to or purchase stock.

195 o. "Stock acquisition date," with respect to any person and any
196 resident domestic corporation, means the date that that person
197 first becomes an interested stockholder of that resident domestic
198 corporation.

199 p. "Subsidiary" of any resident domestic corporation means
200 any other corporation of which voting stock having a majority of
201 the votes entitled to be cast is owned, directly or indirectly, by
202 that resident domestic corporation.

203 q. "Voting stock" means shares of capital stock of a corpora-
204 tion entitled to vote generally in the election of directors.

1 ***[3.]*** *4.* Notwithstanding anything to the contrary contained
2 in this act (except section ***[5]*** *6* of this act), no resident
3 domestic corporation shall engage in any business combination
4 with any interested stockholder of that resident domestic corpora-
5 tion for a period of five years following that interested stock-
6 holder's stock acquisition date unless that business combination is
7 approved by the board of directors of that resident domestic corpo-
8 ration prior to that interested stockholder's stock acquisition date.

1 ***[4.]*** *5.* In addition to the restriction contained in section
2 ***[3]*** *4* of this act, and except as provided in section ***[5]*** *6*
3 of this act, no resident domestic corporation shall engage at any
4 time in any business combination with any interested stockholder
5 of that resident domestic corporation other than a business com-
6 bination specified in any one of subsections a., b. or c. of this
6A section;

7 a. a business combination approved by the board of directors
8 of that resident domestic corporation prior to that interested
9 stockholder's stock acquisition date.

10 b. a business combination approved by the affirmative vote of
11 the holders of two-thirds of the voting stock not beneficially owned
12 by that interested stockholder at a meeting called for such purpose.

13 c. a business combination that meets all of the following condi-
14 tions:

15 (1) the aggregate amount of the cash and the market value, as
16 of the consummation date, of consideration other than cash to be
17 received per share by holders of outstanding shares of common
18 stock of that resident domestic corporation in that business com-
19 bination is at least equal to the higher of the following:

20 (a) the highest per share price (including any brokerage com-
21 missions, transfer taxes and soliciting dealers' fees) paid by that
22 interested stockholder for any shares of common stock of the
23 same class or series acquired by it (i) within the five-year period
24 immediately prior to the announcement date with respect to that
25 business combination, or (ii) within the five-year period imme-
26 diately prior to, or in, the transaction in which that interested
27 stockholder became an interested stockholder, whichever is higher;
28 plus, in either case, interest compounded annually from the earliest
29 date on which that highest per share acquisition price was paid
30 through the consummation date at the rate for one-year United
31 States Treasury obligations from time to time in effect; less the

32 aggregate amount of any cash dividends paid, and the market
33 value of any dividends paid other than in cash, per share of
34 common stock since that earliest date, up to the amount of that
35 interest; and

36 (b) the market value per share of common stock on the an-
37 nouncement date with respect to that business combination or on
38 that interested stockholder's stock acquisition date, whichever is
39 higher; plus interest compounded annually from that date through
40 the consummation date at the rate for one-year United States
41 Treasury obligations from time to time in effect; less the aggre-
42 gate amount of any cash dividends paid, and the market value of
43 any dividends paid other than in cash, per share of common stock
44 since that date, up to the amount of that interest;

45 (2) the aggregate amount of the cash and the market value as
46 of the consummation date of consideration other than cash to be
47 received per share by holders of outstanding shares of any class
48 or series of stock, other than common stock, of that resident
49 domestic corporation is at least equal to the highest of the fol-
50 lowing (whether or not that interested stockholder has previously
51 acquired any shares of that class or series of stock):

52 (a) the highest per share price (including any brokerage com-
53 missions, transfer taxes and soliciting dealers' fees) paid by that
54 interested stockholder for any shares of that class or series of
55 stock acquired by it (i) within the five-year period immediately
56 prior to the announcement date with respect to that business
57 combination, or (ii) within the five-year period immediately prior
58 to, or in, the transaction in which that interested stockholder
59 became an interested stockholder, whichever is higher; plus, in
60 either case, interest compounded annually from the earliest date
61 on which that highest per share acquisition price was paid through
62 the consummation date at the rate for one-year United States
63 Treasury obligations from time to time in effect; less the aggre-
64 gate amount of any cash dividends paid, and the market value of
65 any dividends paid other than in cash, per share of that class or
66 series of stock since that earliest date, up to the amount of that
67 interest;

68 (b) the highest preferential amount per share to which the
69 holders of shares of that class or series of stock are entitled in
70 the event of any liquidation, dissolution or winding up of that
71 resident domestic corporation, plus the aggregate amount of any
72 dividends declared or due as to which those holders are entitled
73 prior to payment of dividends on some other class or series of

74 stock (unless the aggregate amount of those dividends is included
75 in that preferential amount); and

76 (c) the market value per share of that class or series of stock
77 on the announcement date with respect to that business combina-
78 tion or on that interested stockholder's stock acquisition date,
79 whichever is higher; plus interest compounded annually from that
80 date through the consummation date at the rate for one-year
81 United States Treasury obligations from time to time in effect;
82 less the aggregate amount of any cash dividends paid, and the
83 market value of any dividends paid other than in cash, per share
84 of that class or series of stock since that date, up to the amount of
85 that interest;

86 (3) the consideration to be received by holders of a particular
87 class or series of outstanding stock (including common stock) of
88 that resident domestic corporation in that business combination
89 is in cash or in the same form as the interested stockholder has
90 used to acquire the largest number of shares of that class or series
91 of stock previously acquired by it;

92 (4) the holders of all outstanding shares of stock of that resi-
93 dent domestic corporation not beneficially owned by that interested
94 stockholder immediately prior to the consummation of that busi-
95 ness combination are entitled to receive in that business combina-
96 tion cash or other consideration for those shares in compliance
97 with paragraphs (1), (2) and (3) of this subsection; and

98 (5) after that interested stockholder's stock acquisition date
99 and prior to the consummation date with respect to that business
100 combination, that interested stockholder has not become the bene-
101 ficial owner of any additional shares of stock of that resident
102 domestic corporation except:

103 (a) as part of the transaction which resulted in that interested
104 stockholder becoming an interested stockholder;

105 (b) by virtue of proportionate stock splits, stock dividends or
106 other distributions of stock in respect of stock not constituting a
107 business combination under paragraph (5) of subsection e. of
108 section 2 of this act;

109 (c) through a business combination meeting all of the conditions
110 of paragraph (3) and this paragraph; or

111 (d) through purchase by that interested stockholder at any
112 price which, if that price had been paid in an otherwise permis-
113 sible business combination, the announcement date and consumma-
114 tion date of which were the date of that purchase, would have
115 satisfied the requirements of paragraphs (1), (2) and (3) of this
116 subsection.

1 ***[5.]*** *6.* a. Unless the certificate of incorporation provides
 2 otherwise, the provisions of this act shall not apply to any business
 3 combination of a resident domestic corporation with an interested
 4 stockholder if the resident domestic corporation did not have a
 5 class of voting stock registered or traded on a national securities
 6 exchange or registered with the Securities and Exchange Commis-
 7 sion pursuant to section 12(g) of the Exchange Act, 48 stat. 892,
 8 (15 U. S. C. 78b.) on that interested stockholder's stock acquisition
 8A date.

9 b. Unless the certificate of incorporation provides otherwise,
 10 the provisions of this act shall not apply to any business combina-
 11 tion with an interested stockholder who was an interested stock-
 12 holder prior to the effective date of this act unless subsequent
 13 thereto that interested stockholder increased his or its interested
 14 stockholder's proportion of the voting power of the resident
 15 domestic corporation's outstanding voting stock to a proportion
 16 in excess of the proportion of voting power that interested stock-
 17 holder held prior to the effective date of this act.

18 ***[c.** The provisions of this act shall not apply to any business
 19 combination of a resident domestic corporation the original certifi-
 20 cate of incorporation of which contains a provision, or whose
 21 board of directors adopts an amendment to the resident domestic
 22 corporation's bylaws prior to 45 days after the enactment of this
 23 act, expressly electing not to be governed by this act.]*

23A *c. *The provisions of this act shall not apply to any business*
 23B *combination of a resident domestic corporation with an interested*
 23C *stockholder of that corporation which became an interested stock-*
 23D *holder on or after January 12, 1988.**

24 d. The provisions of this act shall not apply to any business
 25 combination of a resident domestic corporation with an interested
 26 stockholder of that corporation which became an interested stock-
 27 holder inadvertently, if such interested stockholder (1) as soon as
 28 practicable divests itself or himself of a sufficient amount of the
 29 voting stock of that resident domestic corporation so that he or it
 30 no longer is the beneficial owner, directly or indirectly, of 10%
 31 or more of the voting power of the outstanding voting stock of that
 32 corporation, ***or a subsidiary of that resident domestic corpora-*
 33 *tion*** and (2) would not at any time within the five-year period
 34 preceding the announcement date with respect to that business
 35 combination have been an interested stockholder but for that in-
 35A advertent acquisition.

36 *e. *The provisions of this act shall not apply to any business*

11

37 combination of a resident domestic corporation **[subject to regu-
38 lation, in whole or in part, pursuant to]** **which is a "bank hold-
39 ing company" as defined in** the "Bank Holding Company Act of
40 1956," 70 Stat. 133, (12 U. S. C. § 1841 et seq.) **as amended, or a
41 subsidiary of the bank holding company** with an interested stock-
42 holder of that resident domestic corporation.

1 7. The Office of Economic Policy, created pursuant to P. L. 1966,
2 c. 129 (C. 52:18A-125 et seq.), shall evaluate the economic impact
3 of this act on the economy of this State, on resident domestic
4 corporations and other corporations located in this State, and on
5 individual and institutional stockholders in this State and shall
6 report its findings to the Legislature on or before September 8,
7 1987.*

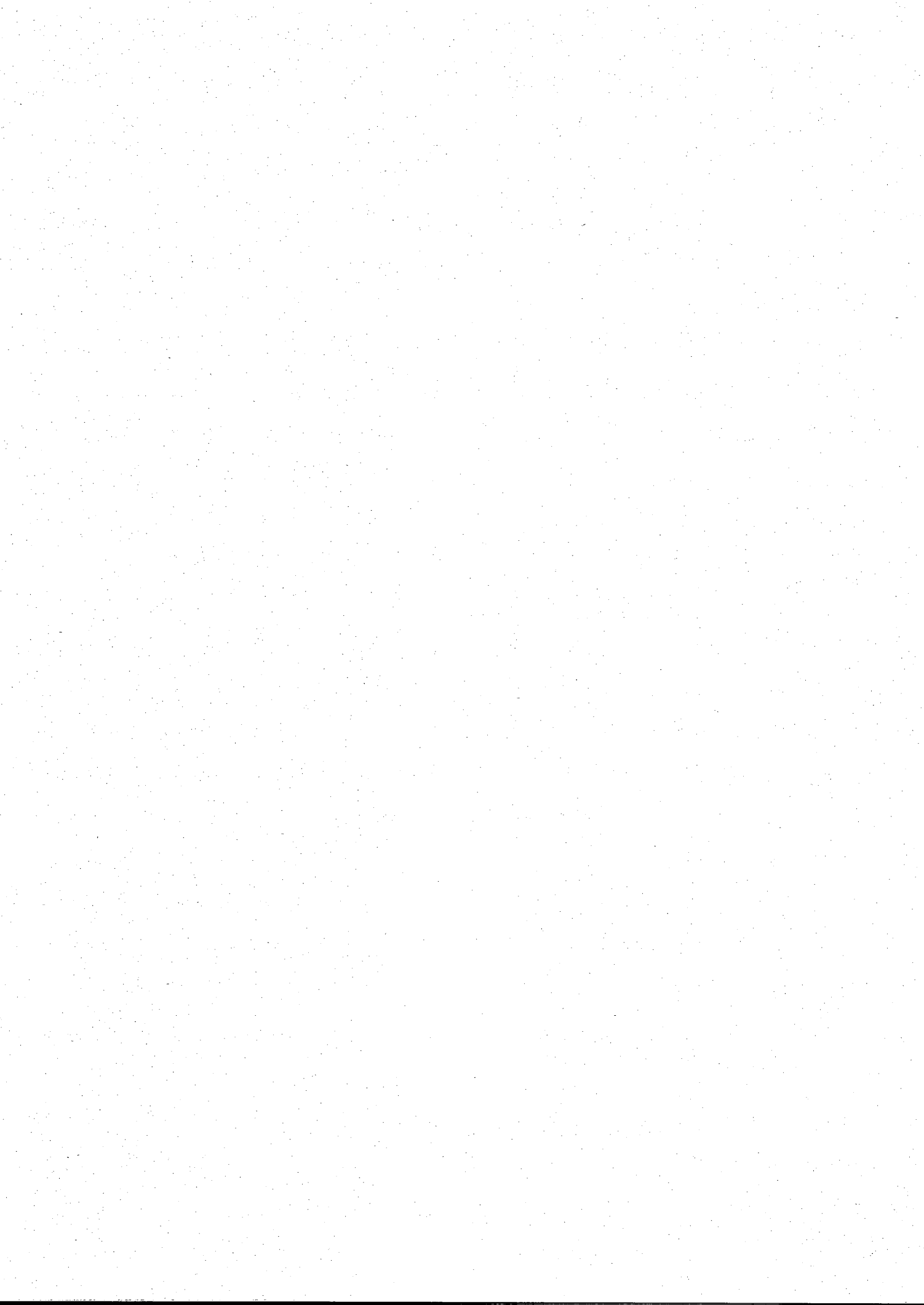
1 ***[6.]*** *8.* a. If any clause, sentence, subparagraph, paragraph,
2 subsection, section, or other portion of this act or the application
3 thereof to any person or circumstances shall be held invalid, such
4 holding shall not affect, impair or invalidate the remainder of this
5 act or the application of that portion held invalid to any other
6 person or circumstances, but shall be confined in its operation to
7 the clause, sentence, subparagraph, paragraph, subsection, section,
8 or other portion thereof directly involved in that holding or to the
9 person or circumstances therein involved.

10 b. If any provision of this act is inconsistent with, in conflict
11 with, or contrary to any other provision of law, that provision of
12 this act shall prevail over that other provision and that other
13 provision shall be deemed to be amended, superseded or repealed
14 to the extent of that inconsistency or conflict.

1 ***[7.]*** *9.* This act shall take effect immediately and shall be
2 retroactive to January 23, 1986.

COMMERCE AND INDUSTRY

Enacts "Shareholders Protection Act" to discourage certain
hostile takeovers.



SENATE LABOR, INDUSTRY AND PROFESSIONS
COMMITTEE

STATEMENT TO
SENATE, No. 1539
with Senate committee amendments

STATE OF NEW JERSEY

DATED: MAY 12, 1986

This bill would encourage any person, before acquiring voting stock of a resident domestic corporation (i. e., a corporation organized under the laws of New Jersey with its principal executive offices and significant business operations in the State) which would entitle that person to cast 10% or more of the votes entitled to be cast in the election of directors of the resident domestic corporation, to seek in advance the approval of the resident domestic corporation's board of directors for any contemplated future business combination between that person and the resident domestic corporation, or for the purchase of the stock. The bill would not prohibit any acquisition of stock, but without advance approval, no person who acquires 10% or more of the voting stock of the resident domestic corporation could thereafter engage in any business combination with the resident domestic corporation for a period of five years from the date the person first acquired 10% or more of the voting stock of the resident domestic corporation.

After the expiration of such five-year period, that person could engage in a business combination with the resident domestic corporation only if it is approved by the affirmative vote of the disinterested holders of two-thirds of the voting stock or if he pays at least a formula price designed to ensure that all holders (other than that person) of stock of the resident domestic corporation receive at least the highest price per share paid by that person.

The provisions of this bill would apply to a business combination of a resident domestic corporation (the target of a takeover) which has a class of voting stock registered or traded on a national securities exchange or registered with the Securities and Exchange Commission pursuant to section 12(g) of the Securities Exchange Act of 1934". Also, the provisions of this bill would not apply to any business combination in which the person acquired 10% or more of the voting stock prior to the effective date of this bill, unless subsequent thereto that

person increased his proportion of the voting power of the resident domestic corporation's outstanding voting stock to a proportion in excess of the proportion of voting power that person held prior to the effective date of the bill, or unless the certificate of incorporation of the resident domestic corporation provides otherwise. Corporations (mainly privately-held resident domestic corporations), other than those referred to at the beginning of this paragraph, may elect to be covered by the provisions of this bill by so providing in their certificates of incorporation. Finally, the provisions of this bill would not apply to the inadvertent acquisition of 10% or more of the resident domestic corporation's voting stock provided an amount of stock necessary to decrease such inadvertent ownership to less than 10% is promptly divested.

The committee amended the bill to require that the Office of Economic Policy study the economic impact of the bill and report to the Legislature approximately 120 days before the application of the bill to hostile takeovers no longer applies (on or after January 12, 1988). The committee amended the bill to eliminate the provision which allows a resident domestic corporation to opt out of the mandatory coverage of the bill by including in the original certificate of incorporation a provision expressly electing not to be governed by this bill, or by the board of directors adopting an amendment to the corporation's bylaws within 45 days after the enactment of the bill expressly electing not to be governed by this bill. The committee also exempted bank holding companies from the provisions of the bill. Lastly, the committee adopted a public policy statement of the need for the legislation.

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SENATOR RAYMOND LESNIAK (Chairman): The public hearing will come to order. This being a public hearing, a quorum does not have to be present. It is past one p.m., the scheduled time of the hearing, which is to be held on Senate Bill 1539. For those of you who are interested, there will be no vote on the bill today.

Our first witness will be Gregg A. Jarrell, Chief Economist, U.S. Securities and Exchange Commission. Mr. Jarrell, first let me thank you for taking the time to appear before the Committee.

G R E G G A. J A R R E L L: Thank you very much. I appreciate it. The lawyers of the SEC told me to be sure I started off by saying that I represent myself as a professional economist and as an expert on tender offer economics, as opposed to representing the Commission itself. That is a fundamental difference; however, I would be happy to answer questions on the SEC's role in regulating tender offers in the course of my testimony. I will try to keep this to 15 minutes.

I want to start off by saying that the value of a share of equity has two components. Those of us who study takeovers usually like to think about the value of a share of equity having two components: One is the market value of the corporation under incumbent management. This is, in a sense, the predicted future net cash flows based on the past performance and expectations for the future. The second is the market value of the control premium.

The vote that goes with a share of common equity has value if -- and only if -- the alternative management policies can yield superior cash flows, and if -- and only if -- there are certain mechanisms in place that will facilitate a controlled change, should the incumbents prove unwilling or unable to implement these desirable changes. Therefore, the market for corporate control, which is what we are proposing to regulate here, is critical for ensuring the optimal allocation

of scarce resources and ensuring this allocation to the highest valued uses.

Now, this is more than just some theoretical mumbo jumbo from ivory tower academics. This is real world economics. It is in action constantly, and it is manifested in several billion dollars a year's worth of mergers and acquisitions activities yearly.

We can quote Justice White from the Supreme Court when he struck down the first generation of anti-takeover amendments. Justice White held that these, "Sweeping extraterritorial regulations, if adopted by most states, would stifle takeover activity." He wrote that these regulations would inflict substantial cost by distorting, in his words, "the reallocation of economy resources to the highest valued use, a process," he goes on to say, "which can improve efficiency and competition by providing incumbent managers with the incentive to perform well, so that stock prices remain high."

That is the fundamental theory that we depart from when we analyze a bill like the one which is before the Committee. The direct evidence on the control premium is all around us. Proxy fights are shown to increase share prices. Poison pills, which reduce the probability of takeovers, decrease share prices. Some dual voting plans, which reduce the probability of takeovers, reduce share prices. Tender offers and mergers activity provide the best evidence for control premiums. We see tremendously large premiums going to target shareholders and other equity owners, and we see no evidence that, on average, bidders overpay.

It has long been recognized that a basic problem of the modern diffusely held corporation -- and this problem was perhaps first recognized by Berle and Means -- is what is called "the separation of ownership and control." Although there is a vote attached to equity, it is only the ability to

secure the votes without the approval of incumbent management-- It is only this ability which ensures that those in control will do what the owners want them to do, which is to maximize value, within tolerable limits. Not only is it -- to most of us -- morally wrong to, in a sense, steal the value of this vote from shareholders without their approval, but it is, I think, a bad idea from an economic standpoint. It is bad national policy, as the SEC has recognized and as the courts have recognized, and I think, as well, it is bad policy for New Jersey.

Let me take a moment to explain. I think everyone agrees that this legislation will virtually eliminate hostile takeovers. That is its purpose, and it is a fair bet that it will be very effective at this. It essentially denies the value of ownership and the value of control for five years after someone crosses the threshold. Imagine doing this to someone in the automobile market. After you buy the car, you can't really use it for five years. If a dealer were to adopt a position like that, I would imagine that his sales would plummet dramatically.

Not only that, however, I think it is important to recognize that this legislation will reduce significantly the incidents of negotiated mergers for firms that are covered by this law. This is obvious because it reduces the negotiating leverage of bidders in friendly deals. No longer will a bidder have the option to go directly to shareholders with any of the terms, should management balk. This, of course, dramatically changes the negotiating leverage, and will result in a reduction in the number of negotiated mergers.

Third, and perhaps most important, this legislation will discourage the beneficial kinds of restructurings that we see everywhere that are, at least in some measure, prompted by a properly functioning market for corporate control.

It seems to me that there is an opinion behind this bill that this bill will deter takeovers that would be harmful to New Jersey; that it is going to eliminate bad takeovers. I think this is incorrect. I haven't seen any evidence to support this. I would be delighted to take a look at it, but I think that the existing evidence on the national scene supports the following kinds of conclusions, at least indirectly: I think the bill will stifle economic innovation. It will allow unproductive use of New Jersey resources.

After this bill is passed, what is to stop incumbents from wasting corporate resources? Not that they are going to willy-nilly do this, but where is the disciplining mechanism that remains? I think it will restrict, dramatically, the ability of New Jersey corporations to compete in the nation's capital markets. Lenders of capital will insist of higher rates of returns to compensate them for the obvious risk they fact of unproductive corporate behavior. They have many, many alternatives in the national and international capital markets, and it is guaranteed that they are going to insist on something to compensate them.

It is my opinion that studies five years from now will show that this was probably a bad idea for the State of New Jersey. I see no evidence to support the idea that these kinds of protectionist measures will deter bad takeovers, while allowing good takeovers.

Related is the idea that hostile takeovers are more harmful--

SENATOR DiFRANCESCO: Could you stop for a minute?

MR. JARRELL: I'm sorry?

SENATOR DiFRANCESCO: Since nobody is listening to you, wait until I-- Has the hearing started?

SENATOR LESNIAK: I'm listening.

SENATOR DiFRANCESCO: Have you started the hearing?

SENATOR LESNIAK: Yes.

SENATOR DiFRANCESCO: By yourself?

SENATOR LESNIAK: Yeah. This is a public hearing, Senator. It is not a meeting.

SENATOR DiFRANCESCO: Yes, but give me a chance to be here, though.

SENATOR LESNIAK: Do you know what time it is?

SENATOR DiFRANCESCO: I was here before you were here.

SENATOR LESNIAK: Do you want to start from the beginning?

MR. JARRELL: I could start again. I am like a recording, sure, what the hell.

SENATOR DiFRANCESCO: No, don't start from the beginning. Does he have written testimony? (no response)

MR. JARRELL: Shall I continue?

SENATOR LESNIAK: Yes.

SENATOR DiFRANCESCO: Okay.

MR. JARRELL: Ready?

SENATOR DiFRANCESCO: Yes.

MR. JARRELL: Related is the idea that hostile takeovers are more harmful or are ill-motivated relative to negotiated mergers. I think that this is a myth and has no empirical support. The charges that the capital market undervalues long-term investments such as research and development, largely because of the growing influence of institutional stockholders-- This idea has been around for several years. The SEC has taken this argument very seriously. Indeed, if it is true, the least of our problems is the high incidence of hostile takeovers. Capital markets are the most important engine in our economic machine, and if they are misfiring in this fundamental way, we have serious problems indeed.

The Office of the Chief Economist and other outfits have studied this, and the results of the study are that there is no merit to this charge. I can briefly mention the evidence

as follows: First off, institutional investors are attracted to high research and development firms, not the reverse. There is no decline in research and development intensity as the role of institutional investors increases. That rejects the theory. Targets are not high research and development firms on average; indeed, the reverse is true. Targets are not firms that have high institutional investor roles, and they are not firms that have had growing institutional investor roles. Contrary to the theory, stock prices rise on the announcements of large research and development projects. Again that contradicts the theory. There is no significant difference between hostile and negotiated takeovers on any of these dimensions.

Another common belief behind this bill is the allegation that the stock market is unappreciative of clean balance sheets. The idea is that responsible low levels of debt enable raiders to take over these firms, financing the acquisitions with massive amounts of leveraging. These, again, are very valid concerns, but there is no evidence to support them. The Office of the Chief Economist and the IRRRC -- which is the Investor Responsibility Research Center -- studies show that targets do not have low debt relative to other firms in their industries.

I would be happy to answer any questions.

SENATOR DiFRANCESCO: Did you read a statement which you distributed, or did you just read it, or what?

MR. JARRELL: I just read it. It's notes.

SENATOR LESNIAK: You don't have a statement for the Committee, do you?

MR. JARRELL: No.

SENATOR DiFRANCESCO: What is your name?

MR. JARRELL: Gregg Jarrell.

SENATOR DiFRANCESCO: Why are you here?

MR. JARRELL: I am the Chief Economist of the Securities and Exchange Commission.

SENATOR DiFRANCESCO: Why are you here?

MR. JARRELL: Why am I here?

SENATOR DiFRANCESCO: Did someone ask you to be here?

MR. JARRELL: Yes.

SENATOR DiFRANCESCO: Who?

MR. JARRELL: I believe it was Mr.-- I believe I talked to Dale Davis.

SENATOR LESNIAK: We requested the FTC--

SENATOR DiFRANCESCO: Oh, we did?

MR. DAVIS (Committee Aide): The Securities and Exchange Commission and the FTC.

SENATOR DiFRANCESCO: Well, I don't know what he said. Could you supply us with a copy of what you just said, since you read what you had written out pretty quickly?

MR. JARRELL: Oh, I would be delighted to.

SENATOR DiFRANCESCO: Unless you want to read it over more slowly. I mean, I am not really attuned to these kinds of terms. I walked in in the middle of it, and secondly, you read the rest of it as quickly as you could. I am not even sure the record will pick him up that clearly.

SENATOR LESNIAK: Unfortunately, this bill will probably come up for a vote before the transcripts are prepared.

SENATOR DiFRANCESCO: Do you mean, like, today?

SENATOR LESNIAK: No, no, no. It will not come up for a vote today.

SENATOR DiFRANCESCO: We're not doing this today?

SENATOR LESNIAK: No.

SENATOR DiFRANCESCO: Seriously, we're not doing this today?

SENATOR LESNIAK: Seriously; very seriously. That is not with reference to when the bill will be posted, but with reference to how long it takes transcripts to be prepared.

If I may ask a question-- I totally agree with your economic philosophy, but there is another concern here that I

have as a State legislator; that is, other states are passing bills similar to this -- New York being one, Kentucky, Indiana. I don't know what is happening in Pennsylvania.

MR. DAVIS: Pennsylvania has the other type of takeover law.

SENATOR LESNIAK: Well, in any event, my concern is how the passage of laws in those states will be viewed by businesses, in terms of their decisions either to incorporate or locate their home offices in the State of New Jersey. Do you have any comments on that?

MR. JARRELL: Well, two comments. One, I have not seen-- I think it is a valid concern, of course. If I were a State Senator, that would be one of my top questions. I haven't seen any evidence to support the notion that there is a flight of corporations to the states that have the most protectionist laws -- the "race to the bottom" theory. Second, if there is some flight by corporations to those, you-- Well, I just haven't seen any evidence that there is. I think that if I were in your shoes, what I would do would be perhaps take California's example. They put forward a bill that was similar to this and, in the course of the hearings, and, you know, the sessions they had where they would elicit opinions of other folks, they decided that they would put this on hold and that they would study it a lot more carefully to answer questions such as that one, and to try to come up with a bill that would perhaps protect legitimate concerns without going too far.

SENATOR LESNIAK: Senator DiFrancesco?

SENATOR DiFRANCESCO: Have you been involved in any testimony in other states involving this kind of legislation?

MR. JARRELL: No, I haven't.

SENATOR DiFRANCESCO: Isn't this--

MR. JARRELL: I'm sorry. Let me give you a better answer than that. The SEC and the Office of the Chief Economist in the SEC talked to the people in Governor Cuomo's

office. We didn't testify, but it would be inaccurate to say that we didn't have any input.

SENATOR DiFRANCESCO: Isn't this really a State responsibility, a State concern we are talking about here?

MR. JARRELL: Well, I think that ideally you are trying to protect State interests, and that it is no one else's business. But, I think that is one of the problems with the bill, that it goes well beyond that. I think it has the same kinds of difficulties that the first generation of state anti-takeover laws had, which caused the Supreme Court to invalidate them. These are national corporations. The stockholders are everywhere in the U.S. and, while there may be some local benefit from protecting local corporations from unapproved offers, the costs are borne not only by New Jersey residents, but by out-of-state people.

SENATOR DiFRANCESCO: My question was, isn't this our role to determine what our laws should be with regard to an area like this, and not your role?

MR. JARRELL: That is a different question. I agree with that, sure.

SENATOR DiFRANCESCO: Isn't that traditionally what it has been?

MR. JARRELL: If you folks vote it in, it's in. We don't get a vote.

SENATOR DiFRANCESCO: You don't get involved in this under normal circumstances--

MR. JARRELL: We don't get--

SENATOR DiFRANCESCO: --unless we are seeking information?

MR. JARRELL: Yes, if someone asks us, we are more than happy to get involved. You know, we are considered to be an expert agency, and we do what we can. I will say that we get involved on the litigation side a lot, so if this bill is challenged, or if other bills are challenged, it would be very surprising if the SEC were not involved in it in an amicus role.

SENATOR DiFRANCESCO: Has that happened?

MR. JARRELL: Oh, yes.

SENATOR DiFRANCESCO: In many places?

MR. JARRELL: In fact, the SEC was very vigilant in many, many instances in this activity. It has consistently opposed these kinds of laws, yes.

SENATOR LESNIAK: Do you want to ask him any questions about Bob Brennan?

SENATOR DiFRANCESCO: No. Who's Bob Brennan? Do you know who Bob Brennan is?

MR. JARRELL: He has a helicopter. (laughter)

SENATOR DiFRANCESCO: I thought he rode a horse.

MR. JARRELL: He rides a horse, too, I suppose. He keeps a lot of our folks busy.

SENATOR LESNIAK: Senator Van Wagner?

SENATOR VAN WAGNER: Yes. I recently read in The Wall Street Journal -- about a month and a half ago -- that the SEC had indicated at that time that they were very much overextended and, in fact, had a great deal of difficulty, particularly with field investigators, in pursuing many of the situations which you indicated you have been very vigilant about. I wondered what your response might be to that, particularly in light of the fact that the Chairman of the SEC himself, I believe, indicated that the SEC was vastly understaffed.

MR. JARRELL: Well, certainly the Chairman of the SEC never indicated that.

SENATOR VAN WAGNER: Well, perhaps it was a high-ranking staff member then.

MR. JARRELL: Well, this got all threshed out a couple of weeks ago at a hearing before Chairman Wirth in the House. I think that there were some charges that the SEC was understaffed. It is certainly one of the things the Chairman is very concerned about. It is not a question of

understaffing. It is a question of how much fraud is out there. We have a booming stock market, and we have a lot of booming businesses, and--

SENATOR VAN WAGNER: But, what I am getting at -- as Senator DiFrancesco said earlier -- is, our concern -- and I think Senator Lesniak had originally articulated it -- is developing some type of level playing field, if you will, as it relates to our State -- as it relates to the 124 corporations that are incorporated in New Jersey. It is our feeling, perhaps, as legislators -- assuming that this bill receives positive attention -- that, in fact, it is our responsibility to address this issue and the concerns that are raised.

You, yourself, indicated there are, in fact, some legitimate concerns. That was the only point I was making.

MR. JARRELL: I understand; I understand. The SEC regulates national tender offers, disclosure, and anti-fraud, and there is no evidence, and I have not heard anyone make any serious accusations that the SEC has been dropping the ball in this area.

SENATOR LESNIAK: Well, I guess that is for another day and another time, when we have the merit review bills again. Somebody introduced them -- Senator Pallone, I think.

Senator DiFrancesco, do you have any other questions?

SENATOR DiFRANCESCO: No, thank you.

SENATOR LESNIAK: Thank you very much for your testimony.

MR. JARRELL: Thank you very much. I appreciate it.

SENATOR LESNIAK: James Balog, from Drexel Burnham Lambert?

SENATOR DiFRANCESCO: What happened to the other guy? The other guy didn't show?

SENATOR LESNIAK: I don't think so. Roland Machold was listed to speak next, but he is not here. He did submit a letter, by the way, that we will include in the record. The

letter basically said -- if I may summarize it-- Well, theoretically, this bill will have a negative impact on the price of shares -- the fact that it has such limited application in terms of the holdings in the pension fund, many of which have to be divested in any event--

SENATOR DiFRANCESCO: Many of these companies?

SENATOR LESNIAK: Right. (continues above statement) --and that the incremental effect of the proposed bill would be negligible. So, I submit this letter from the Division of Investment for the record, which basically says that the bill would have a negligible impact on the stability of the pension fund.

Mr. Balog?

JAMES BALOG: Thank you, Senator Lesniak. My name is James Balog. I am Vice Chairman of Drexel Burnham Lambert. I would like to thank you for extending the invitation for me to be her today. I am a resident of Spring Lake, New Jersey. I have a graduate degree in business from the Rutgers Graduate School of Business, and for 10 years of my working experience -- from 1951 to 1961 -- I was with Merck and Company in Rahway, New Jersey.

I am here representing Drexel Burnham Lambert today. Drexel Burnham Lambert is the country's second largest private investment banking firm, with over \$1 billion in capital. Drexel Burnham is often credited with developing the public market for high yield securities, and is a major participant in the mergers and acquisitions area.

You received from me -- I believe, last week -- a full paper on my views. Today, I am just going to comment on some highlights of the positions we have on this very important issue confronting the New Jersey State Legislature.

We are testifying in opposition to the proposed anti-takeover legislation. We believe the bill is not beneficial to the economy of New Jersey. It endangers jobs and

economic growth, and will disrupt community affairs. It is, at the bottom, a management protection bill, not a shareholder protection bill. We believe it will have the following major effects:

First of all, it will endanger jobs in the future economic growth in New Jersey. The essence of the free market system is that it allows competition to force changes in how corporations are managed. Takeovers -- even their possibility -- create an atmosphere which spurs management to operate companies more efficiently and remain competitive in world markets. Good and vital company management is essential to a strong State and local economy. Jobs are created by a dynamic company which adapts to constantly changing market conditions. Legislation which protects management from the disciplines of the free market system endangers jobs and future growth.

Secondly, we believe this bill would produce a contrary effect on the economy of New Jersey. Although the proposed legislation is intended to make New Jersey a more hospitable place to do business, the bill would actually have the opposite effect. Investors will be reluctant to contribute capital to New Jersey corporations, and strong incentives will be created to take whatever action is necessary to free corporations from the strictures of the bill -- by reincorporating in another state or by moving the company's headquarters and operations out of New Jersey. The ability of New Jersey corporations to raise capital in the public markets would be adversely affected, as investors recognized the long-term problems this legislation would engender.

Further, we believe it would be disruptive to community affairs. Now, this is kind of a contrary point of view from what one generally hears, because sometimes takeovers can have very dramatic near-term effects. But, more often, the absence of change will so debilitate an industry or a company, that massive job loss is the eventual consequence of failure to

adapt over time. No amount of community involvement is as critical to the long-term health of the community as a strong, dynamic management focusing on job creation and growth. How many jobs might have been saved in the steel industry, for example, if the management in that industry had been challenged 25 years ago? Would it not have been better for them to have faced a "Made in America" competition, instead of competition from abroad?

Well-run companies should not be regarded simply as profitable investments for their shareholders, because a healthy corporation is likely to provide a community with employment opportunities and tax revenues commensurate with its success. Legislation which erects barriers to acquisition and rejuvenation of poorly-run companies would produce far-reaching social and economic losses to the community and its residents.

Next, we believe a bill of this sort would disenfranchise shareholders. Shareholders, not managements, own the company. Managements' obligation is to see to it that shareholders' values are optimized, both in the short- and in the long-term. The proposed legislation would cover all New Jersey headquartered corporations. Whether they wanted the so-called protection or not, the five-year freeze on merger activities, unless voted in advance by incumbent management, would lock up assets for five years, thereby disenfranchising shareholders, the true owners of a corporation.

In recent congressional testimony -- which went beyond the letter that Senator Lesniak just referred to--

SENATOR DiFRANCESCO: Excuse me. Are you going to quote the guy who was on the list to testify, who sent the letter which Senator Lesniak just summarized?

MR. BALOG: Right. I think it is considerably more detailed, and perhaps more relevant to this group than some of the points I am making.

SENATOR LESNIAK: Are we talking about Roland Machold's letter?

SENATOR DiFRANCESCO: Yeah.

MR. BALOG: Right. I am going to quote some of the testimony he gave before Senator (sic) Wirth's Committee some months ago. In that congressional testimony, Roland Machold, Director of Investment for the State of New Jersey, and Cochairman of the Council of Institutional Investors, addressed the issue of shareholder rights. Mr. Machold is a fiduciary for 380,000 beneficiaries of the New Jersey Public Employee Pension Fund system, and is responsible for investing 99 State funds with total assets of about \$19 billion. The number of beneficiaries constitutes over 5% of the population of the State of New Jersey.

In his remarks before the U.S. House Subcommittee on Telecommunications, Consumer Protection, and Finance, Mr. Machold stated, and I quote: "It is my view that the managements of many American corporations are acting against the interests of shareholders by initiating changes in corporate governance procedures which protect management, abridge shareholder rights, and reduce the value of securities held by shareholders." Continuing the quote: "It is my contention that limitation of shareholders' voting rights will serve to entrench management, to limit the maximum realization of shareholder values, and to inhibit the vitality of capital markets in the United States."

SENATOR DiFRANCESCO: Did you add something to that, or--

MR. BALOG: Pardon me, did I add something?

SENATOR LESNIAK: No, let me comment on that, Senator DiFrancesco. I don't think that the statements are contradictory at all.

SENATOR DiFRANCESCO: I didn't say that.

SENATOR LESNIAK: Okay. Mr. Machold points out that New Jersey pension funds have gained from merger activity to the tune of \$107 million, but those gains were basically from

companies which were not incorporated in New Jersey. Therefore, this bill would not affect that activity.

MR. BALOG: I think the Senator is alluding to my summary remarks -- which would be page 3 in the thing I think he is following-- I went on into the attachments, the further testimony on page 10, which is where I am reading from now.

SENATOR DiFRANCESCO: Oh, I see.

MR. BALOG: I thought that since so little was put into the record on this subject, I would give the full expanded commentary that he had in the back.

SENATOR DiFRANCESCO: Oh, okay. I thought you were reading this word for word.

MR. BALOG: No, I'm not. I am kind of adding a little bit. And here I think is a very important point that is made about all of these things: Beneficiaries of pension funds would also be hurt because the proposed legislation would reduce the market value of shares of New Jersey corporations -- and others -- by rendering them unattractive to large investors and, in many respects, takeover proof -- to the detriment of individual shareholders and beneficiaries of pension plans.

In many direct ways, the beneficiaries of pension plans -- that is, firemen, policemen, teachers, and all State employees -- are the beneficiaries of the best possible price. A very startling example of what this means took place with respect to the Unocal transaction in 1985. Under the threat of takeover, Unocal restructured its capital and paid its shareholders substantial premiums over the preexisting price. The result of this to the Unocal pension and profit-sharing plans for currently retired employees and future retiring employees was a net gain of some \$220 million of new value for their assets.

A way to protect shareholders against management actions which may limit maximum realization of shareholder values is to adopt sunset provisions on management's actions.

Whenever shareholders grant management authority to make decisions on their behalf, this authority should be subject to regular shareholder review.

The need for management review has been raised by Roland Machold in his testimony before the House Committee, in which he stated: "Ten years ago, I was concerned that the government was intruding upon shareholder values and management initiatives through price controls, mandated nonproductive expenditures, and government regulation. Now, in the present laissez-faire environment, I am concerned that corporate managements are taking advantage of investors, with the cooperation of local governments and the indifference of the Federal government."

SENATOR DiFRANCESCO: When was this testimony given?

MR. BALOG: I have a copy here; I think it was about four or five months ago.

SENATOR DiFRANCESCO: Would you give the Committee a copy of what you quoted from?

MR. BALOG: Sure, I would be glad to. Continuing with another point I would like to make, I believe that this kind of legislation is unnecessary in the context of the current business environment. Shareholders already have the ability to bolster their defenses against takeovers. The bill does not provide a New Jersey corporation with any benefits, or protection, that could not be secured by the corporation itself through properly adopted amendments to the certificates of incorporation and/or by the bylaws.

A recent study by the Investor Responsibility Research Center reported that almost 80% of all Standard & Poor's 500 companies had adopted some form of anti-takeover measures by the end of 1985. In fact, in New Jersey, there must be a couple dozen companies, including Becton Dickinson, Merck, Johnson and Johnson, Campbell Soup, and so on, that have adopted anti-takeover measures. Since the Delaware Supreme

Court decision in the Household International case, some 150 companies have adopted the poison pill defense. Moreover, despite all the headlines about corporate takeovers, many of the largest Fortune 500 companies are voluntarily restructuring themselves in response to changing market conditions brought about by competitive pressures of an interdependent world economy, and not in response to a takeover.

The stock market rally this year has also produced a slowdown in takeover activity by making many previously undervalued companies less attractive as takeover targets.

My final point: The proposed legislation may be unconstitutional and disruptive. Similar legislation in Michigan and Indiana has been declared unconstitutional -- at least in part -- by the courts. The proposed New Jersey legislation may be unconstitutional, and could lead to lengthy and costly court challenges, and even greater economic uncertainty within the State.

In addition, this bill could encourage large investors to seek control of corporations through means other than stock acquisition, such as costly proxy battles. It could create an unhealthy atmosphere in the board rooms of New Jersey, in which a frozen "interested stockholder" has board representation and can't do anything about it.

In conclusion, the anti-takeover legislation proposed by the New Jersey Legislature is not a shareholder protection bill, but rather a management protection bill. It will not enhance or increase assets or protect job formation in the State, but will be detrimental to the overall economy of New Jersey. The best defense for the State's economy is good and vital company management. Good management is what creates jobs and tax revenues. No legislation should inhibit this process.

Thank you very much.

SENATOR LESNIAK: Mr. Balog, we have heard a lot of testimony about--

MR. BALOG: Incidentally, Senator, the testimony of Mr. Roland Machold was March 19, 1986, so it is much more recent that I even remembered.

SENATOR DiFRANCESCO: Will you give us a copy?

MR. BALOG: Yes, it is right here.

SENATOR LESNIAK: By the way, I don't think there is any doubt that shareholder protection provisions approved by shareholders, or these laws, depress stock prices. That, quite frankly, may be interesting to you, and very important to you or the Securities Exchange Commission. It is interesting to us, and important to us, but there is another thing that is important to us; that is, the impact on New Jersey's economy and jobs in the State of New Jersey.

There has been testimony about hostile takeovers -- bust-up, hostile takeovers -- financed by junk bonds. There is a derogatory meaning, I guess, to the words "junk bonds." You know a lot about junk bonds. How do you feel about that?

MR. BALOG: Well, first of all, Senator, I really do believe that what happens in a share price is important to New Jersey.

SENATOR LESNIAK: Oh, it's important. I didn't mean to say it is not important.

MR. BALOG: It is important in a very direct way. I don't mean just for pension beneficiaries. I mean from this standpoint: If the average price of a New Jersey chemical company, or what have you, is lower than its compatriot in some other state -- or some other country for that matter -- its cost of capital goes up. So, when it goes to the capital market it pays more in share of equity for the same amount of dollars to build a new plant. That is what is important. That's why the capital cost ultimately gets that benefit.

SENATOR LESNIAK: What you're saying is that you know more than the corporate managers then, who would decide to take action, would like this protection, to keep their stock prices

depressed, even though it may cost them more to get into the capital market.

MR. BALOG: I don't believe that is the motivation. I don't believe that is the motivation at all.

SENATOR LESNIAK: Oh, I'm sure it's not the motivation.

MR. BALOG: I think that the free market and the free operation of the corporate government system are probably better than me, than the management, and perhaps than any Legislature there is. So, I am making an appeal for the free market system to determine what is the right behavior.

SENATOR LESNIAK: What do you think about junk bonds?

MR. BALOG: I am not familiar with the term, actually. (laughter)

SENATOR LESNIAK: You could either be a legislator or a lawyer.

MR. BALOG: But, I'm learning. Well, we call them, of course, high yield bonds. I think it is very important to make that distinction, Senator, because a junk bond is really a bond that once had a high grade rating, but for some reason -- some change in technology, some inability to adapt to a change in world competition, what have you -- it fell from grace, and fell down into the below-investment-grade category. There are good examples of that. Lockheed, the Ford Motor Company, and Chrysler Corporation where excellent examples of junk bonds. They were once Triple As, but fell into some kind of a problem and went below the investment grade category. That is what is typically called a junk bond.

We simply took that notion of below investment grade, and adapted it to new companies that never had an investment grade rating. We call those high yield bonds. You may be interested to know that there are, in America, 19,000 companies with assets above \$25 million. Of those 19,000 companies, 600 have investment grade ratings, and the rest of the almost 19,000 couldn't get an investment grade rating if they tried. It is that group of companies that we finance.

So, this notion-- I think what you are getting at, Senator, is that the issuance of high yield -- or junk bonds, whichever, just so that everybody stays on track -- has been adapted to takeovers, which is the subject of your Committee's interest, and I think justifiably so. Very few junk bonds, or high yield bonds are used in takeover activity. I think we had a study out that tracked the takeover financing for the last two years. I think they found \$239 billion of financings that were involved in takeovers of companies across America. Of that \$239 billion, 4% was in below-investment-grade bonds. The rest of the takeover financing was insurance company financing, bank financing, high grade bond financing. This is a very small part of the takeover mix, and yet it is a very easy one to focus on -- that something about these instruments causes takeovers to occur.

Ninety percent -- or thereabouts-- Of all the high yield bonds that have ever been issued in this country in the last 10 or 11 years, 90-plus percent have gone to build new jobs, new companies, new factories in your State and in every other state. For example, I have a list of New Jersey companies that are high yield bond issuers, going from affluent industries -- Bally Park, Carlton -- some of the companies I'm afraid I don't even know myself-- Hovnanian Enterprises is an excellent example of the kind of thing that can happen when you get access to the capital markets denied to a small below-investment-rate company. Horizon Corp, Midland Glass, People Express-- These are marvelous companies that are creating the jobs. As you know, in our economy, the Fortune 500 -- even the Fortune 100 companies -- are net losers of jobs, have been for the last decade. These are the companies that are growing jobs. I think it would be really foolish to, in some way, inhibit the issuance of this kind of instrument to build jobs in this State and in every other state.

So, that is what I think about high yield bonds. I think they are marvelous devices to raise capital for a company which can't get it anywhere else.

SENATOR LESNIAK: Senator DiFrancesco?

SENATOR DiFRANCESCO: No questions.

SENATOR LESNIAK: Senator Van Wagner has a question?

SENATOR VAN WAGNER: The investment grade bonds you are talking about, though, are issued as a matter of course in many cases -- right? (Mr. Balog nods affirmatively) I mean in terms of the use of these high yield bonds.

MR. BALOG: Below investment grade, Senator. Do you mean the kind we are talking about?

SENATOR VAN WAGNER: Below investment grade, right, when it relates to an acquisition. I would assume that in order for the issuer to be in a position to issue the bonds and for an underwriter to be in a position to market them, there has to be some type of a credit enhancement along with that bond, even though it may be below investment grade. Is that a correct assumption?

MR. BALOG: Do you mean an inducement for the buyer to buy?

SENATOR VAN WAGNER: To buy, yes.

MR. BALOG: Yes, sir, absolutely.

SENATOR VAN WAGNER: Okay. And, in most cases, isn't part of that inducement the possibility not only of a high yield, but a relatively short period where there is a capital return?

MR. BALOG: I don't think so. I think that most of the buyers of these instruments are institutional investors. They are not speculators, not individuals. They are mutual funds, corporate pension plans, insurance companies--

SENATOR VAN WAGNER: They are not your average everyday shareholder kind of a person?

MR. BALOG: They surely are not.

SENATOR VAN WAGNER: They are really the large--

MR. BALOG: I would say it is a 98-plus percent institutional marketplace.

SENATOR VAN WAGNER: They are primarily the people who are purchasing these high yield instruments -- below-investment-grade instruments--

MR. BALOG: To get a better return for the beneficiaries of their pension plans.

SENATOR VAN WAGNER: To get a better return, enhance their own--

MR. BALOG: I don't know if the State of New Jersey buys them or not, but many pension plans do buy them.

SENATOR VAN WAGNER: But the goal is to enhance their own portfolio.

MR. BALOG: Correct.

SENATOR VAN WAGNER: Is that a correct assumption?

MR. BALOG: That is correct. And, they trade off a perceived, or perhaps even real, higher risk for a much higher return. You generally get a 4% or a 5% higher return.

SENATOR VAN WAGNER: How does the issuer usually retire those bonds; I mean, you know, ultimately that is what the goal is? How do they usually retire them?

MR. BALOG: Generally--

SENATOR VAN WAGNER: I mean, they wouldn't get involved, for example an issuer, in order to retire that kind of a below-investment-grade issue. They wouldn't be tempted to sell off an asset, or anything like that.

MR. BALOG: It's possible.

SENATOR VAN WAGNER: It's possible?

MR. BALOG: Sure. That can happen. If it were a takeover, for example, that would be a very important part--

SENATOR VAN WAGNER: In a takeover--

MR. BALOG: Sure.

SENATOR VAN WAGNER: --situation?

MR. BALOG: Taking a normal course company, it would generally retire the high yield bonds from earnings.

SENATOR VAN WAGNER: Right.

MR. BALOG: Or, it will refund them. If the interest rates when they issued them were 14% or 15% and that is what they paid, and now they can do them at 11%, they will refund them, and we would be happy to do that for them.

SENATOR VAN WAGNER: But, in a takeover, wouldn't you say that-- Generally speaking, in a takeover, the tendency would be to sell off, perhaps, the more valuable of the assets of that company being taken over to retire that debt as quickly as possible.

MR. BALOG: I think the first thing that the successful takeover -- the aggressor does when he does a takeover, is to look over the assets to see which of them are being underutilized, and then he sells them off. He may go to the crown jewels as well, but his first inclination would be to take divisions which were not relevant to the strategic plan of the company, find a buyer, and sell them off.

I think it is important to note that these divisions don't go into a black hole. Those jobs don't disappear. Generally, the people who buy those spun-off divisions are the managements of those divisions. They can probably run the company a lot better than it was run before. The overheads are a lot lower. And, out of those spin-offs, come very, very viable companies in this State and in every other state.

I think the idea of leverage buy-outs -- that is what I am talking about-- Those are tremendous rejuvenating aspects of companies. Many people focus--

SENATOR LESNIAK: And have absolutely no disruptive effect.

MR. BALOG: Absolutely not -- I couldn't say that. I couldn't say absolutely not. But, it's clear that if we get a division that is being owned by the management, generally they

put money into the new company. They mortgage their homes -- wherever they get it -- and they've got capital on the line besides their own sweat and tears. And I think they turn out to be good companies as a result.

SENATOR VAN WAGNER: It seems to me what you have created-- From what I've read, at least the literature seems to indicate that Drexel Burnham was particularly a leader in this field; is tantamount to motherhood and apple pie for the entire economy. It sounds to me from some of the reports I read -- for example, some of the poison pill strategies that you talked about earlier -- the accumulation of debt, and the defensive measures taken and everything by corporations, really, in the long run, are going to have a very positive effect on this economy.

SENATOR LESNIAK: You're not in favor of those poison pill mechanisms? Did you say that?

MR. BALOG: No, no. I think that anything that inhibits the free workings of the business society is a bad idea. No, I am not in favor of poison pills at all.

SENATOR VAN WAGNER: Yeah, but you acknowledge somewhere in your testimony that this, in fact, was available to companies and, in fact, you listed a whole bunch of companies that had already taken on those types of defensive measures.

MR. BALOG: Yeah.

SENATOR VAN WAGNER: So, obviously, whether it is shareholders protection or management protection, there is something occurring there that is saying to corporations that they have to take certain steps, that they might, otherwise, under reasonable management conditions, might not take.

MR. BALOG: Yeah. Senator, you're absolutely right. This gives me a chance to make a point which perhaps I didn't make as well as I should have, and that is the following: The question that Senator DiFrancesco was talking about before,

"Where in the spectrum of defense for corporations does all this fit?" -- in other words, is it a Federal question, is it a State question?-- In my humble opinion, the place where the company can erect all the defenses it needs is at the shareholder level. Poison pills are introduced by shareholders. I happen to think that they are wrong. I think there are too many poison pills that inhibit and defend management. But, if the shareholders want to do it, it is their perfect right to do it.

I believe that most of the anti-takeover provisions that are put in, should be put in by the shareholders through a proper vote. As I have indicated to you, 80% of the S&P 500 have already done it, and a number of your New Jersey corporations have already done it. This raises the question of, why have a State law that covers all companies, when those that need the protection can get it from the shareholders?

SENATOR VAN WAGNER: But, as you pointed out, that really doesn't happen, because most of those little shareholders who we are talking about in these corporations, really aren't little shareholders. These votes are generally taken by institutional shareholders who have control of the largest amount of stock in that particular corporation.

In addition, it would appear, from watching on television -- for example the RCA/Westinghouse takeover--

MR. BALOG: RCA/GE.

SENATOR VAN WAGNER: --the RCA/GE -- I'm sorry, I have Westinghouse on my mind -- which, I guess, was beneficial to all of the shareholders in that company, they were still there at that public meeting -- at that shareholders' meeting -- where that merger was approved-- There were still shareholders there who were very upset with that whole thing.

MR. BALOG: Yes.

SENATOR VAN WAGNER: And yet, they do not have the benefit of any type of law yet; in fact, they had no voice,

apparently, in what was decided before they arrived at that meeting.

MR. BALOG: See, Senator, I think, following your line of inquiry, certain of the shareholders of RCA Corporation were disenfranchised. They were a minority, so whatever happened wasn't to their liking. This bill would make every shareholder subordinate to this bill, which disenfranchises all of them. That is what I find so onerous about this kind of a bill. Every corporation in New Jersey which meets these standards and criteria would be covered by this bill, whether they wanted it or not. Moreover, the assets would be frozen for five years. Moreover, if I bought 11% of a New Jersey company under this bill, and four years from now, or two years from now, you were the board of directors and we decided it would be a good idea if I took over the company, I cannot change it, you cannot change it, the shareholders cannot change it. For five years those assets are frozen.

I think anybody in elected office would love not being called back--

SENATOR VAN WAGNER: But, those shareholders could go to the other members and, through a friendly acquisition--

MR. BALOG: No, not under this bill. I could not combine them if--

SENATOR LESNIAK: If that is done prior, but not after.

MR. BALOG: If it were done before I made my purchase -- if we all agreed it was a good idea for Balog to come and buy into this company -- yes, we could. But if at the time we were hostile, and a year from now we became friendly, I couldn't do a thing and you couldn't do a thing for five years. I think that is a bad idea -- to freeze assets in place that way.

SENATOR LESNIAK: Senator Van Wagner will amend the law if that happens.

MR. BALOG: But, you see, I think it's freezing assets, freezing shareholders, disenfranchising. That is what I object to. Shareholders can do all of--

SENATOR LESNIAK: It will never happen. It will never happen, because, well, you wouldn't be that stupid to buy 11% if this law were in place.

MR. BALOG: Well, exactly, and the company would not get the benefit of the juice that comes from responding to competitive realities.

SENATOR LESNIAK: Doesn't Merck wish now that they gave you the raise? (laughter)

MR. BALOG: It's a marvelous company. They put in a lot of anti-takeover devices.

SENATOR VAN WAGNER: Are they still in favor of this bill?

MR. BALOG: Yes. I can't understand why, to be honest with you. They go back to the shareholders and they get more anti-takeover devices. Do you know why? Because it is a good company. Bad companies need this kind of legislation; good companies do not.

SENATOR VAN WAGNER: It seems to me that just about all of the 124 New Jersey corporations have, by ballot, approved of this measure.

SENATOR LESNIAK: Well, they haven't notified this Committee, Senator Van Wagner. As a matter of fact, two of the largest ones -- Johnson and Johnson and Campbell Soup Company -- have not taken a position at all on the bill as far as this Committee is concerned.

MR. BALOG: Senator, if I were an insider in management, I would certainly do this, too. I would do all that, and some more. Why not? That is the point of it. It is a management protection bill. Why would I be against it?

SENATOR LESNIAK: Is that the same reason you are against the bill as a member of Drexel Burnham?

MR. BALOG: Exactly. I have a vested interest, absolutely.

SENATOR LESNIAK: You know, let's face it. You're here, and everybody else is here because it is the marketplace--

SENATOR DiFRANCESCO: He's like a member of the Trial Lawyers Association coming here on no-fault, right?

SENATOR VAN WAGNER: If we want to argue that point--

SENATOR LESNIAK: All right, wait, wait. I don't know how we are going to get a record out of five people talking at once. No other questions? (negative response) Thank you very much for your testimony.

MR. BALOG: Thank you very much, gentlemen.

SENATOR LESNIAK: I am going to read a letter now into the record from the Department of Commerce and Economic Development, Office of Economic Policy, from Dr. Adam Broner, dated May 12, 1986, stating: "I am authorized by the Economic Policy Council to comment on the proposed new section 7 concerning an evaluation of the economic impact of S-1539." That is the famous proposed sunset provision. That was my own parenthetical there.

"The Council and Office will be glad to provide such an evaluation. However, it will be difficult to find appropriate data as requested in new section 7. Therefore, our evaluation will have to be based on other economic studies of this issue and on the opinion of the Council members." Actually, that is exactly what I had intended them to do -- another parenthetical.

"We also think that our opinion and evaluation would be more useful if provided before the enactment of the legislation." I don't know how we are going to be able to do that, but in light of this letter, I think we should ask them to get on it right away. I'm sure they are not going to have that ready by two weeks from the end of the day.

Okay, thank you, Senator Van Wagner. Now we will have William Van Buren, Vice President, Merck & Co., Inc. Are you any relation to Bob?

W I L L I A M V A N B U R E N: Yes, blood brother. (laughter) I'm speaking for Merck today, however. Good afternoon, Chairman Lesniak and members of the Committee. Merck seems to have been spoken for already, and we will vote for that salary increase. (laughter)

Let me give possibly a more semi-official reaction. I am William Van Buren, Vice President and Secretary of Merck & Co., Inc. It is my pleasure to speak to you this afternoon on behalf of Senator Van Wagner's bill -- S-1539. I urge your support of this important legislation.

Merck is a world-wide organization engaged primarily in the business of discovering, developing, producing, and marketing products and services for the maintenance or restoration of human and animal health. With sales exceeding \$3.5 billion in 1985, Merck places in the top 20% of the Fortune 500. The company's income, before taxes, topped \$857 million. Merck employs 31,000 people world-wide, 4500 of whom presently work in New Jersey. Merck's world-wide headquarters and a major research facility are located in Rahway, New Jersey. The company has additional research, manufacturing, or administrative facilities in Hawthorne, Woodbridge, Three Bridges, and Branchburg. Consequently, we play a vital role in New Jersey's economy.

As a leader among New Jersey's research-intensive health care industries, Merck believes that its economic vitality and the benefits it can bring to mankind depend upon a constant flow of new and better products coming from its sustained research and development activities at the leading edge of science.

Our commitment to long-range research and development is reflected by the appointment in June of 1985 of Dr. Roy

Vagelos, a physician, to the Chief Executive position in the company, after seven years as head of our research and development operations. The continued success of many of New Jersey's health products companies is premised on a similar commitment to major future investments in research and development, and in capital renewal and expansion.

As you know, S-1539 addresses the issue of hostile takeovers of New Jersey corporations and the organizational dismemberment methods used by raiders to retire debt once they have gained control. We in Merck are concerned about the process itself and its potential impact upon our efforts -- yours and mine -- to establish New Jersey as the premier science and technology State.

Even when unsuccessful, hostile takeover efforts directed toward research-intensive companies may be expected to have at least two adverse effects: They can deplete financial resources which otherwise could be directed into research activity, and they can unsettle our principal resource -- our scientific staff.

A creative, innovative staff is at the heart of the efforts of a company like ours to devise novel and effective medicines to alleviate suffering and eliminate disease. Full innovation flourishes best in a stable environment. Hostile takeovers upset the stability of such a group, disrupt scientific programs, and prompt scientists to seek better environs in which to work.

Peter Drucker, a world-respected author on business practices, concerned about the recent rash of hostile takeovers, has just written an article in which he states: "The fear of the raider demoralizes and paralyzes. The impact on the morale of management people and of professional people in a company can hardly be over-estimated. Worse still, after a successful takeover, the morale in a company is destroyed, often forever. The people who can leave, do. The others do

their minimum. Hence, the impact of a takeover on morale is total catastrophe."

He goes on to say, "Clearly, hostile takeovers cannot be justified as leading to a more efficient allocation of resources. The fact that the result of the hostile takeover, almost without exception, is also a demoralization and severe impairment of the human organization, disproves the argument that hostile takeover results in a more efficient allocation of resources. Actually, all it proves is that resources in the modern business enterprise are not primarily bricks and mortar, or even oil on the ground. They are human organization."

In 1986, Merck will increase its commitment to innovation by spending \$450 million on research and development. Well in excess of \$100 million of that amount will be spent here in New Jersey alone. Other New Jersey firms are also spending significant sums on research that will benefit medicine. Our vitality as innovative companies is based on our financial commitment to novel research -- and not on fighting raiders whose primary concern is their own profit.

New Jersey ranks fourth among the states in terms of money its companies spend on research and development. It is the site of dozens of Fortune 500 corporations' research centers. New Jersey scientists hold the third-largest number of patents on a state-by-state ranking. Our State is perhaps best known for the strong presence here of the nation's health care products industry, which does about 29% of its research in New Jersey.

This concentration has benefited the State's economy as well as the corporate bottom line. It has also contributed to the State's distinctive character in business, affecting both government and corporate planning. The network of economic benefits to New Jersey from health products manufacturing extends well beyond the private sector to a variety of institutions -- schools, colleges and universities, hospitals, and other health service organizations.

The 18 major drug firms doing business in New Jersey now comprise the State's largest industry, but the perennial question facing the industry is whether it can sustain a level of financial performance sufficient to continue the heavy commitment to research and development necessary to maintain growth and vitality.

The Shareholders Protection Act is very important in this regard, as it will help keep our earnings available for added support to research-related activities, and will lessen the need to fight off expensive, debt-financed hostile takeover efforts.

Senator Van Wagner's bill does not stop all mergers, but it does encourage potential acquirers to negotiate a proposed merger with the target company's board of directors. The bill sets ground rules which we believe are fair to both sides. So, most important, from the perspective of research-intensive companies and companies that are concerned with the community, the bill creates a stable environment for negotiation and allows both parties to consider the public interest.

Again, as Peter Drucker stated in his article: "The shareholders' interest is important, but it is only one of many competing interests. An enterprise has functions well beyond that of producing returns for the shareholder. It functions as an employer, as a citizen of the community, as a customer, and as a supplier. If the speculator's interest" -- never mind that the speculator has legal title as an owner -- "is the only interest to be considered, the free enterprise system is unlikely to survive. It will rapidly lose public support. Most people, even though they do benefit, however indirectly, from the speculator's game, stand to lose more from the hostile takeover as employees, whether blue-collar or managers, and as citizens of a community. And, more and more people are concerned with the hostile takeover as a moral issue. It deeply offends the sense of justice of a great many Americans."

Again, I urge you to support Senate Bill 1539, and to encourage other members of the Senate to support it as well. The bill is good public policy that will serve the needs of New Jersey, as well as the needs and best interests of the shareholders, employees, and the other important stakeholders in corporate America.

Thank you very much for considering our position on this.

SENATOR LESNIAK: Senator Jackman? Senator DiFrancesco? (no response) Mr. Van Buren, I have two things that really bother me about this bill that I would like to ask you about.

MR. VAN BUREN: Right.

SENATOR LESNIAK: One is, what happens if the day after we enact this bill one of the companies that is given its protection just decides to sell off one of its divisions to some foreign country or other state, and displaces 50, 150, or 500 workers? We don't have any protection for those workers at all, do we?

MR. VAN BUREN: Not in this legislation, sir.

SENATOR LESNIAK: And, this bill does not include any of those protections?

MR. VAN BUREN: That is correct.

SENATOR LESNIAK: Which leads me to my next concern, which is, the same people who are promoting this bill -- who are in favor of this bill -- vigorously lobbied against three months notice to workers.

SENATOR JACKMAN: Plant closings.

SENATOR LESNIAK: Three months notice to workers. Yet, under this bill I can own a company and not be able to-- I am tied up for five years. People behind this bill, including Merck, were against giving workers -- by legislation -- three months notice before they lost their jobs. I have a real hard time accepting one position and then the other.

MR. VAN BUREN: Well, I am not trying to be unresponsive, Senator, but I am not prepared on what the terms and provisions of that legislation were, so I don't know whether there are equal equities on both sides. I understand the point you're making, but I am not equipped to argue whether that was a reasonable and realistic bill in its own right.

SENATOR LESNIAK: You're right; it's unfair to ask you that question because you weren't here testifying against it.

SENATOR JACKMAN: No, but your company-- Excuse me -- with your permission--

MR. VAN BUREN: Sure.

SENATOR JACKMAN: Your company was well notified by -- and I know your industry, because I have checked with Merck on a couple of occasions -- but your company was notified to the extent of what the plant closing bill personified. I'm not saying that you-- You may not have participated, but all of industry was well notified around this State.

At Business and Industry, they do a remarkably good job in disseminating the kind of legislation that comes before this Committee, especially, and they let that get back out to their committees. I guess it is an unfair question to ask you to make an evaluation on it, but I can tell you -- as my colleague mentioned -- it doesn't sound plausible to me that when people want certain things for their "own protection," and then "don't worry about the little guy," the guy who helps to make that so-called company what it is, then it becomes a little disturbing for people who sit in the positions we do. They come to us later on, and say, "Well, Mr. Lesniak, Mr. Jackman, how can you go with that bill, when in essence you didn't pursue our bill to the extent you are doing with this one?" That's the difference.

MR. VAN BUREN: Well, look, I am not trying to challenge what you say about Merck's position. I just don't know what it was based on, is what I am saying to you.

SENATOR JACKMAN: Yes, I agree with you; I agree.

MR. VAN BUREN: Our position here is not to protect the big stiff; it is to protect everybody, including the hourly worker. So, we are not being inconsistent there, I don't think.

SENATOR LESNIAK: But, there is nothing in this bill that prevents Merck from -- and I know Merck is not going to do it; they just made a big investment in my district, so let's not say Merck. But, there is nothing to prevent a company from closing down tomorrow.

MR. VAN BUREN: No, there is not.

SENATOR LESNIAK: Without notifying its employees.

MR. VAN BUREN: That is correct.

SENATOR JACKMAN: The steel company just did it in this State. They notified them at two o'clock in the afternoon, "There's no work tomorrow. We're out of business." One, two, three -- two o'clock in the afternoon -- everybody went home. That's all; that was the end of it. Wiped out; completely wiped out. People had nine and a half years, sum total, going on to their tenth year to get pension coverage -- wiped out.

SENATOR LESNIAK: I think we will have to reintroduce the plant closing bill. Instead of three months, give them five years. (laughter) Thank you very much, Mr. Van Buren. Don't anybody have a heart attack. That's negotiable.

May we have Michael Jensen, a Professor from Rochester University? By the way, this is a summary of his testimony (referring to statement he is holding)

SENATOR DiFRANCESCO: In all the years of being on committees, you have brought more people from the educational community to this Committee in three months--

SENATOR JACKMAN: Professor, if this is a summary, I wouldn't want to see what the whole statement is going to be.

SENATOR LESNIAK: Chris, if you came all the way from Rochester to here, you would want to be heard, so--

SENATOR JACKMAN: Well, I have to be honest with you. Rochester is one of my districts. (laughter)

SENATOR LESNIAK: Okay.

SENATOR DiFRANCESCO: Chris, what isn't your district? What don't you have?

SENATOR JACKMAN: Well, now, it sounds facetious, but that happens to be the district that I cover with my union. I have New York and New Jersey, and Rochester is in my district.

SENATOR LESNIAK: Okay, let's hear the Professor.

M I C H A E L C. J E N S E N: You should see what I can do if I have chalk in my hand. Fortunately, the summary only goes for three pages. I won't bore you by dragging you through all the rest of it.

My name is Michael Jensen. I am an economist and I serve on the faculties of two universities -- the University of Rochester Graduate School of Management and the Harvard Business School. I direct something called MERC -- the Rochester version of it -- the Managerial Economics Research Center at the University of Rochester, and I am a founder and Co-editor of something called "The Journal of Financial Economics," which is one of the leading scientific journals in its area.

I was invited here today by the Securities Industry Association, I gather from conversations with Mr. Davis.

The proposed anti-takeover legislation, the "New Jersey Shareholders Protection Act" -- which I will hereafter refer to as the bill -- does not protect shareholders. It does not protect New Jersey corporations. The bill does protect top-level managers of New Jersey's largest corporations because it shields them from effective competition for their jobs. The bill will harm shareholders and, in the long run, it will harm employees of New Jersey companies by transferring power from shareholders to managers.

During the 50 years since the publication of Adolf Berle and Gardner Mean's book on the modern corporation, there has been great concern about the separation between ownership and control engendered by widespread small stockholdings in large corporations. Corporations were then said to be run by managers who were not owners. Large stockholders were then considered desirable. Now they are a pariah in many quarters, and there is a great longing for something called the "long-term" investor, who, as far as I can tell, is somebody who knows little or nothing about the corporation and doesn't care, because his holdings are, in fact, so small.

The change in these attitudes has come after two decades of development of the takeover market, development which has gone a long way toward solving many of the basic conflicts between managers and boards of directors and shareholders that were properly elucidated by Berle and Means. This progress is now threatened on a number of fronts, including the Shareholders Protection Act which you have before you today. That act -- the very essence of that act -- is a discrimination against large shareholders.

The takeover market is an effective agent for change in corporate America that is increasing efficiency. Imposing the severe limitations contained in this bill will make it difficult and expensive for anyone to take effective control of a New Jersey company, without the permission of that company's board. This will weaken the incentives for efficiency and innovation faced by New Jersey companies. Let me illustrate it with maybe a simple homely point. Let's consider the effects of a "Warehouse Manager Protection" bill that would give warehouse managers the identical powers contained in the current bill. Such a bill would remove many of the forces motivating the renovation and discovery of creative new uses for underutilized warehouses that have been under way throughout this country. Indeed, in the presence of such

blocking powers, developments such as Harborside in Jersey City would be less likely.

Supporters of the bill claim it is designed to protect only against "junk bond bust-up takeovers," which is a great piece of emotional language that, unfortunately, has no analytical or substantive content. Those arguments are incorrect for several reasons: First, in fact, the bill restricts all takeovers not approved by management and boards, not just those financed by debt. Secondly, divestitures are a highly desirable private market force limiting excessive growth and inefficient concentration of assets in corporations. Moreover, divestiture of a subsidiary, division, or plant means that the ownership of the assets changes, not that the assets, and the employees that go with them, are thrown on the junk pile.

Divestiture does not inevitably lead to loss of jobs. In fact, it can result in exactly the opposite, as new life and new management talent and a new corporate strategy are infused in these divisions or plants.

Lastly -- and we can talk more about this -- debt plays a very important, but poorly understood role, in motivating efficiency in organizations that are otherwise wasteful.

I see this bill as one more salvo in a campaign by top-level managers of many of the country's largest corporations to protect themselves from effective competition for their jobs. I think the point was illustrated very well in the conversation and the question I just heard Senator Jackman ask the gentleman from Merck: "Why do you take a different attitude on this bill than you take on plant closing notification?" The point is obvious. This one affects them directly.

There have been a number of studies -- the most recent of which was covered in The Wall Street Journal just last week

by Mitchell and Company -- that indicated that within three years of acquisition -- and, incidentally, this turns out to be independent of whether it is hostile or voluntary -- roughly 50% to 60% of top-level managers are gone. It has become common for these advocates to argue that all we want is a level playing field. The changes that have already occurred in the regulations in this area have tilted the field dangerously in the direction of management, in my opinion. Some of the changes which I have reference to that have already occurred include: Extensions of the offer period under the Williams Act -- some of the other Williams Act restrictions; stringent 13d disclosure requirements -- which give an enormous upper hand to management in these contexts; authorization by the courts for boards to issue poison pills without the vote of shareholders -- poison pills that deny shareholders very important rights; the rights to make discriminatory repurchases that impoverish a potential acquirer -- the kind of thing that was done in the Unocal transaction, and is now being incorporated in many of the poison pills that are being introduced at the rate of-- Well, since November's Delaware decision, something like 150 of the nation's largest firms have introduced such pills; and, charter amendments -- which are voted on by shareholders and, therefore, which I have less objection to, but I will come back to some problems there -- that include fair price, super-majority, and staggered board provisions.

I believe that shareholders, and the public who depend on efficient corporations to deliver goods and services at low cost, can benefit by a shareholders' protection act, but not this one.

If the Senate is interested in protecting shareholders, I recommend that you give very serious consideration to the problems caused by the lack of secret ballots in proxy voting procedures. The problems in this process are directly due to the fact that managers know who

votes for and against every proposal. It has become increasingly clear that top-level managers are using this information to distort the voting process in favor of themselves. They threaten retribution to institutional money managers, banks, and others who vote against management. There was a very interesting report by the Investor Responsibility Research Center in last year's proxy season, which has a fairly extensive discussion of these problems. Some stockholder/employees have told me, in private conversation, that they throw away their proxies rather than face potential retribution from managers who, they believe, are proposing inappropriate changes for the corporation, rather than to risk punishment.

I recommend that you do not implement this bill but, if you must, I implore you to pass one that covers only those firms whose shareholders elect by majority vote in a secret ballot to be covered by the act. And, let them do that at any time, not simply the 45-day provision -- the opt out provision -- that is currently there. If the proponents of the act oppose this secret ballot as a condition for coverage under the act, as I expect they will, I believe it will be clear that the act is not designed to protect shareholders. Its effect will be to exploit them. Given the way the tables are now tipped in favor of management proposals in current proxy votes, managers must believe shareholder opposition is so strong that they cannot get these provisions approved, or they wouldn't be here asking the State of New Jersey to impose them on their shareholders. There is evidence, however, that it can be done voluntarily, since at least one company -- R. J. Reynolds -- has received shareholder approval for charter amendments that impose restrictions that are very similar to those in this bill.

The remainder of my statement contains a discussion of many of the issues associated with the corporate control market, and I think I would like to mention one issue before I

close my formal remarks and take your questions. The so-called junk bonds -- the high yield bonds -- that Drexel Burnham and others have been involved in promoting recently-- This is probably one of the most important changes that have occurred in the capital markets in the last two or three decades. It has gotten a very bad name because of the unfortunate language -- the name -- that was attached to the bonds early on, and because of the activities of some people who want to stop takeovers.

High yield bonds, and their use in takeovers, are not bad. They allow someone -- an entrepreneur -- who sees that an organization is being mismanaged in a way that its assets are less valuable, that they are being employed at a lower benefit, both to the owners of those assets and to society than they otherwise might-- It allows such an entrepreneur to make an offer for that company, and to finance it in the same way that you and I finance the purchase of a house. Nobody would say that when we buy a house and go to the bank -- we sign a purchase offer for a house and go to the bank to get financing, and put up the house as collateral on the issue, that that is a junk bond. And yet, that transaction is identical in structure to the use of high yield debt in takeover transactions, which, incidentally, has not been very much. But it is the possibility of that financing which, in fact, removes mere size as a defense against takeovers, that has so drastically upset the CEOs in the very largest corporations in this country.

It wasn't until Boone Pickens' takeover attempt on-- Actually, it wasn't a takeover attempt. He wanted Gulf Resources to turn itself into a royalty trust. The fact that he could get the financing to make it a viable threat shocked the business round table -- a group of people who generally I don't disagree with very often.

Furthermore, it is very important to understand that these takeover activities are a very important external force

that motivates change, which is never easy in a large organization. You see it in your own organization in the State government of New Jersey, I'm sure. We have it in New York State, and I'll guarantee you that it exists at Harvard and Rochester, and any large organization.

The shock that can come -- and it does upset people, but we never get anything for free -- from an outside offer -- an unsolicited offer, can be and has been of enormous benefit to revitalizing companies which had become sleepy, been stuck in strategies that were no longer appropriate, and who were busy eroding their franchises and not doing the State of New Jersey -- if it happened to be here -- or any other state that they were located in, or their employees any good.

High yield debt can play an important role, although a very small one, in doing that. Debt, itself, can play a very important role in helping top-level managers in such organizations who face tremendous opposition from middle-management people to cut out wasteful expenditure programs, in fact, to institute those efficiencies.

We don't very often hear people arguing in favor of debt, and I thought it was important to add it here. Let me stop here. I would be happy to answer any questions you might have.

SENATOR LESNIAK: Any questions?

SENATOR O'CONNOR: Professor, your suggestion that before the bill is implemented there be a secret ballot by the shareholders-- Isn't it true that most corporations are controlled by institutional shareholders?

PROFESSOR JENSEN: That's an assertion that is often made. The fact of the matter, though, is, it simply isn't true. I have spent -- in the last year or two -- some time talking to institutions about the processes that are involved here. The costs to these individuals are so high that they refused to allow their names to be used. The horror stories I

hear of the raw use of power by CEOs and chief financial officers in proxy contests to force institutions to vote in the way that they want to vote--

Now, they cannot put that pressure on all institutions, and if you look at the ones that are able to be independent-- If you find them and they speak out in public, it affects the investment banking community as a whole as well. Drexel is probably the only one that is brave enough to come down here. Nevertheless, they all feel the same way about this bill.

The only institutions that really are not subject to these pressures are public pension funds, and it is not by accident that you see the Council of Institutional Investors primarily composed of those organizations -- organizations like College Retirement Equity Fund, which has my pension, but doesn't answer to anybody, and other university nonprofit kinds of organizations. Even those, though -- I have spent time talking with them -- are subject to non-trivial retribution that causes some of them to be unwilling to speak out and, what is more important, to vote their proxies in a way that they believe is in line with their fiduciary responsibilities.

The reason that even some of those are afraid to vote it -- although there is no threat of direct removal of business relations, as there is in the case of pension fund management -- has to do with the fact that top-level managers often threaten and will institute policies to refuse to talk to their security analysts, and to refuse to make them part of the normal flow of information, which substantially handicaps their task. This is a big problem, and I don't see any way to solve it other than through the institution of a secret ballot. I am very reluctant to call for legislation to impose it on people. I much prefer to see it happen voluntarily, and I think there are ways to begin to get that ball moving.

But, if you were to pass a bill like this -- and if you really are concerned, as I think you are about shareholder welfare, as well as jobs -- give very serious consideration to making an opt-in provision. It is very important there, then, to make it subject to a secret ballot, and we will find that this market works much more effectively.

SENATOR JACKMAN: Let me ask you one question on that secret ballot. How could you have a secret ballot vote? Would it be a weighted vote? If I owned 150,000 shares of a stock and you owned one share, are you going to have the same vote as I have?

PROFESSOR JENSEN: No, no, no. You would make the secret ballot simply by having the trustee who normally accumulates the proxies and votes--

SENATOR JACKMAN: But, it's not a secret. If I am going to--

PROFESSOR JENSEN: I understand. I understand, Senator Jackman. It's perfectly legitimate. The only people it need be secret from are the managers of the company.

SENATOR JACKMAN: Oh.

PROFESSOR JENSEN: You do obviously have, because of the weighted voting -- one share/one vote-- You can't have me send something in which doesn't have my name on it. It has to be identified -- absolutely. Now, maybe you want to have bank trust departments do that; maybe you want to have a public accounting firm. Price Waterhouse is good at things like that. There are all kinds of ways to get it done, and at not very much expense.

SENATOR LESNIAK: I'm glad to see they are good at something -- not at computers.

PROFESSOR JENSEN: Yeah.

SENATOR O'CONNOR: But, getting back to my original question, if the majority of shareholders are institutional shareholders, as opposed to individuals, your suggestion

wouldn't, in any way, protect the real shareholder. Am I right? I mean, the institutions could still control how the election came out.

PROFESSOR JENSEN: I understand. Let me try to meet that. The institutionalization of the equity markets is a very important phenomenon that has been occurring. I think it is a very desirable one. The reason it is desirable is because if we were to go back 30 years, or 40 years, to a situation in which there were very little institutional holdings, and look at the situation when you had widely diffused small ownerships, the kind that concern Berle and Means in their book -- as I said before, people with small amounts -- you had people who were holding the equities directly with small amounts of money in any individual company, relative to what institutions have today, and people, who were doctors, lawyers, truck drivers, whatever, who did not have very much expertise in evaluating the kinds of proposals and changes that we are talking about here.

Now we've got-- Two things have happened, for various reasons having to do with the fact that it is much more efficient to do it this way. Those resources are still being held in the interest of those individuals, but they are in the hands of institutions which specialize, with experts, in both doing the investment -- the buy/sell decisions -- and, now, the evaluation of the kinds of proxy proposals that come before them.

Those organizations have-- For two major reasons, they will be better at doing that voting than individual shareholders -- the small shareholders of 20 or 30 years ago. The reason is why? They have much larger positions; therefore, it pays them to invest the non-trivial time and effort to find out how to vote -- what really are the implications of their votes. Second of all, they have people who are experts at it. The result is, we will get a much better system if it is

allowed to work. What has happened, though, is that because of that evolution and because they are not only acting in a fiduciary responsibility to the beneficiaries of those funds, but they are also acting as agents for the CEOs or CFOs through the pension plans and other kinds of relationships, for many of the same companies.

That puts them in a very severe conflict of interest, in which they cannot exercise the fiduciary responsibilities without threat of retribution. Frankly, I didn't understand until a year or a year and a half ago what an important problem this is. It is a major problem. Mark my words, it will become, obviously, a much more major problem in public discussions over the next year.

SENATOR LESNIAK: Professor, you said that hostile takeovers target mismanaged corporations. That is not always the case.

PROFESSOR JENSEN: Absolutely not. Somehow the way I put that-- I mislead people. Oftentimes, organizations that are recipients of hostile -- unsolicited offers are organizations that have fine managers and which are in basically good shape. It may be, though, that somebody else perceives that there is a way to use those assets -- a completely different way. It doesn't mean that the managers are incompetent. They are doing a fine job of running them as they currently are, but it is a way to change the use of those assets that will benefit both themselves and everybody who is involved.

I spent last Thursday at a conference at the National Bureau of Economic Research in Cambridge -- all day. At times I thought maybe it had been organized just for me, because I have ended up speaking on these issues on the unpopular side, at least it seems to me, quite a bit. That conference was designed to have some of us who have been working on these topics -- to give us an opportunity to listen to CEOs of

companies which had been taken over in the last four or five years. There were four of them there to talk in a very personal way about what had happened and what went on. It was a very educational day for me and, without revealing confidences, at least let me tell you that three out of the four CEOs who were there, when they got finished telling their stories, basically made it very clear that the takeovers -- one had been involved in two companies that were taken over -- but the takeovers basically benefited their companies, even though they lost their jobs. They chose to leave, not that they were fired.

In one case, the individual who had been involved in two, simply said, after the fact, that he then realized had the takeover not occurred, both of those companies would have gone right down the tubes; that at the time they got done, or right after they got done, things became clear to him -- by his own words -- that he didn't see because he was a zealot. He was committed. Things became clear to him that made it obvious that both of those companies would go down the tubes if they had stayed under his control. He was a remarkably brave man to say this.

On the other hand, in their summary remarks, all of them opposed hostile takeovers, even though three out of four of them said it was basically good for their companies.

Now, I don't find that surprising. It's easy for me to say this, having tenure not in one place, but in two places-- Tenure is something that I have also opposed. When it was first given to me at the University of Rochester 15 years ago, I resigned it. They didn't know what to do with me. I resigned it for the same reasons that I am making a plea for not shutting off this takeover process.

There are problems in the process. There are costs in the process. Nothing comes for free. But, when you are considering a bill like this, and especially when the people

who are promoting it to you are the top-level managers, there is no evidence that I know of -- maybe it is true, but there is no evidence I know of that indicates that plant closings and layoffs are associated, in a disproportionate way, with situations where there have been acquisitions and takeovers. There is some evidence -- we are only now beginning to get the numbers-- There is some evidence that they are not. I expect that when we see things unraveled and we really get a clear-cut studies-- Unfortunately, it will probably take a couple of years, because the numbers are very hard to get. I expect we are not going to find that prohibiting takeovers does anything to save jobs.

I also believe -- and I think it is going to be much harder to document this because of the subtleties involved-- I also believe that by enacting a bill like this, which builds brick walls around these companies, you are going to set in place -- almost in concrete -- a set of managements that, while they may be very good now-- New Jersey companies are not companies that are, in my short study of the problem, especially liable to takeovers. While they may not be subject to it now, you are removing a very potent force that keeps them on their toes, and that will not do your constituents good.

SENATOR JACKMAN: You and I don't know -- and I don't think any one of us could be an authority on this -- that if I want to make a deal with you for a takeover, I can make a deal on the basis that you say to me, "In order for me to take you over, you shut down your plant in Edison, and you shut down your plant in Rochester. Then when you do that, then we will talk about a takeover." Now, that's been done heretofore on plant takeovers.

I'll tell you how I know it, because I was part of it. Understand? Because I happened to be where companies took over a paper mill. They said, "You shut your mill down in the South. You shut down the one up in Albany, New York, and then we will take you over."

PROFESSOR JENSEN: This was a voluntary acquisition.

SENATOR JACKMAN: Well, sure, but the point I am trying to make to you is, somewhere along the line-- I don't want to be facetious when I say this.

PROFESSOR JENSEN: That's all right.

SENATOR JACKMAN: You don't recommend this bill as you see it now. Is that right?

PROFESSOR JENSEN: Yes. I don't.

SENATOR JACKMAN: What would you -- as a Professor of Economics, with a good background and everything that goes with it-- What would you suggest? What would you recommend to a Committee like this, which is endeavoring to do something that we think ought to be corrected? What would you recommend?

PROFESSOR JENSEN: I would pass a bill that would provide for effective secret ballots for shareholders. By doing that, you could do more to ensure the vitality, the vibrancy, and the further growth of the companies in New Jersey, than anything else I can imagine. It would have a huge effect.

SENATOR JACKMAN: Would you support a plant closing bill?

PROFESSOR JENSEN: Would I support a plant closing bill? What do you mean by a plant closing bill?

SENATOR JACKMAN: In other words--

SENATOR LESNIAK: Mandatory notice.

SENATOR JACKMAN: Mandatory notice to the employees before you shut the plant down -- like a small period, six months.

PROFESSOR JENSEN: Well, I haven't studied plant closing bills like I have studied takeovers. My reaction to that -- and I urge you not to take it too seriously because it isn't the product of a large amount of study -- would be that we would want to be very careful about passing a law which seriously inhibited the shutting down of plants which were

uneconomical. Businessmen -- nobody, to my knowledge -- do not very often shut down profitable plants. That doesn't make sense. You might want to pay attention to whether or not there is appropriate compensation, and whether or not there is appropriate help in aiding people to go back into the labor market.

The essence of shutting down a plant, though, is to release those resources so that they can move to higher valued uses.

SENATOR JACKMAN: But, who makes that decision?

PROFESSOR JENSEN: The people who are bearing the costs of keeping it open.

SENATOR JACKMAN: No disrespect, Professor -- I don't mean to interrupt you -- but you don't remain open, or you never even got where you were without me being in that plant making that product that you were selling.

PROFESSOR JENSEN: I understand.

SENATOR JACKMAN: So, evidently, nobody puts a value on me until it comes down, again, to that dollar sign -- "the dollar sign" that says, "Well, now, let's move out of Jersey," or, "Let's move out of New York. The energy costs are going to be cheaper down South, and the hell with them up here. Close it down and move." No secret ballot vote. No nothing. Down they go.

PROFESSOR JENSEN: Well, it's true that that problem will not be resolved by a secret ballot vote. That is a different issue. It's the kind of-- If you had a secret ballot, I think you would have far more companies that would never get to this position. Many times, when plants get in that situation, it is not the fault of the people who are out there working on the line. It is the fault of the managers, who followed bad policies, who got the thing so far underwater that it was impossible to bring it back.

SENATOR JACKMAN: Yeah.

PROFESSOR JENSEN: What I am arguing is that this bill-- I don't believe any of you or, in fact, any of the proponents want the bill because it will do this. I believe it will do this, and the results won't be attractive. It won't happen next year.

SENATOR JACKMAN: I like what you say. I would like to have the secret ballot vote, with the people voting to get rid of the general managers. (laughter)

PROFESSOR JENSEN: There is a lot to be said for that.

SENATOR JACKMAN: Maybe that might be the--

PROFESSOR JENSEN: In Rochester, we have been going through some major readjustments with Kodak and Xerox with major cutbacks. Those organizations--

SENATOR JACKMAN: I know you have. I know. I make the-- In case you don't know it, Professor, we make the boxes. Everything that Kodak makes, we package. That is the industry I am in charge of.

PROFESSOR JENSEN: I see; I see.

SENATOR LESNIAK: Maybe you guys can negotiate a contract.

SENATOR JACKMAN: No, no.

PROFESSOR JENSEN: Anyway, they have followed very enlightened and, I think, sensible policies for very good reasons. The people they have been laying off have gone out with substantial warning, in general, and substantial separation benefits -- their own little golden parachute, so to speak. And, the economy seems to be doing very well in the environment. Those people are finding new jobs in other organizations, and it has been healthy. I don't think it has been as major an adjustment as I think parts of New Jersey has faced. But, it is possible to do that, and do it in a way which accomplishes this shift, and which generates social benefits, which are of non-trivial amounts, without imposing undue hardship on individual employees who had nothing to do with getting it there.

SENATOR LESNIAK: Senator Cardinale, you are curiously silent today. No questions?

SENATOR CARDINALE: I haven't been here for very much of the hearing, Mr. Chairman. No questions.

SENATOR LESNIAK: That wouldn't have been on the record but for your saying it.

Thank you very much, Professor Jensen.

PROFESSOR JENSEN: Thank you.

SENATOR LESNIAK: Dr. Glenn Yago, Labor Economist, State University of New York. (inaudible comment by Senator Jackman) Do you know Dr. Yago?

SENATOR JACKMAN: No, I don't know him.

SENATOR LESNIAK: Do you know Senator Chris Jackman?

SENATOR JACKMAN: No, he doesn't know me. I went up to their labor courses at the State University. They have good courses, yes.

SENATOR LESNIAK: Oh, wait until you hear this.

SENATOR DiFRANCESCO: You took courses up there?

SENATOR O'CONNOR: It's a 14-week course.

SENATOR LESNIAK: Dr. Yago?

D R. G L E N N Y A G O: Thank you, Senator. Let me introduce myself a little bit more.

SENATOR LESNIAK: May we have a little quiet in the room, please? (audience complies)

DR. YAGO: I am a member of the Management Faculty at the State University at Stony Brook, and Director of the Economic Research Bureau there. I have a Ph.D. from the University of Wisconsin. This is my colleague, Gelvin Stevenson, who is a Research Associate at the Economic Research Bureau, whose Ph.D. is from the University of Washington in St. Louis. He covered economics and corporate finance at "Business Week" for seven years, and is Research Associate with us on this project, and other projects at the Economic Research Bureau.

Our Bureau has been involved, over the last two years, in a study that was sponsored by the National Science Foundation on the causes and consequences of plant closings. I spent last year as a Marshall Fellow looking at economic adjustment policies in the European community, and other economic adjustment problems in other states in this country.

We have completed a report on the problems of plant closings and corporate reorganization for the Director of Economic Development and the Industrial Cooperation Council of the State of New York, and are just completing a soon-to-be-released strategic plan entitled, "Project 2000," which was commissioned by the Governor and the State Legislature in New York.

The Securities Industry Association asked us to look at the empirical experience -- at the factual experience of takeovers, mergers, and acquisitions in New Jersey. The type of picture that really emerges from our study, I think, provides, hopefully, some basis to inform your decision-making at this point.

SENATOR LESNIAK: May I ask you a preliminary question?

DR. YAGO: Yes, sir.

SENATOR LESNIAK: Did you do a similar study for New York?

DR. YAGO: Interestingly enough, we have done this over the last six months. We have looked at mergers, acquisitions, takeovers, and the like, in anticipation-- If you are referring to the anti-takeover measure that was enacted in New York, the answer is "no." We were asked our opinion, and the opinion I gave to the Department of Commerce at that point, is similar to the opinion that I will give here. Unfortunately, however, no empirical study at that time -- last summer; I am referring to last July -- was commissioned, though I did recommend it, as you might imagine.

SENATOR JACKMAN: I notice in your statement that you took over one of my companies -- one which I referred to before.

DR. YAGO: At the Economic Research Bureau, we are not involved in takeovers. (laughter)

SENATOR JACKMAN: No, no, I'm just saying-- It's funny that my friend on the other side there mentioned the fact -- and I notice in here that the Boorum & Pease Company--

DR. YAGO: Which one is that -- I'm sorry?

SENATOR JACKMAN: The Boorum & Pease Company -- it says "an acquisition." I know that was one of my companies.

DR. YAGO: Right.

SENATOR JACKMAN: And it was taken over. It's ironic that-- That company, of course, is shutting down their installation over here, and moving South. I was talking to you about it. Okay? It's funny that you mention this, and here it is. It's in his statement.

DR. YAGO: Well, we have a list -- as you will see in the tables there-- that includes all of the major acquisitions that we covered in the study. Basically, what emerges is that the popular image of voracious corporations gobbling up one company after another, liquifying their assets, laying off workers, and dominating markets is largely a myth. If we look at the structure of corporations within the country -- and within New Jersey -- the average concentration levels have remained relatively stable, and the market share of the largest corporations have been eroding.

Merger and acquisition activity, and takeovers, are a response, not a cause of structural economic changes in technologies and international markets that are occurring. Merger and acquisition activity is a means of restoring international competitiveness, by extending product lines, creating efficiencies within different firms, obtaining larger shares of the market, leading toward larger and better new product development, improvements in distribution, and the like.

If we start, I think, to try to de-mystify what merger and acquisition activity is, and try to understand its impacts,

we find a number of types of merger and acquisition activities that occur. Many of these combinations can increase competitiveness -- and I think that point has been made here repeatedly -- and not diminish it. The one we are currently observing -- a hostile takeover in the Sperry Burroughs case -- is a typical example of an industry that has been dominated by IBM, and the possibility of a combination within that case may lead to a greater chance of competitiveness of a Sperry Burroughs combination, than any one would have been able to alone.

Acquisitions are really an attempt, and work toward trimming down the type of corporate girth that has emerged in a number of firms, that hides a multitude of sins and has led to a lack of competitiveness in U.S. industry. New Jersey, like many other states, is in the throes of a major economic transformation. From 1980 to '85, total employment increased by 11.7%, but at the same time manufacturing employment fell by 7.9%, costing the State 62,000 jobs. Permanent layoffs occurred 913 times during this period because of plant closings, contractions, or relocations, idling 95,215 workers. There was no evidence in our sample of plant closing occurring as a result of a hostile takeover. Only six of the firms that we looked at -- six of the takeover transactions that we looked at -- were hostile. None of them would have been covered under this legislation in terms of being incorporated and headquartered within New Jersey. So, if this legislation had been in effect, it would have had no effect, basically only a symbolic reaction to what is a fundamental economic restructuring problem within the State.

The transition that is occurring occurs as a result of increased international competition, high value of the dollar, changes in technology, and not by merger and acquisition activity. According to original survey data, less than 1% of the total jobs lost in New Jersey were associated in any way

with acquired firms and, again, I would like to emphasize that none of those were hostiles or unfriendly.

There is no evidence that the change in ownership had anything to do with these reductions in employment. Acquisitions increased the wealth of owners and stock in New Jersey firms by \$1.2 billion. Merger and acquisition activity involving New Jersey firms made up only 2.2% of the total number of transactions in the country at large, and only 1.9% of total U.S. transactions. Most of New Jersey merger and acquisition activity was friendly, reflecting the mutual economic benefits of consolidation. Moreover, the merger and acquisition activity that did occur in New Jersey was concentrated in the hard-head manufacturing sector, and only 21% of New Jersey jobs are in manufacturing. The 55.6% of major merger and acquisition activities in the State occurred in manufacturing.

In some instances, selling the plant to new owners was clearly an alternative to closing the plant and laying off workers. More generally, merger transactions appeared to facilitate the adjustment to structural change, and help restore industrial competitiveness in some of the cases we examined.

Increasing State takeover regulations is, we believe, an ineffective way to prevent plant closings and retard job loss, this according to international domestic studies, as well as the evidence we found in New Jersey. The preferred strategy is to integrate legislative responses into a broader program to assist and to enhance structural adjustment. Takeovers are not done largely in order to shut down a company, but in order to operate it more efficiently. Merger and acquisition activities are an alternative to plant closings in many cases. Basically, to try to look at takeover regulation as an instrument for job retention is, I believe, an ineffective and meaningless approach to the problem.

States have granted corporations ample opportunity to defend themselves, as I think has been amply discussed here today, and states should not prevent corporate takeovers or mergers that may result from inefficiencies or changing corporate strategies and market conditions. Well-formulated policies should interact, not interfere with market forces.

That is basically the substance of our statement here today. My colleague, Dr. Stevenson, could certainly elaborate a little bit on some of the employment cases that you may have questions about.

SENATOR LESNIAK: Your study doesn't distinguish between hostile takeovers and friendly ones, does it?

DR. YAGO: Yes, sir, it does.

SENATOR LESNIAK: What are your conclusions on that distinction? You probably testified to that -- I'm sorry -- but could you repeat it if you did?

DR. YAGO: Oh, that's okay. Basically, no hostile takeovers were associated with plant closings.

SENATOR LESNIAK: You're talking about New Jersey?

DR. YAGO: In New Jersey.

SENATOR LESNIAK: How many hostile takeovers did you look at?

DR. YAGO: We looked at-- Out of the total sample, only six were unfriendlies.

SENATOR LESNIAK: What was the total sample?

DR. YAGO: The total sample we were looking at -- that we studied in-depth -- was 61, 51 of which were completed successfully. Only six of those 51 which were valued at over \$35 million and accounted for a little bit more than half of the total merger and acquisition activities within the State, were the ones we looked at closely.

SENATOR LESNIAK: How did you choose your sample?

DR. YAGO: Basically, we looked at all merger and acquisition activity in the State.

SENATOR LESNIAK: From when to when?

DR. YAGO: From 1978 through 1985.

D R. G E L V I N S T E V E N S O N: For which there is public data available. One can never know. I mean, the State does not have any independent list of those, so we had to go with the sources that were there. Then we picked the most significant -- the largest ones of those to focus on in-depth.

SENATOR LESNIAK: Senator Jackman?

SENATOR JACKMAN: No, thank you.

SENATOR LESNIAK: Senator DiFrancesco?

SENATOR DiFRANCESCO: No.

SENATOR LESNIAK: Senator Cardinale?

SENATOR CARDINALE: No.

SENATOR LESNIAK: I'm sorry, you had something to add, Dr. Stevenson?

SENATOR JACKMAN: That was a good report.

DR. YAGO: Thank you, Senator.

DR. STEVENSON: No, I think Dr. Yago hit the things I--

SENATOR LESNIAK: You should give it to Governor Cuomo.

DR. STEVENSON: Excuse me?

DR. YAGO: He's getting a copy.

DR. STEVENSON: Tonight, I think.

We agree that the plant closings and permanent layoffs are a critical problem, and there are times when mergers and acquisitions, you know, are associated with companies that have layoffs, and times when mergers and acquisitions are associated with companies that have employment growth.

SENATOR JACKMAN: I have no problem with that because it is part of my contract. You shut me down, you pay me-- For every year I worked there, you pay me one week. You pay me one week for every year, right up to date. That's number one. If I'm there 20 years, that's 20 weeks for which I get paid. And, anybody who served less than 10 years-- You've got to pick up the difference between the fifth year and the tenth year in

pension programs, so that person has coverage. So, you don't shut me down at nine and a half years, and then shove it to me. I have it in the contract that after five years-- By the way, it's ironic, the Federal government is now going to come up with a five-year program, instead of 10 years, for vesting rights. It's going to be a five-year vesting. It's ironic. We already have five guaranteed, you've got to pay 10. So, we covered that. Boorum & Pease is one of them; that's why it's funny that it is in this book that you--

DR. STEVENSON: They lost some headquarters staff.

SENATOR JACKMAN: Yes.

DR. STEVENSON: Are they closing down the warehouse, too?

SENATOR JACKMAN: Yes, they're closing down the warehouse, too.

DR. STEVENSON: But not manufacturing?

SENATOR JACKMAN: Not manufacturing, no. Manufacturing-- They cut me back, and I can accept that. You understand? I understand their reasoning. When you are talking in terms-- I am not being disrespectful, but when you are talking in terms of the rentals in New York today, you know, in some of those factories-- They were paying \$3 and \$4 a square foot, and they're now making them waltz, and they are getting \$17 to \$35 a square foot.

DR. STEVENSON: Are those the ones in Brooklyn that are moving over here?

SENATOR JACKMAN: Yeah.

DR. STEVENSON: They're moving to New Jersey, right?

SENATOR JACKMAN: That's what we are going to do, yeah. We are going to move to Jersey. You know, I'm not selfish. I'm just only doing that--

SENATOR LESNIAK: Sounds good to me. Thank you very much.

Raymond Sweeney, Sheet Metal Workers' National Pension Fund and the Council of Institutional Investors.

RAYMOND SWEENEY: Mr. Chairman, fellow Committee members, members of the staff: I am grateful for the opportunity to speak with you this afternoon.

SENATOR LESNIAK: Do you have a prepared statement?

MR. SWEENEY: I do not, but I will provide one for you.

As noted by the Chairman, my name is Raymond Sweeney. I am neither an investment banker--

SENATOR JACKMAN: Automatically, that is a good name.

SENATOR LESNIAK: I wasn't the one who said that, now.

MR. SWEENEY: Nor am I a college professor.

SENATOR JACKMAN: My mother was a Carrigan.

MR. SWEENEY: Nor a president or a CEO. I hope I can share with you, perhaps, a different perspective on the issue that is now before this Committee. I am, however, the General Counsel for the Sheet Metal Workers' National Pension Fund, a multi-employer pension plan representing approximately 150,000 sheet metal workers throughout the United States. The plan now has assets in the vicinity of \$1 billion, and represents approximately 5000 sheet metal workers in the State of New Jersey.

SENATOR DiFRANCESCO: Does Chris Jackman represent those people, too?

SENATOR LESNIAK: No.

SENATOR JACKMAN: I know them; they are a good group. They're good friends of mine, so don't talk.

MR. SWEENEY: I am also a member of the Council of Institutional Investors, a group of approximately 40 members with aggregate assets to the tune of \$160 billion.

However, today I am not here to speak on behalf of the Council, nor am I presenting you with the views of the trustees of the Sheet Metal Workers' National Pension Plan. On the contrary, I will try to share with you one concern I have with respect to your bill. As has been noted here today, I spoke to Governor Cuomo a year ago -- unsuccessfully, unfortunately.

My concern is a very simple one. My analysis of mergers and acquisitions is somewhat identical to the Professor who spoke prior to my speaking. In fact, I had the opportunity to review the Professor's report prior to its submission to this body. If plagiarism is the greatest compliment there is, the Professor may note that some of my comments are very similar to those that you will find in his report.

When I spoke to Governor Cuomo over a year ago, my position then -- however, without the empirical data -- was that mergers and acquisitions do not have a detrimental effect upon a state's economy. They do -- we have found in the sheet metal industry -- have two effects: One, in representing the participants in the pension plan, we increase the assets in the plan; and two, we find that the open marketplace increases job opportunities for our members.

We look at mergers and acquisitions -- or hostile takeovers -- from two perspectives at the same time: One, we are representing the beneficiaries of the pension plan. That is our primary interest. However, if our members do not have jobs, there is no money flowing into the pension plan. So, we have a dual purpose when we analyze hostile takeover provisions.

My fear is very simply this, in a nutshell: When you have a generalized restrictive regulation on corporate mergers and acquisitions, it is inappropriate, because you are going to be penalizing the good as well as the bad. The appropriate way, I feel, to deal with economic problems, is not to legislate a certain problem out of existence; it is to attack it directly. Legislating an end to takeovers, for example, may only reduce investment in this State, and I believe, will lead to inefficiencies and the reduction in the competitiveness of your corporations.

Efficiency and competition are adjustments which I believe can and should be made more efficiently by participating in, and facilitating capital and labor market

adjustments. What does that mean essentially? Labor and management getting together. They realize there is a problem, and each one of them realizes -- to use the parlance of the street -- that each one has its own stick. Management knows they are there at the behest of the shareholder. And, when you take away the strength of the shareholder -- and in my case, the shareholder is not -- as many people have said today -- an institution-- An institution, yes; on paper the Sheet Metal Workers' National Pension Fund. But that institution represents 150,000 small shareholders, and that institution uses its stick, namely its \$1 billion worth of assets.

So, I think it is a misnomer, or perhaps people mislead others when they say, "All these stocks are owned by institutions." But, go beyond the institution, I submit to this Committee-- If you go beyond the institution, you have 150,000 small shareholders. That is the entity that I represent.

To emphasize once again, policy responses to structural economic changes in firms, industries, and regions rely too heavily upon restrictive regulations that embed market rigidities in labor and capital markets. I interpret that as saying essentially, "When you have a bill which entrenches management, labor cannot exercise the muscle -- as weak as it may be at times -- as it should. In this case, you are taking away the right of 150,000 sheet metal workers to exercise their right in voting their shares. Once you do that, you are, in effect, not stripping the institution of its power; you are stripping the individual shareholders.

I submit that takeover regulations, such as are being posed in the bill now before this Committee, are, at best, redundant. Given the self-protection corporations have themselves inherently -- in corporate governance -- they do not need your anti-takeover legislation. I also submit that at worst, anti-takeover legislation attempts to ascribe a very

simple and a single clause to plant closings and job losses that are misleading, and result in symbolic, I submit, rather than substantive policy changes to deep-rooted economic changes within an industry.

In closing, I would like to submit to this Committee one note that wasn't even in the remarks that I was going to prepare, but came up again and again. It appears that people think that when an institution holds the stock, an individual does not. I submit that that is wrong. In my case, in particular, as I am noting, we have 150,000 members. Yes, the stock is owned by the Sheet Metal Workers' National Pension Fund, but when you take away that stock's right to remove management, or you take away the value of that stock when you do take away its break-up potential, you are taking away the value to the individual shareholder -- the individual, in my case, the sheet metal worker.

SENATOR LESNIAK: Are the sheet metal workers an independent member of the AFL-CIO?

MR. SWEENEY: They are affiliated with the AFL-CIO.

SENATOR LESNIAK: The AFL-CIO has come out in favor of this legislation.

MR. SWEENEY: Well, the AFL-CIO also came out in favor of Governor Cuomo's legislation, and we opposed it for two reasons: One, we do not think-- I should put it in the positive. We think that anti-takeover legislation decreases job opportunities, and it also decreases the value of the stock.

SENATOR JACKMAN: What would happen on a takeover of one of the companies you are dealing with where, for example-- You have the vesting right after 10 years, I assume, like everybody, or do you--

MR. SWEENEY: We have immediate vesting -- one year.

SENATOR JACKMAN: One year. Well, then, you are ahead of me. I have five. In other words, you have vesting after one year?

MR. SWEENEY: Yes.

SENATOR JACKMAN: And the individual (indiscernible) are vesting on jobs all around--

MR. SWEENEY: All over the country.

SENATOR JACKMAN: All over the country. So, there is no big problem on that one on a plant closing, because all he does is just go to the next company, and they pick it up.

MR. SWEENEY: I wouldn't want to mislead you though, Senator. Some companies -- for example, Carrier Corporation, Lenox Industries -- have their own pension plans where there is no quotability of credits.

SENATOR JACKMAN: Okay.

MR. SWEENEY: But, the majority of the--

SENATOR JACKMAN: I have the same thing with Crown Zellerbach and I.P.-- They have their own pension programs. But, when I say, in essence, nothing is less than five years, even they have to abide by our five-year thing. You don't have quotability there; we don't have quotability. I want you to know that, too. I gotcha, okay.

MR. SWEENEY: The majority of our employers do contribute to the national plan, not to individual employer plans.

SENATOR JACKMAN: Yeah, I gotcha. Okay.

SENATOR LESNIAK: Senator O'Connor?

SENATOR O'CONNOR: But, isn't there, Mr. Sweeney, a difference between the investor you are talking about, who is part of the institutional investors, and the average guy on the street? Let me try to tell you how I perceive that there is a difference. If I'm wrong, correct me. If it has been answered already, forgive me, because I have been in and out.

The person who is one of the individual shareholders -- part of an institution -- isn't it true that basically what he is interested in, primarily, is getting the most money for his share?

MR. SWEENEY: Yes, I would say so.

SENATOR O'CONNOR: Yeah. And the other guy, who may be, you know, the average guy on the street kind of investor-- Doesn't he have an interest not only in the share, but perhaps in the continuity of that company, and the company staying in business?

MR. SWEENEY: Would this be a shareholder who is also employed by that company?

SENATOR O'CONNOR: Well, it could be.

MR. SWEENEY: I guess if you had that dual loyalty, one, the value of the share, and the continuity of the company, in that case, I would agree with you. But I think the average shareholder who-- Let's say Raymond Sweeney owned five shares of Carrier Corporation. I would be more concerned with the value of the stock, as opposed to whether Carrier Corporation remained in Syracuse, where it is today, or in Taiwan, where it is moving most of its operations.

SENATOR O'CONNOR: So, in the situations that this bill is directed to, where there is a raid, and the ultimate purpose is to liquidate the company, don't you see a difference in the interest that the individual -- the person who I am calling the individual shareholder -- has and the individual shareholder who is part of the institution that you describe?

MR. SWEENEY: One comment I have on that-- My experience has been when-- Let's say they are in a hostile takeover, and the successful raider then liquidates parts A and B of this corporation. Usually that liquidation is in the form of the managers of that little segment of the conglomerate keep the corporation functioning on the local level, and is usually more efficient, and usually more labor-intensive -- which is more in my interest -- than when it was part of the conglomerate. My experience in that-- Let's say Carrier Corporation. Carrier Corporation is now in the process of moving a substantial amount of its operations out of the

country. What we are finding, in that case, is that we are vehemently opposed to what Carrier's management is doing, and we are trying to exercise our economic clout to stop them from moving jobs out of the country.

But, in the case you posed, where in the hostile takeover they liquidate one or two facets of it, usually in my experience, Senator -- and I am not positing this as being universal -- the managers of that small segment take over the company -- a leveraged buy-out -- and they keep the company functioning, usually more efficiently than it was when it was a part of the conglomerate.

So, my experience has been -- even though I will submit it has been somewhat limited -- that when there is that spin-off, it is actually more labor-intensive -- the resulting corporation -- than it was prior to the spin-off.

SENATOR LESNIAK: Senator Cardinale, Senator DiFrancesco? (no response)

SENATOR O'CONNOR: You're right about Senator Cardinale today.

SENATOR LESNIAK: He's curiously silent.

SENATOR DiFRANCESCO: Very subdued.

SENATOR CARDINALE: I'm turning over a new leaf.

SENATOR DiFRANCESCO: You represent who?

MR. SWEENEY: The Sheet Metal Workers' National Pension Fund.

SENATOR DiFRANCESCO: But not today?

MR. SWEENEY: Well, I am General Counsel, and I am here at their behest, but I am not necessarily representing--

SENATOR DiFRANCESCO: You confused me when you opened up. Are you giving your personal opinions, or are you here because someone has decided -- or some company, or some union, or some pension fund has decided -- that you should represent their interest in opposing this legislation?

MR. SWEENEY: Yes. If I misspoke-- I said all of the trustees of the Sheet Metal Workers' National Pension Fund may not agree 100% with my comments, but the Chairman of the Board of the Trustees does, and I am here at his direction.

SENATOR LESNIAK: That's good enough for me. Thank you very much. We are going to break until 3:30.

(RECESS)

AFTER RECESS:

SENATOR LESNIAK: If there is anyone in the audience who has written testimony, we will be happy to accept it to be made a part of the record.

I will now call upon Senator Van Wagner, the sponsor of Senate Bill 1539.

SENATOR VAN WAGNER: Some of the comments made by some of the people testifying today could probably be duplicated on the other side of the issue -- arguments against the positions that were articulated today, and vice versa. The purpose I have, as sponsor of this bill -- regardless of whether or not the title -- as some have claimed -- is misleading, or whether or not it does, in fact, protect shareholders, or who, in fact, are the shareholders, or who, in fact, is being affected by this bill -- is a question that I suppose we could argue into the middle of next year about. However, it is my feeling that in the analysis, at least, that I have had available to me, and from my discussions with both -- not only the business community in the State, but also members of labor, who have indicated their interest in this bill, that, in fact, taking action of this sort, in this very limited way, will, in fact, provide, I believe, a better atmosphere under which the 124 companies that are incorporated in this State can do business.

I think if we allow, during that time, for a study to be conducted by the Department of Commerce, at the same time as other information and data is developed that might lead us toward other actions that might be necessary to either amend or change this bill, then we can do so. But, I believe it is, in fact, in the best interest of the people of this State, and it is in the interest of public policy, that we do take the action that several other states have already taken, in order to create a level playing field for the 124 New Jersey corporations and the workers in those companies, including the management of those companies, which are affected by these takeovers. End of impassioned plea.

I really do believe, though, Mr. Chairman, that it is important for us, as a Legislature, to make our statement. If, in fact, the courts are going to take the action that some have suggested might be taken, then, in fact, the Legislature can re-look at its own actions. Not to be facetious, but certainly taking a potential unconstitutional action on legislation in this Legislature has not been untraditional. I think that in some cases there are enough gray areas that have been raised to question whether or not, in fact, this particular statute might be upheld constitutionally.

SENATOR LESNIAK: Senator, as you know, you and I have differences of opinion on this bill.

SENATOR VAN WAGNER: Yes, we do.

SENATOR LESNIAK: I am concerned with the letter we received from the Office of Economic Policy, which asks for time for a study of the economic implications of this bill on the State of New Jersey. Quite frankly, if I had my way, I wouldn't be considering this bill today until that study is completed. However, I think it is fair to establish a moratorium in the manner which you propose. My concern is that if we put a bill like this in place and a study comes back from our own Office of Economic Policy advisers, or, in fact, if it

actually does have results that you do not intend it to have, to dismantle the bill would be just about impossible.

So I think the better way for us to deal with this, since there is uncertainty -- and we have heard much testimony on both sides of this issue -- would be to provide for the bill -- which I could support -- with a provision that it sunset on the last day of the legislative session, with the understanding that what that means is that anyone who acquires a 10% interest between now and January 12--

MR. DAVIS: The eleventh, I guess. If you want it on the last day of the session, it would be the eleventh.

SENATOR LESNIAK: --make it January 11, 1988 -- would be subject to the five-year standstill and everything else that is provided in the bill. Anyone who acquires a 10% or more interest on January 12, 1988, if the bill is not either extended or permanently enacted, would not be subject to the provisions of the bill.

I understand you feel strongly about your views, and you know that I feel strongly about mine. I would, at this time, propose an amendment establishing a new section. I want to make it clear we are not moving the amendment that was drafted, because that would have just sunsetted the entire bill, which, in effect, would have made it, unless reenacted, not operable to people who acquired a 10% interest within this time period.

So, we are not voting on the sunset amendment that was distributed, because that would have, in fact, gutted the bill. My amendment would be a new section which would state that the provisions of this act shall not apply to any business combination of a resident domestic corporation with an interested stockholder of that corporation--

MR. DAVIS: Which became an interested--

SENATOR LESNIAK: --which became an interested stockholder on or after January 12, 1988.

SENATOR JACKMAN: What about all of the other amendments that you proposed? Are they all eliminated?

SENATOR LESNIAK: We'll deal with them as Senator Jackman sees fit.

SENATOR O'CONNOR: Take them one by one, Chris.

SENATOR JACKMAN: Yeah, one by one; I don't want to vote on them one by one.

SENATOR LESNIAK: (inaudible comment)

SENATOR JACKMAN: Okay.

SENATOR LESNIAK: Seconded?

SENATOR O'CONNOR: Seconded.

UNIDENTIFIED MEMBER OF COMMITTEE: Now, that will include, also, the new section which calls for the study.

SENATOR LESNIAK: It would also include the study by the Office of Economic Policy.

SENATOR VAN WAGNER: I just want to make a point. Obviously, as you pointed out, this is not an amendment that I am wild about. Okay?

SENATOR JACKMAN: Neither am I, so you've got nothing to worry about.

SENATOR VAN WAGNER: Neither is Senator Jackman.

SENATOR JACKMAN: Right.

SENATOR VAN WAGNER: But I think it would be-- I know it would be palatable, or more palatable, if, in fact, the language relative to the study is included.

SENATOR LESNIAK: Oh, absolutely.

SENATOR VAN WAGNER: And if we could, perhaps, prescribe a date by which the Office of Economic Policy committee would report to us--

MR DAVIS: It is prescribed.

SENATOR VAN WAGNER: It is prescribed? (no response) So, in effect, if the Legislature -- either under my sponsorship or someone else's sponsorship -- saw fit to provide a longer life to this bill, they would, in fact, have a study already completed at that point.

SENATOR LESNIAK: Senator, you have my commitment, if that is the case, that we will take it up forthwith, just as we have this bill.

SENATOR VAN WAGNER: Yes.

SENATOR LESNIAK: Do we have a second?

SENATOR O'CONNOR: Yeah, but before-- I am going to second that, but I just want to say that I, too-- I am sort of in-between your position and Senator Van Wagner's. I think the bill is a good bill, but I can see the point of having the study and, in the meantime, imposing some type of a moratorium. So, I am going to support the suggested amendment.

SENATOR LESNIAK: Dale, will you call the roll?

MR. DAVIS: For the amendment?

SENATOR LESNIAK: Yes.

MR. DAVIS: Senator DiFrancesco?

SENATOR DiFRANCESCO: Yes.

MR. DAVIS: Senator O'Connor?

SENATOR O'CONNOR: Yes.

MR. DAVIS: Senator Jackman?

SENATOR JACKMAN: Yes.

MR. DAVIS: Senator Lesniak?

SENATOR LESNIAK: Yes. Now, we have other amendments-- We have a public policy amendment that was distributed. May I have a motion to move the public policy?

SENATOR O'CONNOR: Motion moved.

SENATOR LESNIAK: Seconded by Senator DiFrancesco. Call the roll.

MR. DAVIS: Senator DiFrancesco?

SENATOR DiFRANCESCO: Yes.

MR. DAVIS: Senator O'Connor?

SENATOR O'CONNOR: Yes.

MR. DAVIS: Senator Jackman?

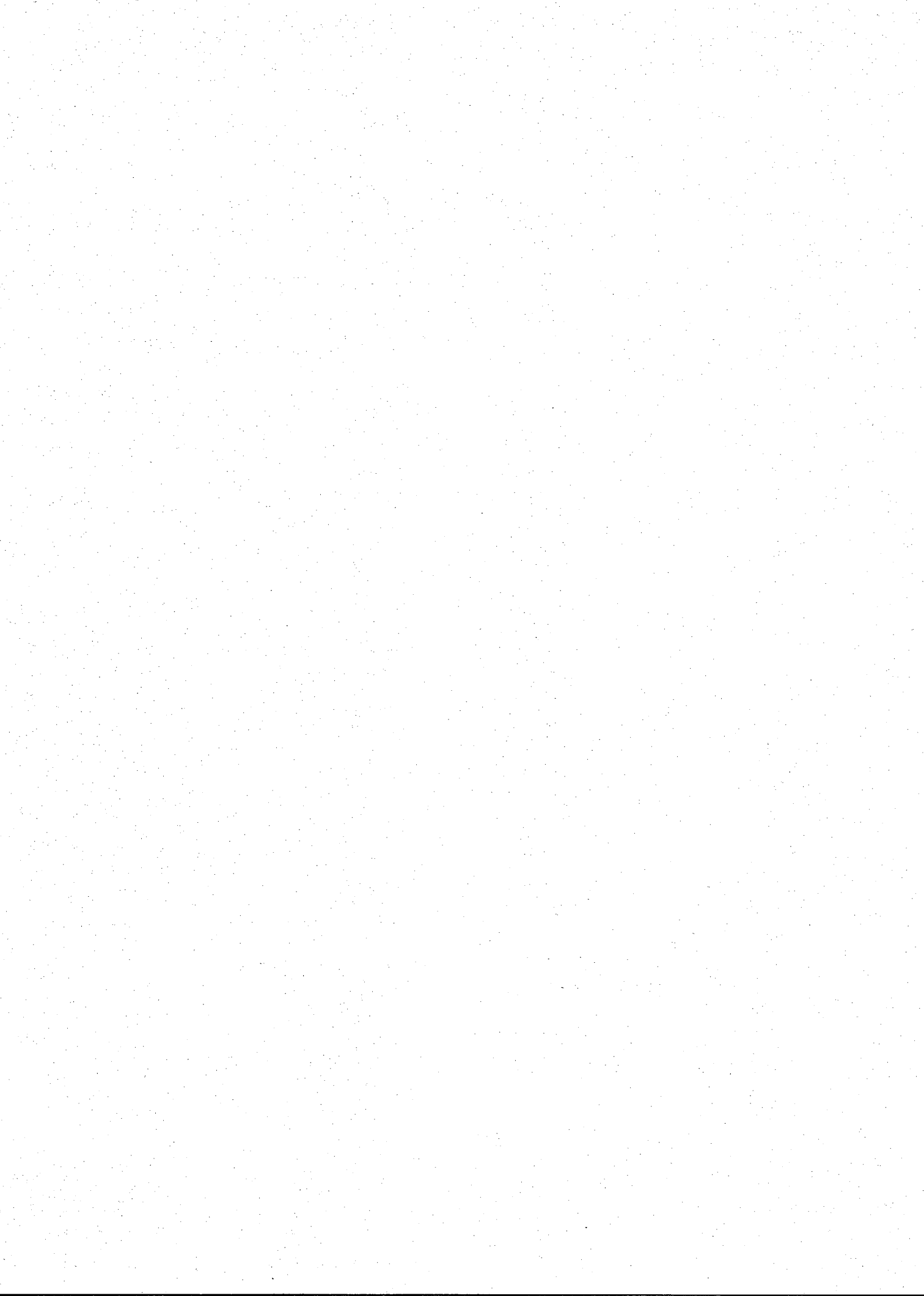
SENATOR JACKMAN: Yeah.

MR. DAVIS: Senator Lesniak?

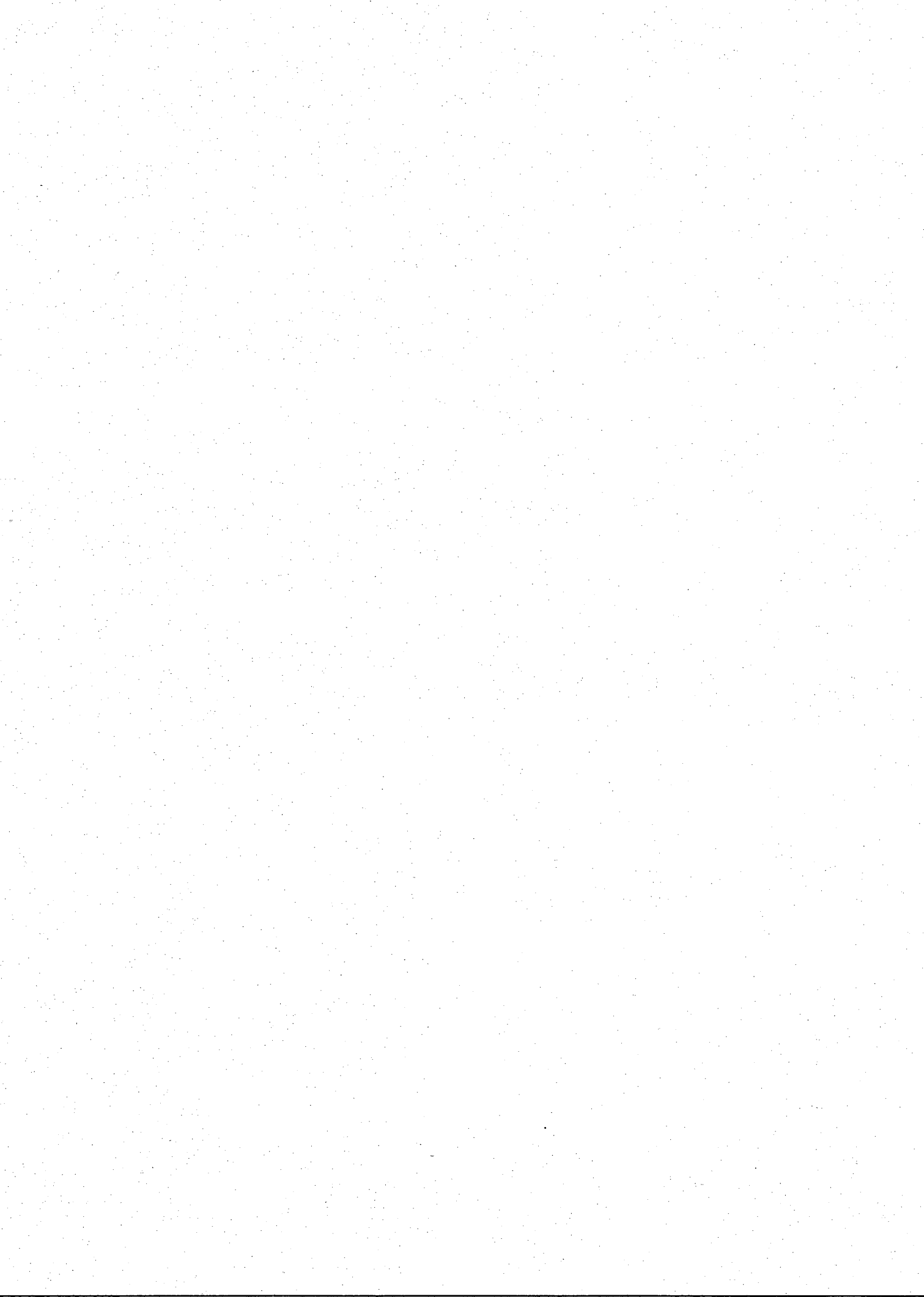
SENATOR LESNIAK: Yes.

MR. DAVIS: Okay, so moved.

(HEARING CONCLUDED)



APPENDIX





State of New Jersey
DEPARTMENT OF THE TREASURY

DIVISION OF INVESTMENT
N-290
TRENTON, N. J. 08625

May 7, 1986

Honorable Raymond J. Lesniak
651 Westfield Avenue
Elizabeth, New Jersey 07208

Dear Senator Lesniak:

Director Forrester has forwarded to me your recent letter to him which requested an opinion as to the effect of S-1539 on New Jersey's retirement funds.

Your letter enclosed a memorandum from Comptroller Regan of New York to Governor Cuomo wherein the Comptroller disapproved of a similar bill before the New York Legislature and cited instances where the pension funds profited from hostile shareholder actions.

A similar analysis for the New Jersey pension funds would show the state pension funds realized gains of \$107 million from the companies which were subject to the shareholder actions that were cited by Comptroller Regan. These gains, of course, were subject to considerable variation, depending upon market conditions at the time and the changing status of various tender offers. To my knowledge, none of the companies (Conoco, Getty, Superior, Gulf Oil, Phillips Petroleum, Unocal) were incorporated in New Jersey, so none would have been affected by the earlier passage of a bill like S-1539.

Comptroller Regan also noted in his letter that the New York state pension funds had not supported management proposals to modify corporate by-laws to provide for various forms of "shark repellants", including anti-greenmail provisions, fair price amendments, blank check preferred stock authorizations, staggered boards of directors, and super majority votes to approve mergers. The Division of Investment has also consistently opposed such by-law modifications in the interests of plan beneficiaries.

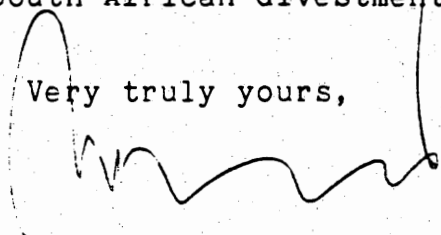
Honorable Raymond J. Lesniak

-2-

May 7, 1986

The Division has not made a study of its holdings to determine which would be affected by the proposed law. The great majority of the corporations represented in the pension fund portfolios are incorporated in other states, particularly Delaware, and thus would not be affected by the bill. Furthermore, many of the affected New Jersey corporations have already adopted anti-merger provisions in their by-laws, so that the incremental effect of the proposed bill would be negligible in these instances. Finally, the great majority of the Division's holdings of New Jersey corporations will shortly be sold under the provisions of the South African divestment legislation enacted last year.

Very truly yours,



Roland M. Machold
Director

RMM/kb

cc Michael R. Cole
Susan M. Connell

SUMMARY STATEMENT

Roland M. Machold

609 292 5106

Remarks before the United States House
of Representatives, Subcommittee on Telecommunications,
Consumer Protection and Finance

March 19, 1986

I am Director of Investment for the State of New Jersey and co-chairman of the Council of Institutional Investors. I am a fiduciary for 380,000 beneficiaries of the New Jersey public employee pension fund systems.

It is my view that the managements of many American corporations are acting against the interests of their own shareholders by initiating changes in corporate governance procedures which protect management, abridge shareholder rights and reduce the value of securities held by shareholders.

I believe that shareholders should be protected by a bill of rights, which would provide that each share of common stock would have one vote for every share of stock; that all common shareholders should be treated equally; that a vote of a majority of shareholders should be required in certain instances; and that corporate compensation and the choice of auditors should be subject to the approval of outside directors.

It is my contention that limitation of shareholders' voting rights will serve to entrench management, to limit the maximum realization of shareholder values and to inhibit the vitality of capital markets in the United States.

Roland M. Machold
Director

RMM/kb

Roland M. Machold

Remarks before the United States House
of Representatives, Subcommittee on Telecommunications,
Consumer Protection and Finance
March 19, 1986

Chairman Wirth, fellow Representatives and members of the staff, I am very grateful for the opportunity to address you today.

I am Roland M. Machold, Director of the Division of Investment, State of New Jersey. I am responsible for investing 99 state funds with total assets of about \$19 billion. Of this amount about \$16 billion represents the holdings of seven state administered pension funds held in trust for 380,000 beneficiaries. The beneficiaries consist of state and municipal policemen, teachers, firemen, judges, and public employees. The New Jersey pension funds represent almost all of the life savings of public employees whose average annual salary is approximately \$19,800 and retirees whose average annual pension payment is about \$5,000. The number of beneficiaries constitutes over 5% of the population of the State of New Jersey. Furthermore, since the pension plans provide for defined benefits, any shortfall in investment returns must be funded by the taxpayers, which include all citizens of the state. In effect, I am the fiduciary for thousands of small investors, and, indeed, all the citizens of my state.

I am appointed by a non-partisan State Investment Council and, in my role as Director of Investment, I have no affiliations with any political party. I am also co-chairman of the Council of Institutional Investors. However, my remarks today are my own, acting as fiduciary for the funds under my supervision, and do not reflect the views of New Jersey or the present administration in New Jersey.

Issues of corporate governance and efforts to increase investor protection are the primary concerns of the Council of Institutional Investors, which was formed in response to the notorious Texaco and Disney "greenmail" share repurchases. I am one of the three co-chairman of this organization, an organization which was formed specifically to protect security holders rights and to exercise our independent fiduciary responsibility to our plan beneficiaries.

Our organization has about 40 members, whose investment responsibilities aggregate about \$160 billion. The Council is open to all institutional investment plan sponsors, including corporate pension funds. It is not our intention to be adversaries of corporate America, but, as investors, to be partners with corporate management. However, it appears that some corporations view us and their other shareholders as adversaries and have taken many initiatives to limit and abridge our rights as securities holders.

The Council of Institutional Investors is not in a position to engage in concerted political action. As fiduciaries, our concerns and individual authority are limited to fiduciary issues, and none of us is in a position to support the political agenda of another party, including each other. We employ no lobbyists or public relations professionals and have no political action committee. In appearing before you and your commission, I am presenting my individual point of view and not a collective point of view.

I cannot address individually the myriad forms of abuses that corporations have initiated: - the shark repellents, green-mail, golden parachutes, poison pills, the issuance of non voting shares of stock, staggered boards of directors, etc. However, collectively, they represent an assault on the value of our securities. Studies by the Securities and Exchange Commission have shown that various abridgements of voting rights have a direct negative effect on the market prices for stocks, and this effect may be a loss in value of between 1% and 5%, depending on the nature of the abridgement. In my own experience the value of a vote may be even higher in certain types of circumstances.

I recognize that these modifications of shareholder rights are often approved by a majority of the shareholders; - nevertheless, in every case a minority of shareholders is disenfranchised and future shareholders are bound by the actions of

current shareholders. Furthermore, corporate proxy voting procedures, and the close relationships between corporations, corporate pension funds and the banks and money managers who serve corporations, together mobilize to advance the interests of corporate managers over shareholder interests.

In the absence of voting rights, a share of common stock is merely a feeble security, no more than a perpetual loan without the assurance of any return. The value of the share is at the mercy of corporate management, a management who is no longer accountable to the investor. It is my contention that the limitation of shareholder voting rights will serve to entrench management, to limit the maximum realization of shareholder values and to inhibit the vitality of capital markets in the United States.

To date the Council's primary function has been to inform its members of corporate and governmental initiatives which affect shareholders' rights. We met with all parties in the Phillips Petroleum contest; we provided a forum for discussing poison pills; we met with representatives of the stock exchanges to express our support for the one-share, one-vote rule; we met with Governor Cuomo of New York to express our opposition to a proposed state law which would have changed the percentage of the shareholder vote required to approve a merger and we met with the Securities and Exchange Commission to discuss these issues. We intend to promulgate a draft of a Shareholder Bill of

Rights for consideration by all interested parties, including other investors, corporate managers, the Securities and Exchange Commission and any interested members of Congress and the public. This draft Bill of Rights will propose that all holders of common stock should have one vote for every share they own, that all common shareholders should be treated equally; that certain corporate issues should be subject to a majority vote of common shareholders; and that the selection of auditors and the establishment of compensation standards should be subject to the approval of outside directors.

Still, we are overwhelmed by the variety and ingenuity of corporate actions which are designed to limit our voting rights and which have reduced the value of our securities. We are shocked that the business judgment rule would be construed so broadly that an executive can claim a \$36 million "golden parachute" for selling his company to a willing buyer. We are appalled that the Delaware court could approve a poison pill mechanism which, if adopted broadly, would effectively entrench corporate managements and sharply reduce the values that might accrue to the shareholder through corporate restructurings or mergers.

Taken collectively, these changes in corporate governance, the judgments of state courts and the enactment of state laws which protect corporate interests, have unbalanced the covenant which exists between investors, corporate management and the

public interest as represented by the Government. This covenant is the cornerstone of our system of private enterprise and the essential ingredient for dynamic capital markets.

Ten years ago I was concerned that the government was intruding upon shareholder values and management initiatives through price controls, mandated non-productive expenditures, and government regulation. Now, in the present laissez faire environment, I am concerned that corporate managements are taking advantage of investors, with the cooperation of local governments and the indifference of the Federal government. I am here today to ask you to support the investor - all investors, both large and small - to retain this essential covenant between investors, corporate management and the public interest.

I am often asked whether it is appropriate that corporations should be controlled by institutional investors and other shareholders, and I reply that, within the context of the aforementioned covenant, would you prefer the alternatives of control by either a small group of corporate managers or by the government. The first would be a return to the oligopolies of many years ago, and the second would be a radical change in our free enterprise system. The investors are the owners of American corporations, and corporate management should be responsive to them and should act to preserve and improve shareholder values.

I am asked whether the investor's goals are too short term to preserve the continuity of corporations, and I reply that investors can and do make long term judgments. In my own instance, I have on occasion voted against Boone Pickens's proposals, and in almost all instances I have supported corporate managements against corporate raiders. However, I believe that such decisions should be subject to the consent of the owners of the corporations and should not be the sole prerogative of corporate managements, who would otherwise be free to serve their own personal interests. I would like to add that there is nothing wrong with judgments over the shorter term as well. The oil industry went through very sharp cyclical changes in recent years, and the managements of these companies were slow to address the overcapitalization and the inventory of unproductive facilities which ensued. The good managements instituted share repurchase programs and liquidated unproductive facilities. The slow ones held back and waited for better times. The bad managements made poor acquisitions, which, for the most part, harmed the shareholder. In every instance the companies should be subject to the discipline of the shareholder vote. Any abridgment of that vote will leave the companies accountable only to the government. This may be appealing to corporate managements at the present time, but in the long run they may feel more comfortable with the shareholder on their side.

I am asked whether it makes sense for institutional in-

vestors to have the authority and power to affect corporate business decisions. My answer is that investors should not intrude upon corporate business decisions, but should have the right of consent to any corporate action which will have a significant financial effect upon a corporation and its shareholders. I would like to be able to vote on specific "poison pill" and similar provisions. I would like to be able to vote on merger proposals which have a significant impact on shareholder values, and I would not like corporate governance procedures to inhibit the presentation of such proposals. I would like to be able to vote on programs which provide for the incurrence by corporations of large amounts of low quality debt. I would like to be able to vote on a \$56 million "golden parachute". However, I do not want to do the job of corporate managers. To the contrary, I would like corporate managers to help me do my job by being better financial managers. The corporate managers of today must be as sophisticated in managing their debt and equity capacity as they are in managing their plant capacity. There would be no room for corporate raiders and arbitrageurs if corporate managements were to act consistently to increase shareholder values.

I am asked whether a handful of large investors will act in collusion in order to control corporations. I believe that, under existing state and Federal prudency laws, such collusion is illegal. I am the fiduciary for the funds under my supervision, and I cannot delegate that responsibility to any other group or

individual.

I am asked whether the maximization of shareholder values conflicts with a corporation's obligations to its employees and its community. My reply is that a healthy corporation and a healthy community are inseparable and that there are many state and Federal laws already on the books which define these relationships. Still, the corporate manager's primary responsibility is to its owners, and a sacrifice of shareholder interests to the interests of others will only harm all parties in the long run.

By these responses, I have addressed many of the issues raised in your invitation to me. Still, you have raised several other specific questions which I will address briefly. Proxy votes are a significant responsibility for the New Jersey pension funds, a responsibility that I take very seriously. They concern matters which significantly affect the plan beneficiaries and the taxpayers of my state. We have very clear guidelines and procedures for voting proxies, and all of my actions are subject to the consent of a non-partisan State Investment Council, which is representative of both the beneficiaries and the broad public interest. We manage all of our money internally, and invest in both large and small companies. The size of our investments and our trading do have an impact on market prices for securities; however, in view of existing prudency law and sound investment practices, we try to

minimize our impact by diversifying our investments both over time and across a large number of companies. As a state agency we are not directly subject to ERISA and the Department of Labor. However, I believe that the law has done a great service by promulgating a national prudent person law. Nevertheless, I am concerned that powerful special interests are mobilized to weaken this law and have shifted their efforts from the state level, where beneficiary interests are fully represented, to the national level, where beneficiary interests may be diluted.

In closing, I would like to thank you for the opportunity of appearing before you today, and would welcome any questions you might have.

APPENDIX A

PUBLIC POLICY CONSIDERATIONS

In evaluating Senate Bill No. 1539 from a public policy standpoint, the focus should be directed to whether the proposed legislation is necessary in the context of the current business environment and advisable as a means of attempting to address a legitimate concern.

Initially, it should be recognized that the bill does not provide a New Jersey corporation that would be covered by its provisions with any benefits or protections that the corporation could not by itself secure through properly adopted amendments to its certificate of incorporation and/or bylaws. This is particularly significant in light of the recent study conducted by the Investor Responsibility Research Center which reveals that almost 80% of all Standard & Poor's 500 companies had adopted some form of anti-takeover measures by the end of 1985. Presumably due care and consideration were given to the measures adopted by each of these corporations in order to tailor the specific measures selected to the specific needs and concerns of the corporation, with appropriate shareholder input.

Senate Bill No. 1539 represents a very broad-brush approach to corporate takeovers that could be inconsistent with many of the actions already taken by New Jersey corporations and their shareholders. We question whether New Jersey should enact what would be perhaps the most restrictive anti-takeover law in the Nation at a time

when the vast majority of corporations have already proceeded independently to adopt measures that they have determined are best suited to their particular needs.

The enactment of Senate Bill No. 1539 could have serious adverse consequences for New Jersey corporations and the environments in which they operate. By freezing such corporations and their 10% stockholders from engaging in a wide variety of transactions, the bill would:

- (1) discourage large investment in New Jersey corporations
- (2) encourage large investors to seek control of such corporations through means other than stock acquisition, such as costly proxy battles
- (3) encourage re-incorporation outside New Jersey by large investors who succeed in obtaining control
- (4) create an unhealthy atmosphere in the boardrooms of New Jersey corporations in which a "frozen" interested stockholder has board representation
- (5) invest incumbent management with the power to prefer one out of multiple bidders for a New Jersey corporation by exercising the authority to approve or disapprove a suitor in advance, and

(6) reduce the market value of shares of New Jersey corporations by rendering them unattractive to large investors and, in many respects, takeover-pr

The clear effect of the bill would be to discourage, if not render impracticable, both unfriendly acquisitions of 10% or more of a New Jersey corporation's stock and tender offers for 100% of a corporation's outstanding shares. By prohibiting (and a five-year freeze is tantamount to a prohibition) a successful offeror from merging with the target company, the bill would discourage all tender offers for New Jersey corporations (other than tender offers that proceed with incumbent management's blessing). Such a restriction serves no purpose other than preservation of incumbent management, whether that management is effective or ineffective at running the corporation.

Tender offers (or the potential for them) play an important role in assuring that the management of a corporation runs it efficiently and effectively. Well-run companies should not be regarded simply as profitable investments for their security holders because a healthy corporation is likely to provide a community with employment opportunities and tax revenues commensurate with its success. By the same token, a poorly-run company can cost a community jobs and financial support. While there are many motivating factors that contribute to tender offer activity, it is clear that depressed stock prices due to ineffective management present attractive possibilities

to would-be acquirors. Legislation that would erect insuperable barriers to the acquisition and rejuvenation of such poorly-run companies would have far-reaching social and economic costs to the State and its residents.

The merger and consolidation prohibitions are by no means the only objectionable restrictions in the bill from a public policy point of view. The prohibitions against sales and exchanges of assets between a corporation and an interested stockholder preclude a broad range of transactions that could be highly beneficial to a corporation and that would, absent the bill, proceed with the overwhelming approval of the corporation's shareholders.

Consider, for example, a corporation with a large unprofitable division located in New Jersey which it must close down or dispose of at a distressed price. An interested stockholder may be the most familiar person with the operations of the division, the most confident with respect to its future prospects and the most likely to offer fair value for it. If, however, his acquisition of stock was not pre-approved by the corporation's board, a sale of the division to the interested stockholder would be precluded for several years -- long enough to assure that the division and the New Jersey jobs it provided disappear. Moreover, neither board nor shareholder action could provide any assistance.

The restrictions on the issuance or transfer of stock to interested stockholders are also flawed. An interested stockholder might be a fertile source of additional capital for a corporation which, for a variety of reasons, might not want to finance in the public markets. The bill would eliminate the option of such a corporation to place additional equity with an existing large stockholder who years earlier had not been pre-approved.

The numbers and types of transactions that would be prohibited or rendered unduly complex and expensive by this legislation are legion. Moreover, the power to control the corporation and to act in its best interest would be saddled with restrictions that will last for a minimum of five years and cannot be removed by action by the corporation's board of directors or shareholders, whether interested or disinterested. One need only consider the dramatic changes in the financial world over the past five years to appreciate how devastating the proposed five-year prohibitions would be.

The likely effect of the proposed restrictions is self-evident. Investors will be reluctant to contribute capital to New Jersey corporations, and strong incentives will be created to take whatever action is necessary to free corporations from the strictures of the bill -- by re-incorporating in another State or moving the company out of New Jersey. The ability of New Jersey corporations

to raise capital in the public markets could be adversely affected as investors recognize the long-term problems this legislation would engender.

In summary, one must evaluate the concern that is sought to be addressed by this legislation, the availability of other, less draconian means of dealing with it and the likely adverse consequences of its enactment. We believe that corporations have acted and will continue to act to provide their shareholders with whatever protection they deem necessary in the context of takeovers. We believe that the State of New Jersey need not and should not intervene in this area through legislation that could be seriously detrimental to its corporations, their shareholders and the communities in which they operate.

REVIEW & OUTLOOK

Takeovers: The Market Test

Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. . . . The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. . . .

The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process or industrial mutation—if I may use that biological term—that instantly revolutionizes the economic structure from within, incessantly destroying the old, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in. . . .

[T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.

*Joseph A. Schumpeter
"Capitalism, Socialism
and Democracy"*

So the greatest economist of our century described the essence of capitalism. And after listening to the big debate on corporate takeovers this year, we found our way back to his great book and particularly the chapter "The Process of Creative Destruction." For the longer we've thought about the subject the less we've come to fear a "takeover mania." Instead

we fear some heavy-handed congressional regulation, if indeed the Delaware Supreme Court has not already gone too far with its recent ruling handing managements new defensive powers. The danger in inhibiting takeovers is cutting off Shumpeter's creative destruction.

Readers of this page have been able to follow a remarkable airing of the sides of the takeover debate: raider Sir James Goldsmith (Feb. 11), poison-pill inventor Martin Lipton (April 5), investment banker Felix Rohatyn (April 18), Prof. William J. Carney of Emory University (April 29), Gregg Jarrell and Kenneth Lehr of the SEC (May 1), Sen. Pete Domenici on his bill to regulate takeovers (May 14), Frederick Joseph of Drexel Burnham Lambert in defense of "junk bonds" (May 31).

Critics of takeovers like Mr. Lipton, Mr. Rohatyn and Sen. Domenici have undoubtedly been able to identify some problems. But many of them are either not unique to takeovers (high leverage) or already being sorted out in the marketplace (greenmail). On balance we have been more impressed by the arguments of the defenders. In particular, they can show that much of what is being criticized is legitimate investment banking—creating new financial instruments and new corporate structures more suited to the contemporary marketplace.

This is perhaps most easily seen by focusing on one issue, the "restructuring" of the oil industry. T. Boone Pickens gave his views on this issue in a Jan. 8 letter, and it was addressed quite independently of the takeover battles in a Feb. 21 article by John Sawhill of McKinsey & Co. The turbulence of energy prices in the 1970s has completely changed the environment

for the oil industry, creating a glut of refinery capacity, leaving producing nations rather than international companies in control of oil reserves and greatly enhancing the importance of the spot market for crude oil. In these new conditions, the traditional verti-

Creative Destruction—I

An Editorial Series

cally integrated oil company is no longer necessarily the best answer for either the investor or the consumer.

The problem is how to shed inefficient refinery capacity, take advantage of the spot market, and return cash flows from oil production to the capital markets so they can be redirected to other opportunities. It is not impossible to do this within the structure of present oil companies; refineries and retail outlets are being closed. Exxon, surely not under any takeover threat, has repurchased some of its shares, a way of returning money to the capital markets. But inertia attaches to any large bureaucratic structure, and even when raiders have not succeeded in ousting managements they have often been the catalysts for necessary restructuring.

This is certainly not to say that every takeover proposal is economically justified, let alone that the raiders are motivated by a public-spirited desire to improve economic efficiency. But legislators or judges who have to decide on takeover law ought to read "The Market for Corporate Control" in February's report by the Council of Economic Advisers, which concluded that takeovers add to economic efficiency and wealth, and should be not discouraged but encouraged.

In particular, it's important to remember that greed is disciplined by

REVIEW & OUTLOOK

Abuses, Real and Imagined

Nearly everyone agrees that a certain amount of corporate takeover activity is a good thing, serving what Joseph A. Schumpeter christened "The Process of Creative Destruction"—capitalism destroying old structures and creating new ones. Even critics who worry about the fairness of takeover rules tend to agree that times do change, that corporate structures must change accordingly, and that the takeover threat is a useful spur.

We have been seeing a lot of takeover attempts because the economic

Creative Destruction—II

An Editorial Series

environment has been changing rapidly, not least because of macroeconomic blunders between 1965 and 1980. The inflation wrought by a guns-and-butter fiscal policy and a monetary policy cut loose from its previous gold anchor created a bubble that was pierced by the near-collapse of the dollar and the resulting appointment of Paul Volcker in August 1979. As inflation went up we experienced a round of takeovers as part of the adjustment to the new environment, and as it abates we are quite predictably experiencing another for the same reasons.

So what's the problem? Number one on most lists is the creation of debt; no matter whether raiders or defenders win, equity is usually replaced by debt. Some feel that debt for takeovers is nonproductive, and will "crowd out" borrowing for better purposes. Yet when funds from the newly acquired debt are paid to shareholders, they do not put them in mattresses. Most likely, they reinvest them. If you believe in markets, indeed, the funds paid to shareholders will be directed into more lucrative opportunities. So future cash flow of Target Company is being used to pay down debt that was in effect invested in Upandcoming Company. The capital markets have reallocated funds to better investments.

Everything will be fine provided Target Company's cash flows can service the debt, and markets are not likely to accept debt they believe will not be repaid. Of course, their expectations may be disappointed, particularly if there are further macroeconomic blunders. This is not an argument against takeovers, but against a tax system that rewards leverage by allowing corporations to deduct interest payments but not dividends.

A second problem, now acknowledged by many of the raiders themselves, has been greenmail. Strictly defined, greenmail is the purchase of the raider's shares by the target corporation at a price not offered to other shareholders. Frequently raiders make big profits from failed takeovers if the stock is bought out by white knights or other bidders. So long as they get the same price as other shareholders, they can walk away feeling they have been catalysts for creative destruction. But if the raiders' shares command a premium, other shareholders' funds have been used to enrich the raiders and entrench the management. Greenmail strictly defined has by now practically vanished: neither raiders nor managements have found it worth the long-run price. But the suspicion that raiders are out for greenmail colors takeover attempts, providing much of the impetus for proposed limitations in Congress and the courts.

Yet surely greenmail is more of an abuse by the managers than by the raiders. If there is a big problem with hostile takeovers, it is that as the biggest potential victims, the managers of a target company, have interests in conflict with those of their shareholders. So most takeover critics at least profess to worry about not only the tactics of raiders but those of defenders. Indeed, the critics tend to fasten on "golden parachutes," though in fact generous severance contracts for management tend to align its interests with shareholders'.

actually working against the inherent conflict of interest.

As for defenses that actually protect management, shareholder approval solves a lot. Who can really complain if a company convinced shareholders that their long-term interest lies in protecting the present structure? One example is our parent, Dow Jones, which as a media company is potentially vulnerable to takeover attempts based on noneconomic motives. Nor is shareholder approval automatic, as the rejection of Rorer Group's "poison pill" showed last month. Given the inherent conflict of interest, a certain suspicion should attach to the desperate measures adopted in the heat of battle and without shareholder approval, even if these measures are defended as attempts to even the odds against "coercive" tactics by raiders.

The coerciveness supposedly results from "two-tier" tender offers. The raider offers to buy 51% of the company now, and 49% later. If the prospect is that the 49% will get less, the shareholder has a big incentive to side with the raider or miss the best price, and thus the deal is decided by this tactical advantage rather than assessments of long-term economic potential. It's far from clear that this problem is as serious in the real world as it is in theory; an SEC study of the issue found no evidence two-tier offers were effective in any coercion, and they are frequently used in friendly as well as hostile takeovers.

In any event, any advantage raiders got from two-tier offers has been at least evened by the Delaware Supreme Court decision in *Unocal vs. Mesa Petroleum*. The court has invited management under attack to counter with its own even more discriminatory two-tier offer. And given this outcome, the present issue is not whether raiders should be stopped but whether regulators have already gone too far in erecting obstacles to takeovers, protecting current corporate structures and thwarting the possibility of Creative Destruction.

REVIEW & OUTLOOK

The Delaware Tilt

In one of the biggest tender offers of the year, R.J. Reynolds is offering to buy 51% of the shares in Nabisco for \$85 a share in cash. A big hunk of cash flow from tobacco—surely a dying industry—is being paid to shareholders in a cookie company. Most of the shareholders who receive this payment will no doubt invest it in other opportunities, and probably more promising ones. Surely the merger is a good example of Joseph A. Schumpeter's "Creative Destruction," capitalism creating new structures to meet new market demands.

The Reynolds-Nabisco case, of course, is a friendly takeover. Reynolds

Creative Destruction—III

Last of a Series

will achieve further diversification out of tobacco. Nabisco CEO F. Ross Johnson will become number two in the much larger company. Nabisco shareholders, whose shares were trading at about \$60 a month ago, will take home a tidy profit. Though the bond rating agencies tut-tutted and Standard & Poor's marked down Reynolds's bond rating, everyone else is happy.

Of course, not all shareholders will get \$85 in cash now. When Reynolds gets its controlling 51%, the remaining 49% of the shares will be exchanged for \$42.50 in senior debt securities and preferred stock with a "stated value" of \$42.50. The deal was put together by Wall Street firms whose very names reek respectability—Dillon, Read and Co., Morgan Stanley & Co., Shearson Lehman Brothers Inc. And we've yet to hear a word of complaint about this two-tier offer.

Yet the same offer would surely be criticized as "coercive" if it were made without the permission of the target company's CEO. And if the offer were made by someone who'd

been in the news as a corporate "raider," advised by racier Wall Street types, the target company could reply with an even more uneven two-tier offer: as much as it wants for shares owned by shareholders it liked, but nothing for those owned by shareholders it didn't like. At least, so the Delaware Supreme Court has just held. This precedent in the state where most corporations are chartered ought at least to end any allegations that in hostile takeovers the rules are stacked in favor of the raiders: it tilts the table enormously toward incumbent management.

The Delaware case is Unocal vs. Mesa Petroleum, the first clear defeat for T. Boone Pickens in a succession of oil company tenders. In justifying the Unocal defensive counteroffer as a valid "business judgment" with which courts should not interfere, the Delaware ruling seems to represent a vast expansion of the rights of management to defend itself against hostile takeovers.

Mesa had offered \$54 a share in cash for 51% of Unocal, with the other 49% to be exchanged for a combination of debt securities and preferred stock. Unocal responded with an offer to exchange 29% of its stock for \$72 in debt securities, but stipulated that it would not accept the shares held by Mesa. Lower courts ruled against the Unocal offer, on the ground that all shareholders must be treated alike.

The Delaware Supreme Court, however, held that it was reasonable for Unocal to conclude its shares were worth more than \$54, that Mr. Pickens was primarily interested in "greenmail," and that it had a duty to protect shareholders from the coercive choice of "accepting \$54 in cash, or later receiving \$54 in what the board has concluded are junk bonds."

After the ruling, Mr. Pickens and Unocal Chairman Fred Hartley negotiated a standstill in which Mr.

Pickens gave up his takeover attempt and agreed to sell his shares only slowly, but was allowed to tender shares for the \$72 offer. In addition to repurchasing shares, Unocal is also restructuring itself by spinning off its reserve holdings into new partnerships with more favorable tax treatment and thus higher value for shareholders.

The notion that in the context of a proxy battle a company can make payments to some shareholders and exclude others, though, breaks new legal ground. Sensitive to the implications of its own logic, the court remarked in its initial decision: "We caution boards of directors of Delaware corporations that they do not have unbridled discretion to defeat any perceived threat to corporate control by any Draconian means available."

It will be interesting to see if this big victory for incumbent management ends congressional proposals to limit takeovers. At last count there were 20-odd bills in Congress to limit tender offers, or at least "balance" the rules of the game.

We would be astonished if Congress showed any particular interest in tilting the tables back toward hostile takeovers; what congressmen bring to the table is the desire to preserve industries and jobs in their particular constituencies. Their incentives lie predominantly in impeding the process of creative destruction; politicians do not like an uninhibited marketplace they cannot control. In all likelihood legislation would lead to overregulation. For our tastes, indeed, the Delaware ruling already goes too far. But the justices are at least sensitive to the problem, and the law evolves under competition between raiders and managers.

For our own part, the more closely we look at hostile takeovers the more we are convinced that while there may be occasional problems and

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The Virtue of Takeovers



News of corporate takeovers and mergers dominated the headlines in 1985. Philip Morris bought General Foods, Procter & Gamble won a bidding war for Richardson-Vicks, and Pantry Pride pursued Revlon—these were among the big business stories of the year.

Critics of takeovers contend that high-yield bonds—pejoratively dubbed “junk” bonds—are the sole cause of the current wave of takeovers. But curbing the use of these bonds will not stop takeovers anymore than breaking the thermometer will eliminate a fever. The real cause of all the takeover activity is directly related to the fundamental structure of the U.S. economy and the discipline of the marketplace.

The U.S. economy has always gone through cycles of boom and bust—unprecedented expansion followed by years of low or stagnant growth. Corporations undergo cycles as well and are tested every day in the capital markets. If a company's stock price goes down far below the underlying assets, the company has to restructure itself to surface those values or else become the target of a takeover bid. The undervaluation of stocks has made many top companies vulnerable to takeover offers.

Over the years, companies experience growth, maturity and decline. Strategies and balance sheets that are sound for the growth phase aren't compatible with maturation or decline. So the very life cycle of a corporation demands that a balance sheet be viewed as a dynamic asset, one that has to be ex-

amined frequently and altered in response to changing conditions. This is a relatively new concept for most companies, one forced on them by the requirements and disciplines of the capital markets.

Of the nearly 400 restructuring efforts undertaken in the past 18 months by some of the largest Fortune-ranked corporations, only 52 were either direct or indirect results of takeover threats, despite all the headlines about hostile takeovers. Corporations are restructuring themselves in response to changing market conditions brought about by the competitive pressures of an interdependent world, by the need for low-cost capital and by inflation.

A Case in Point

Just as financing structures follow economic developments, industry follows certain cycles. The oil industry is a good example of this pattern. As the oil industry matured, it became a “cash cow.” At the same time, the external factors of the industry changed. Surges in price, shortages in supply, and pressure to find more oil and add to reserves, all of which guided the industry in the 1970s and during the OPEC price shocks, are over. Today's plummeting prices are roughly half what they were at their peak five years ago. Indeed, some analysts predict that the world may be crossing a threshold, marking the emergence from a dozen painful years of high-cost oil and skewed economies, geopolitics and national and individual priorities.

Today, oil companies know that there isn't any point in punching holes in the surface of the earth when there is a world surplus. It became obvious to many that it was cheaper to drill for oil on Wall Street than on the North Slope. Because oil companies' assets were undervalued, many companies became the target for takeovers, particularly when they didn't move fast enough to improve the use of assets.

The restructuring efforts initiated by many oil companies have been caused by real economic forces independent of takeovers, although the timing and the particular measures adopted have been influenced by takeover activity. Phillips Petroleum, Sohio and Sun Co. all decided recently to abandon a shale-oil venture because they felt that continued operations of the leases were not justified in light of declining oil and gas prices. Corporate acquirers did not force the abandonment of the shale-oil project, as some maintain. The project ended because the companies themselves concluded that it didn't have sufficient economic value.

Companies that survive are those that demonstrate a capacity for dynamic change. Restructuring a balance sheet is essential for a company trying to maintain its competitiveness within its industry and against foreign challengers. Thus, contests for corporate control, spurred by takeover activities, benefit the U.S. economy in a fundamental way. This point was stated emphatically in the 1985 annual report of the president's Council of Economic Advisers: “The success of the American economy depends on competition. Competition breaks down entrenched market positions, unsettles comfortable managerial lives, and provides incentives for innovative forms of business organization and finance.”

Unocal, Phillips Petroleum, Walt Disney Productions and other companies that have been the targets of hostile takeover attempts have stated publicly that the takeover threat caused them to do what they should have been doing anyway—running the company better. Are takeovers all bad? Certainly not. We believe that a certain amount of restructuring and shaking up of American industry is necessary to keep us competitive in world markets. ■

Mr. Balog is vice chairman of Drexel Burnham Lambert

23X



In Praise of Boone

ROBERT J. SAMUELSON

Let us now praise the Boone Pickenses of the world.

They're parodied as capitalism's juvenile delinquents: corporate "raiders" engaged in "hostile" takeovers financed by "junk" bonds. In fact, hostile takeovers are not simply a giant Monopoly game played for private gain and social loss. They represent a crude check on the power of corporate managers to waste wealth and create inefficiency. I doubt those in Congress who condemn Pickens and want to regulate takeovers understand the distinction.

The ultimate social role of business is to enhance national living standards and competitiveness. Mismanagement has social consequences. In Britain, investment as a proportion of national output has been higher than in the United States. But our investment is 60 percent more productive because American companies invest more wisely and use their investments more efficiently. I am not arguing, therefore, that most management is incompetent or that most investment is made whimsically.

But hostile takeovers represent a healthy reaction to flaws in our business system. When corporate managers are not the major owners of their companies—as most are not—their loyalties become confused. They may be less interested in maximizing profits than in preserving and expanding their corporate domain. By contrast, society's interest lies in maximizing efficiency and living standards; profitability—which means companies producing what people want and doing so efficiently—is a social, not just a business, indicator.

Mature Markets: As long as a company's primary business is thriving, the conflict may lie dormant. Managers can maximize profits and expand simultaneously. But this happy marriage rarely lasts forever. Almost all products have life cycles. Markets mature, and traditional products often generate more cash than can profitably be reinvested in the same product. Corporate management then faces a dilemma: to overinvest in a mature business, or to diversify into a new business, where the company may have no special knowledge or talent.

Hostile takeovers arise mainly to exploit profit opportunities created when corporations cannot cope with their growth dilemmas. Some firms can diversify successfully,

others cannot. In some, the force of habit compels them to invest in declining businesses. Given the impulse for survival, managements only grudgingly react to a paucity of internal investment opportunities by paying more of their cash flow to shareholders, who would then reinvest for themselves.

The oil industry epitomizes the process. It has a huge cash flow and scarce reinvestment opportunities. Plowing money back into oil erodes profitability. Consider Phillips Petroleum, a Pickens target. Between 1974 and 1980 its rate of return on shareholders' investment averaged 18 percent; in the last four years the return has averaged 13 percent. Some oil companies have acknowledged this situation by buying back

Hostile takeovers are more than a giant game of Monopoly for private profit. They discipline bad management.

their stock, which raises the price of the remaining shares. In 1984 six firms, led by Exxon, repurchased \$5.7 billion of shares.

Pickens's maneuvering has aimed at achieving a similar result elsewhere. For example, Phillips ultimately gave existing shareholders debt securities, which commit the company to paying out much of its cash flow as interest payments. Gulf was purchased by Chevron for \$13.2 billion. Gulf's shareholders were paid off, and much of the cash flow of the new company will repay the loans used to finance the merger. Again, funds flow from the oil industry into more profitable uses. Since 1981 oil drilling has fallen nearly 40 percent.

The question naturally arises: is what's good for Boone good for the country? My hunch is yes. There's a fixed amount of oil left in the United States, and it's increasingly costly to find and extract. The poor profitability of new exploration reflects these high finding costs and falling world oil prices, a sign of plentiful supplies. As a nation, there's no point in rushing to deplete domestic reserves while international sup-

plies are ample. When they aren't, prices will rise and make recovery more profitable.

I admit that Pickens and other takeover specialists don't inspire much sympathy. We envy their wealth and resent the apparent ease by which it was acquired. The error, though, is to see profits only as a gauge of private greed. It also measures social utility. Anything that shifts investment to more profitable uses—or spurs efficiency—improves our collective welfare.

Bad Mergers: In part, today's hostile takeovers represent a corrective for yesterday's abuses. Wasteful corporate diversification via mergers has been a major misuse of management autonomy, fed by tax policies that discourage dividends and encourage borrowing. (The interest payments on debt are deductible, while dividends are taxed at both the corporate and personal levels.) Many companies have become cumbersome empires; they cannot motivate workers or be managed effectively.

It is precisely these companies that emerge as potential takeover targets. If CBS is at all vulnerable to Ted Turner, it is not because the network is poorly run; it is because the breakup value of the CBS conglomerate—which includes toys, records and magazines—may be worth more than the combined company. Even the distant threat of a takeover can be therapeutic. Companies are furiously selling unwanted divisions and subsidiaries; according to W.T. Grimm & Co., more than a third of acquisition activity now represents sell-offs.

The sin of Pickens and other takeover specialists is to discomfort the barons of business, who are now running to Washington for protection. Corporate executives reserve to themselves the right to buy and sell divisions, open and close factories, change products and shift strategies. But when someone suggests changing corporate leadership, then America's board-room chiefs piously declare the sanctity—as The Business Roundtable puts it—of preserving "the long-term viability of a corporation."

This is sheer hypocrisy. Most corporations can adequately contest takeovers. Congress should limit artificial tax incentives for mergers of all sorts. But it doesn't need to protect already entrenched managements. Can you imagine a group less deserving of help? I can't.

Takeover Threats Don't Crimp Long-Term Planning

By GREGG A. JARRELL
And KENNETH LEHN

Critics of hostile tender offers argue that such threats are inducing corporate managers to defer research and development and adopt a variety of defensive tactics ranging from "golden parachutes" to anti-takeover charter amendments. If this were the case, one would expect to find evidence that managers are maximizing short-term earnings at the expense of long-term projects, such as research and development. But a study we conducted as economists at the Security and Exchange Commission indicates precisely the opposite.

Critics of hostile takeovers have argued that these defensive actions and the increasing neglect of long-term projects are visible symptoms of a serious economic problem. Their central point is that hostile takeovers result largely from undervalued equity of the takeover target. This fundamental problem is attributed to large holdings of institutional investors in most publicly held corporations. These professional managers of billion-dollar portfolios operate in an intensely competitive environment. Their focus on short-term earnings reports, the argument goes, is a natural consequence of the pressure on them for short-term performance.

This points to a troublesome side effect. The contention is that a capital market dominated by competitive fund managers causes equity prices to favor short-term earnings reports disproportionately to long-term prospects, that the shares of firms with significant long-term programs sell at lower prices than those of comparable companies that maximize their immediate earnings, and that this environment creates openings for hostile takeovers.

This scenario of the causes and consequences of hostile takeovers has been widely publicized. Three articles in *The Wall Street Journal* in the past few months by authors with outstanding credentials (Martin Lipton, Felix Rohatyn and Peter Drucker) have advanced these arguments. Key congressmen have expressed support for the theory in hearings, and several anti-takeover bills have been proposed in response to this alleged problem.

However, this theory is based on very

shaky empirical evidence. In fact, no advocates have provided supporting facts. They have relied instead on the "reasonableness" of this argument, and anecdotes. This neglect is quite surprising because of the economic sophistication of the proponents and because the theory has many direct empirical implications that can be tested with readily available data.

The SEC's Office of Chief Economist conducted a study of the relationship between institutional ownership of public companies and their R&D expenditures. Specifically, data were collected on 324 companies representing a cross-section of 19 R&D intensive industries, including aerospace, drugs, oil, timber, steel, semiconductors and telecommunications. For the years 1980-1983, measurements were made of the percentage of common equity held by institutions and the ratio of such companies' R&D expenditures to their total revenues.

The aggregate data reveal that as average institutional ownership has increased (from 30% in 1980 to 38% in 1983), so has the average R&D-to-revenue ratio (from 3.38% in 1980 to 4.03% in 1983). Thus, there is no evidence that the increasing institutional ownership has induced companies to curtail their R&D programs.

For each company, the relationship between the 1980-1983 change in institutional ownership and the 1980-1983 change in R&D-to-revenue ratio was closely examined. The purpose was to test the theory that rising institutional ownership causes companies to curtail their R&D expenditures. The facts show the opposite to be true. Apparently, institutional fund managers show a noticeable preference for firms with increasing R&D expenditures.

The study also examined the 217 firms that were takeover targets between 1981-1984 in an effort to isolate any patterns between institutional ownership and R&D expenditures for actual targets. First, 160 of these target companies reported that their R&D expenditures were "not material." For the remaining 57 firms, the data show that over the four years preceding their takeover, they had R&D-to-revenue ratios (0.76%) only half as large as the average for the other firms in their respective in-

dustries (1.53%). These data show that the target firms of the 1980s are characterized by very low R&D expenditures. Again, this fact contradicts the view that investment in long-term projects such as R&D makes firms vulnerable to takeovers.

The ownership structure of these 1981-1984 takeover targets was also examined to see if institutional ownership in these firms was unusually large. Ownership data were available for 177 target firms. Contrary to the prediction of the theory, the percentage of equity held by institutional investors in target firms (19.3%) was significantly lower than the corresponding average percentage for non-target firms in the same industry (33.7%). These data strongly suggest that institutional ownership per se does not fuel takeovers.

The proponents of the theory have asserted that stock prices decline in response to increasing R&D expenditures. This is another direct implication of the theory, and it too had not been systematically tested for validity. Our study examined the net-of-market stock price reaction to 62 *Wall Street Journal* announcements between 1973-1983 that firms were embarking on new R&D projects. These tests show that, on average, the stock prices of these firms increased (1% to 2%) in the period immediately following the publication of these stories. Again, this direct implication of the theory is refuted by the data.

Although these data refute the theory, we do not expect them to silence the critics of hostile tender offers. The dramatic human consequences of hostile tender offers give rise to claims and counterclaims about their economic and social desirability. However, policy makers should insist on empirical evidence, rather than rhetoric. Isolated anecdotes can be found to support any theory, and therefore prove none. Empirical evidence offers policy makers the best hope for intelligent decisions.

Mr. Jarrell is the chief economist and Mr. Lehn is the deputy chief economist of the Securities and Exchange Commission.



Associated Press

Fred L. Hartley, left, of Unocal, Warren M. Anderson, center, of Union Carbide, and William C. Douce, of Phillips Petroleum. The three chief executives are restructuring their companies after fending off takeovers.

How Restructurings Can Help

By LESLIE WAYNE

Now that the Union Carbide Corporation has escaped the clutches of Samuel J. Heyman and the GAF Corporation, the tough work begins.

Carbide will be traveling a difficult road, but one that other companies have struggled down before — trying to restructure after fending off a raider. Recent targets such as CBS, Phillips Petroleum, Unocal and Uniroyal are stripping away assets and working down huge debt burdens. And past targets, such as Martin Marietta, Brunswick and Walt Disney Productions, changed drastically after they repelled raiders.

Now there are many — in academia and in the target companies themselves — who say these companies may be better off for these changes. The price of victory may be high, measured in weakened balance sheets, the fire sale of assets and wholesale layoffs. Yet corporate raiders, unwanted though they may be, often force stodgy corporations to unlock valuable assets and make the difficult strategic decisions that will make them more competitive and efficient.

"This may not be as dangerous as people first think," said Robert H. Hayes, a management professor at the Harvard Business School. "Companies are forced to take new risks,

but they have new opportunities. They look a lot like younger companies — high debt and only a few businesses. When a company gets old, they often look back on this as the good old days."

Even target companies concur. "We've come out ahead," said Fred Terry, director of investor relations at Phillips Petroleum, which restructured after successfully defeating both T. Boone Pickens and Carl C. Icahn. "We've sorted through our assets and sold things that were not No. 1 priorities."

Overwhelming Debt

This is not to say, however, that serious concerns do not exist. The debt — money borrowed to beat the raider — can be so overwhelming that any economic downturn could bring these companies perilously close to bankruptcy. After victory, corporate cash flow becomes directed toward the repayment of debt rather than toward the research and capital investments needed to guarantee future growth. Corporate retrenchments, like the closing of plants and the elimination of employees, does little for wealth creation, either for the corporation or for the nation's economic well-being.

"There's a real downside," said Paul C. Christopherson, an analyst who follows Union Carbide for Bear Stearns & Company. "It results in a

preoccupation with reducing debt. This means you let people go, which reduces employment, and you cut back on capital spending, which reduces economic growth, and you cut discretionary spending, like research, which has long-term implications. If that happens to one company, do we care? But if it's 10, 50 or 100, it would start to affect the economy."

Data about the fate of forced corporate restructurings are still sketchy and anecdotal and far from conclusive. "It's really too early to know what the answer is," said Malcolm S. Salter, a Harvard Business School policy professor. "What you are looking at is a lot of prognostications." And just how this turns out will be decided largely by how a small group of executives steer their companies, men like Warren M. Anderson, chief executive of Carbide, Fred L. Hartley, chief executive of Unocal, and William C. Douce, chief executive of Phillips.

Accelerate Needed Changes

Still, some trends are clear. If stock price is a key measure of corporate performance, many of these restructured companies are doing well — some better than ever, with shares trading well above the raider's offer. And many target companies say the raid did not alter their existing business plan, but forced them to accelerate needed changes.

APRIL 14, 1986

Whose Company Is It, Anyway?

by James Balog*

Corporate takeovers were big news in 1985. The very word "takeover" has become supercharged. But are takeovers all bad?

Most of the angry comment is directed at hostile takeovers. But are all hostile takeovers bad and all friendly takeovers good? And friendly to whom? In most "friendly" deals, entrenched managements fare better than shareholders and employees.

Friendly takeovers rarely bring maximum value to shareholders. While takeovers can precipitate job reductions in the short-term because of the fundamental economic forces that led to the takeover, it is often the case that friendly takeovers cause greater employee dislocation because of job duplication and overlap. For example, for the year prior to the friendly merger of Chevron and Gulf Oil Company, combined total employment was 82,791. The year after the merger, employment dropped to 62,000. More than one-third of the drop was caused by duplication and early retirement.

There are essentially two points of view in the debate over whether hostile takeovers are good or bad, that of the acquirors and that of the managements of target companies. Acquirors believe that managers suppress shareholder values, and in so doing, maintain their own entrenched positions. The acquirors believe they can surface values of the target company's assets and share the benefits with the shareholders. Management, on the other hand, believe that the acquirors are out for a quick profit, put too much debt on the company's books, throw people out of work, and cause a short-term focus.

The debate boils down to the question of whose company is it, anyway—management's or the shareholders'?

Takeovers are one way of bringing two critical factors to a company—financing and entrepreneurial management—which enable a company to expand and grow. We feel considerably more secure with a good management behind a company than we do with a "good" rating.

A study by the Securities and Exchange Commission found that well-managed companies, which consistently spent money on research and pursued long-range objectives, were not takeover targets. Takeover targets were consistently below average in long-range spending, across the board.

Companies that survive are those that demonstrate a capacity for dynamic change. Restructuring the balance sheet is essential for companies trying to maintain their competitiveness within their industry and against foreign challengers. Contests for corporate control stimulate competition and require that companies adapt to changing market demands and fluctuating capital market conditions. Unocal, Phillips Petroleum, Walt Disney Productions, and other companies that have been the subject of a hostile takeover, have stated publicly that the takeover threat caused them to do what they should have been doing anyway—running the company better.

Are takeovers all bad? Certainly not. We believe that the very success of the American economy depends on them.

*Vice Chairman, Drexel Burnham Lambert

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FINANCING AND RESTRUCTURING FOR A COMPETITIVE WORLD

ADDRESS TO VALLEY NATIONAL BANK
INVESTMENT MANAGEMENT FORUM
OCTOBER 1985

BY
JAMES BALOG
VICE CHAIRMAN
DREXEL BURNHAM LAMBERT INCORPORATED

Good afternoon, ladies and gentlemen. Thank you for inviting me to join you today.

We've all seen the headlines: Philip Morris buys General Foods, Procter & Gamble wins in a bidding war for Richardson-Vicks, Revlon is being pursued by Pantry Pride, SCM is trying to fight off Hanson Trust. Exxon and CBS are buying back large blocks of their stock from the public.

Just what is causing this flurry of activity? The answer can be found in the structure of our economy. If we look back to the Thirties; we see that economic planners began to follow the philosophy of a man named John Maynard Keynes. Keynes believed in stimulating a stagnant economy into growth. In the post-Depression and postwar economies, Keynes' theories made a lot of sense. Somewhere along the line, though, we took only half of Keynes' theory -- the part about government spending to create jobs and economic activity -- and ignored his belief in raising taxes in the subsequent recovery to pay for the stimulus.

Under Lyndon Johnson, our hunger for both guns and butter -- yet the refusal to raise taxes to pay for them -- set off an inflationary spiral

and other economic problems that we are still grappling with today.

Keynesian economics was the basis of our system until fairly recently, when it was supplanted by supply-side economics. Supply-siders believe that cutting taxes will stimulate the economy and ultimately produce higher tax revenues from the new level of economic activity.

Unfortunately, the supply-siders have only been paying attention to one-half of the equation as well. They haven't managed to deal with our soaring federal deficit either and it is that deficit that may ultimately be our economic downfall.

We've seen the national economy go through cycles of boom and bust, unprecedented expansion followed by years of low or stagnant growth. Corporations experience cycles also. In fact, they go through life cycles just as people do. Over the years, companies experience growth, maturity and decline. Strategies and balance sheets that are sound for the growth phase aren't compatible with maturation or decline. So the very life cycle

of the corporation demands that balance sheets be viewed as a dynamic asset, one that has to be examined frequently and altered in response to changing conditions.

This is a relatively new concept for most companies, which has been forced on them by the requirements of the capital markets. But keep in mind that finance merely follows the underlying economics. Finance requirements have changed over time with the postwar rise and maturation of industries.

The need to clean up the balance sheet, then, is the underlying cause of the wave of corporate restructurings we've been seeing.

In the 18 months from January 1984 to mid-1985, nearly 400 of the 850 largest Fortune 500 corporations underwent some type of restructuring effort -- acquisition, divestiture, spinoff, stock buyback, or so forth. Despite all the headlines given to hostile takeovers, only 52 of these moves were either direct or indirect results of takeover threats.

The size and frequency of these restructurings are awesome, yet the trend is just beginning:

- * 282 units of companies were sold for \$57.2 billion,
- * 190 units were acquired at a cost of \$93.4 billion,
- * 33 units were spunoff into separate companies, valued at \$15.8 billion,
- * 86 companies announced stock repurchases of \$51.5 billion worth of stock,
- * 80 public companies underwent leveraged buyouts and became privately held concerns, and
- * 140 companies were involved in a range of other financial restructurings, from debt underwritings, to swaps, redemptions, refinancings and the like.

Only an eighth of these transactions were forced by takeover attempts. But restructuring activities proliferate, nonetheless. Companies have discovered that if they don't keep pace with a changing world, their performance -- and perhaps their existence -- can be damaged.

Corporations are restructuring themselves in response to:

- * the competitive pressures of an interdependent world,
- * the need for capital, and
- * inflation.

Just as finance follows economic flows, industry follows certain cycles. One that has had an enormous impact on our basic industries is that manufacturing moves to the areas of lowest cost of production. We've seen that concept in action for years. The textile and shoe plants that dominated New England in the 19th century began to mature and moved to the South, where wages and overhead costs were lower. In the Sixties and Seventies, the South lost those plants to Hong Kong and more recently to Singapore, Korea and Taiwan. And all of them are hearing the footsteps of China's stirrings to become a world-class industrial power. In the same way, the domestic steel industry and other smokestack industries have lost out to cheaper competition from Japan and Europe, now Korea.

We're seeing an even greater competition today in high-tech industries. Just as we've built up little Silicon Valleys in a dozen communities around the nation, the Japanese have cut costs and seized the edge in production of electronic components and consumer products. Now the Koreans are moving into many of the same high-tech areas that the Japanese had exploited. The cycle continues as price competition grows keener.

Despite the current pressures in Congress for protectionism, it should be clear that protectionist policies won't stop the economic reality at work here. Industries move to the areas of the lowest cost of production today and will in the future just as they have in the past. That's an economic reality that no legislation can change.

The news is not all bad as competition gets tougher. As some industries stumble against stiff competition, others change and adapt. The steel industry has shut down some product lines that can be made more efficiently overseas but a niche opened up to minimills, a sector of the steel industry that can operate efficiently because it is closer to the scrap supply.

That's just one example of the little cycles within a cycle that develop as industries mature. It's all part of the major sea change we're seeing in the competitive posture of America.

As industries mature and these cycles spin on, the financial structure in which these companies operate also must change. The capital structure that was good for a company's growth phase is not good for its low-growth or flat phase, or for its declining phase.

The oil industry is a good example. As the oil industry matured, it became a cash cow. At the same time, the external factors of the industry had changed. The expansion years are over, at least for the time being. The price surges, supply shortages, and pressure to find more oil and add to reserves that guided the industry in the Seventies and during the OPEC price shocks are over. The price and supply problems that contributed to the inflationary environment are temporarily on hold.

Today, oil companies know that there isn't any point in punching holes in the surface of the earth at random when oil prices are unstable and there's a world surplus. When natural gas is priced at the equivalent of \$12 a barrel of oil, it doesn't make sense to spend over \$12 a barrel to find more oil. Why bother? And, of course, Boone Pickens and the restructurers found you could "drill for oil" on Wall Street and get it at \$5 a barrel, \$6 a barrel, by taking over a whole company. So why drill on the North Slope? That's what happened. Oil company assets were undervalued and became targets for takeover when companies didn't move fast enough to improve their use of assets.

The companies that wanted to avert takeover attempts and put their cash reserves into action looked around for alternatives. Underlying their activity, of course, was the fact that the capital structures that are good for one phase are not good for another. As oil prices rose and fell, 14 big oil companies had to consider how to structure their balance sheet in order to cope with the changes.

Mobil went out and bought Montgomery Ward, another major bought Kennecott Copper and so forth. But in these diversification attempts, the oil companies failed miserably. Some companies, like Exxon, decided, well, we don't have any good ideas for all this cash and so they decided to buy back their stock from shareholders.

A lot of this activity is clearly defensive. The best defense against a takeover artist is simple: "do unto yourself before he does unto you." That's what companies have to do. They have to get very smart very quickly.

But not too many big companies have demonstrated the agility and flexibility to do that. Look at some of the biggest names in America, the companies that dominated the corporate scene in the Fifties:

Westinghouse, General Electric, Allis-Chalmers, and others. There is a fantastic difference in the way that the managements of Westinghouse and General Electric guided their companies over the postwar period. GE doesn't look like GE did a few years ago; it diversified into new product lines, products that promised future growth, and it sold off many of its best-known lines -- even its small appliance division. Westinghouse, meanwhile, is still hanging on to some of the basic products it had 20 or 30 years ago.

The companies that survive demonstrate a capacity for dynamic change.

Restructuring the balance sheet is essential for companies trying to maintain their competitiveness within their industry and against foreign challengers, but the cost of capital has forced companies to be creative and aggressive in leveraging their available assets.

American companies, by and large, have raised funds for expansion or restructuring in the credit markets rather than the stock market in recent years. Stock offerings have accounted for less than 3 percent of corporate cash needs from 1950 through 1984. With stock prices

sharply undervalued and the stock market itself less receptive to new offerings, the credit markets have been the cheaper and more efficient alternative for companies in need of cash. The markets have met the demand by creating an array of creative short-term financing instruments that offer terms custom-tailored to a specific company's need. And, of course, our tax policy makes debt offerings more attractive than stock offerings by permitting the deduction of interest payments while it penalizes stockholders through double taxation of dividends.

Corporate credit market debt increased \$170 billion last year, nearly double the increase in 1983. The trend is likely to continue in coming years. While critics have begun raising alarms about the corporate credit burden, arguing that too much debt is unhealthy, it's important to look at the move toward leveraging balance sheets in perspective.

Leverage is a powerful tool for companies, especially in today's interdependent world. Its importance has long been recognized by some of our leading foreign competitors, whose governments support high debt levels for their industry. Despite the concerns about the leveraging of America, studies show that U.S. companies carry a sharply lower percentage of debt than Japanese and German manufacturers.

From 1972 through 1982, Japanese manufacturers averaged 66 percent and the Germans averaged 64 percent of debt. During that time, American manufacturers averaged about 30 percent.

Higher leverage gives foreign makers many advantages over American companies, permitting them to pass on advantageous capital costs to customers in the form of lower price, better service and improved products. These are advantages that American companies can no longer afford to leave to their competition.

Inflation, while it is temporarily tamed, is another factor that corporations must plan for in the long term. Make no mistake about it, inflation is still very much alive in our economy. Over the past year you might have been lulled into a sense of security as inflation has dropped to negligible levels, commodity prices have collapsed, oil is flat on its back and so on.

But we're setting ourselves up for a fall. This nation is running the largest federal deficit ever. We're pumping up the money supply. We're living beyond our means and printing money to pay for it. Think about it. Indebtedness in America today is \$10,000 for every

man, woman and child. Debt service will cost approximately \$200 billion in fiscal 1986. One out of every \$2 collected in individual taxes goes to service the debt.

By living beyond our means, we are mortgaging the future. That's exactly what every other economy in the world that's borrowing money for current consumption is doing. Borrowing money for investment can be a healthy thing, but borrowing money for current consumption is another matter. When you incur that kind of debt, eventually your interest expenses eat into your ability to consume. That's what our government has been doing for years.

Money is like any other commodity, whether wheat or coffee or oil. If there are too many units of the commodity given current demand, the price per unit goes down and the value depreciates. That's what happens when we print excess money relative to economic growth. We're depreciating the dollar and it's being concealed by other factors.

Ultimately, we will have to pay for these deficits and these policies. Inflation, then, is certainly not a dead issue.

With this prospect, investors like yourselves should look for areas that will benefit from inflation. Real estate remains a sound investment, despite the high prices that some properties have reached. And in areas where real estate prices have begun to falter, you may well find some bargains now. In the stock market, you should look to industries involved in natural resources, food processing, and health care. When you're selecting specific companies, look for companies that are going through change and have shown a willingness and ability to adapt to change. Don't invest in companies fighting for protectionism, look for those that are changing, adapting their financial structures to new realities.

As American companies recognize the need to restructure themselves to remain competitive and operate more efficiently in a changing world, there will be more and more opportunities for investors.

Scientific Evidence on the Effects of Takeovers

In a nutshell, scientific analysis of the market for corporate control produced in dozens of studies over the last decade reveals that:¹

1. Takeovers benefit target shareholders -- premiums in hostile offers historically exceed 30% on average, and in recent times average about 50%.
2. Acquiring firm shareholders on average earn about 4% in hostile takeovers and roughly zero in mergers. In recent times these returns have fallen to zero as target firms have gained an upper hand in the negotiations.
3. Takeovers do not waste credit or resources, they generate substantial gains that historically have amounted to 8.4% of the total value of both companies. In recent times, the gains have been even larger.
4. Actions of managers that eliminate or prevent offers or mergers are most suspect as harmful to shareholders.
5. Golden parachutes for top level managers do not, on average, harm shareholders.
6. The activities of takeover specialists such as Icahn, Posner, Steinberg, and Pickens, on average, benefit shareholders.²
7. Takeover gains do not come from the creation of monopoly power.

¹ Michael C. Jensen, and R. Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, (April 1983), pp. 5-50, and Michael C. Jensen, "Takeovers: Folklore and Science," *Harvard Business Review* (Nov.-Dec. 1984).

² Clifford G. Holderness, and Dennis P. Sheehan, "Raiders or Saviors? The Evidence on Six Controversial Investors," *Journal of Financial Economics*, V. 14 (December, 1985), pp. 555-579, and Wayne H. Mikkelson, and Richard S. Ruback, "An Empirical Analysis of the Interfirm Equity Investment Process," *Journal of Financial Economics*, V. 14 (December, 1985).

8. Takeovers do not cause corporations to reduce expenditures on R & D.³
9. There is no reliable evidence which indicates that acquisitions cause an increase in plant closings and layoffs, and there is evidence which indicates little relationship between plant closings and acquisition activity.⁴

Transactions in the Corporate Control Market Are Bringing About a Restructuring of Corporate America

The transactions are generating large benefits for shareholders and for the economy as a whole. The corporate control market generates these gains by loosening control over vast amounts of resources and enabling them to move more quickly to their highest-valued use. This is a healthy market in operation, on both the takeover side and the divestiture side.

The total benefits generated by the control market have been huge as reflected in gains of \$40 billion to stockholders of acquired firms in 260 tender offers alone in the period January 1981 through May 1985.⁵ This figure does not include the gains from other control transactions such as mergers, leveraged buyouts, or divestitures, nor does it include the gains from reorganizations such as that of Phillips, Unocal and others that have been motivated by takeover attempts. (The Phillips, Unocal and Arco reorganizations alone created gains of an additional \$6.6 billion.) The gains to shareholders of New Jersey corporations were \$1.2 billion dollars in the period since 1978.⁶

³ Gregg Jarrell and Ken Lehn, "Institutional Ownership, Tender Offers and Long Term Investments," (Office of the Chief Economist, Securities and Exchange Commission, April, 1985), and "R&D Scoreboard: Reagan & Foreign Rivalry Light a Fire Under Spending", *Business Week* (July, 8, 1985), p. 86 ff.

⁴ Glenn Yago and Gelvin Stevenson, "Mergers and Acquisitions in the New Jersey Economy," (Economic Research Bureau, State University of New York at Stony Brook, May 8, 1986)

⁵ As estimated by the office of the Chief Economist of the SEC.

⁶ Glenn Yago and Gelvin Stevenson, "Mergers and Acquisitions in the New Jersey Economy," (Economic Research Bureau, State University of New York at Stony Brook, May 8, 1986)

Major Reasons for Takeover Activities

The current high level of takeover activity seems to be caused by a number of factors, including:

1. The relaxation of restrictions on mergers imposed by the antitrust laws.
2. The necessity to withdraw resources from industries that are growing more slowly or which must shrink.
3. Deregulation in the financial services, oil and gas, transportation and broadcasting markets that is bringing about a major restructuring of those industries.
4. Improvements in takeover technology, including a larger supply of increasingly sophisticated legal and financial advisors, and improvements in financing technology (for example, the strip financing commonly used in leveraged buyouts and the original issue of high-yield non-investment grade bonds).

The first three factors (antitrust relaxation, exit and deregulation) are generally consistent with data showing the intensity of takeover activity by industry. For example, over the last 4 years the value of merger and acquisition transactions was highest in oil and gas, followed by banking and finance, insurance, food processing, and mining and minerals.

Many areas of the U.S. economy have been experiencing reduced rates of growth and, in some cases, even retrenchment -- a phenomenon that has many causes, including substantially increased competition from foreign firms. This has increased takeover activity because takeovers play an important role in facilitating exit from an industry or activity. The declining energy industry is a good example. Deregulation of the financial services market is consistent with the fact that banking and finance, and insurance are ranked high in the list. Deregulation has also been an important factor in the transportation and broadcasting industries. Mining and minerals has been subject to many of the same forces impinging on the energy industry, including changes in the value of the dollar.

Takeovers Threaten Top-Level Managers

The market for corporate control is best viewed as a major component of the managerial labor market. It is the arena in which alternative management teams compete for the rights to manage corporate resources. Understanding this is crucial to understanding much of the rhetoric about the effects of hostile takeovers.

Managers formerly protected from competition for their jobs by antitrust constraints that prevented takeover of the nation's largest corporations are now facing a more demanding environment and a more uncertain future. Estimates indicate that roughly half or more of top-level executives leave during the first three years after acquisition.⁷ The development of innovative financing vehicles, like high-yield non-investment grade bonds (often pejoratively referred to as "junk" bonds), have also removed size as a significant impediment to competition in this market. Although they have not been widely used in hostile takeovers as yet, these new financing techniques permit small firms to obtain resources for acquisition of much larger firms by issuing claims on the value of the venture (that is, the target firm's assets) just like any other corporate investment activity. It is not surprising that many executives of large corporations would like relief from this new competition for their jobs, but restricting the corporate control market is not the efficient way to handle the problems caused by the increased uncertainty in their contracting environment.

Takeovers Provide External Control

The internal control mechanisms of corporations, which operate through the board of directors, generally work well. However, on occasion they break down. One important source of protection for investors in these situations is the takeover market. Other management teams that recognize an opportunity to reorganize or redeploy an organization's assets and thereby create new value can bid for the control rights in the

⁷ As reported by the *Wall Street Journal* (May 6, p. 1) summarizing a study by Mitchell & Company of acquisitions valued at more than \$500 million.

takeover market. To be successful such bids must be at a premium over current market value. This provides investors an opportunity to realize part of the gains from reorganization and redeployment of the assets.

The Market for Corporate Control is an Agent for Change

Takeovers generally occur because changing technology or market conditions mean a major restructuring of corporate assets is required, but in some cases takeovers occur because incumbent managers are incompetent. When the internal processes for change in large corporations are too slow, costly and clumsy to efficiently accomplish the required restructuring or change in managers, the capital markets, through the market for corporate control, are bringing about the changes. The capital markets have been responsible for substantial changes in corporate strategy in recent times.

Managers often have difficulty abandoning strategies they have spent years formulating and implementing, even when those strategies no longer contribute to the organization's survival. Such changes often require abandonment of major projects, relocation of facilities, changes in managerial assignments, and closure or sale of facilities or divisions. It is easier for new top-level managers with no ties or previous association with current employees or communities to make such changes. Moreover, normal organizational resistance to change commonly falls significantly in the early stages of the reign of new top-level managers. For example, Carl Icahn's victory over Texas Air for the acquisition of TWA was accomplished in part by the willingness of some TWA unions to negotiate favorable contract concessions with Icahn that TWA was unable to attain prior to the takeover conflict. Such organizational factors that make change easier for newcomers, coupled with a fresh view of the business, can be a major advantage to new managers after a takeover. On the other hand, lack of detailed knowledge about the firm also poses risks for new managers and increases the likelihood of mistakes.

Takeovers are particularly important in bringing about efficiencies when exit from an activity is required. The oil industry is a good example of the control market as an

instrument of change in such a situation. It is particularly hard for many managers to deal with the fact that some firms in the oil industry have to go out of business. This is cheaper to accomplish through merger and the orderly liquidation of marginal assets of the combined firms than by slow, agonizing death in a competitive struggle in an industry with overcapacity. The end of such a process often occurs in the bankruptcy courts with high losses and unnecessary destruction of valuable parts of organizations that could be used productively by others.

In short, the external takeover market serves as a court of last resort that plays an important role in: 1) generating organizational change, 2) motivating the efficient utilization of resources, and 3) protecting shareholders when the corporation's internal controls and board-level control mechanisms are slow, clumsy, or break down entirely.

Divestitures Are the Subject of Much Erroneous Criticism

If assets are to move to their most highly valued use, acquirers must be able to sell off assets to those who can use them more productively. Therefore, divestitures are a critical element in the functioning of the corporate control market and it is important to avoid inhibiting them. Labeling divestitures with emotional terms such as "bustups" is not a substitute for analysis or evidence.

Moreover, it is important to recognize that divested plants and assets do not disappear, they are reallocated. Sometimes they continue to be used in similar ways in the same industry, and in other cases they are used in very different ways and in different industries. But in both cases they are moving to uses that their new owners are betting are more productive. This is beneficial to society.

Proponents of restrictions on takeover activity argue that it causes plant closings and the loss of jobs that are greater than that which would occur in the absence of an acquisition. There is no evidence to support this assertion. There is evidence that seems to indicate it is false, but the difficult problem here is controlling for what the job losses would have been in the absence of takeover. The data from several studies by the

Conference Board, Government Accounting Office, Yago, and Yago and Stevenson indicate little or no relation between takeover activity and plant closings and job losses in the nation, New York State and in New Jersey. Yago and Stevenson found that only about 2% of the 62,000 jobs lost in New Jersey in the period 1982-1985 were attributable to acquired firms, and non-acquired firms experienced higher rates of employment loss than acquired firms.⁸

Finally, it is useful to recognize that the takeover and divestiture market provides a private market constraint against bigness for its own sake. The potential gains available to those who correctly perceive that a firm can be purchased for less than the value realizable from the sale of its components provide an incentive for entrepreneurs to search out such opportunities and to capitalize on them by reorganizing such firms into smaller entities.

The mere possibility of such takeovers also motivates managers to avoid putting together uneconomic conglomerates and to break up those that currently exist. This is now happening. The defensive reaction of many firms to avoid an unwanted takeover often leads to policy changes that are similar to the proposed actions of the potential acquirer. Examples of this are the reorganizations that are occurring in the oil industry, broadcasting and chemicals (for example, CBS and Union Carbide), the sale of "crown jewels," and divestitures brought on by the desire to liquidate large debt positions incurred to buy back stock or to make other payments to stockholders. Unfortunately, the basic economic sense of these transactions is often lost in a blur of emotional rhetoric and controversy.

⁸ See General Accounting Office, "Preliminary Analysis of U. S. Business Closures and Permanent Layoffs During 1983-1984", (Presented at the Office of Technological Assessment/Government Accounting Office Workshop on Plant Closing, April 3-May 1, 1986, Glenn Yago and Gelvin Stevenson, "Mergers and Acquisitions in the New Jersey Economy." (Economic Research Bureau, State University of New York at Stony Brook, May 8, 1986), Glenn Yago, et. al., "Investment and Disinvestment in New York, 1960-1980," *Annals of the American Academy of Political and Social Science*, 475 (September, 1984) pp. 28-38, Glenn Yago, "Plant Closings in New York: Causes, Consequences and Policy Implications, (Report to the New York State Director of Economic Development and the Industrial Cooperation Council, January 31, 1986).

Takeovers Do Not Cause Managers To Behave Myopically

It has been argued that growing institutional equity holdings and the fear of takeover cause managers to behave myopically and therefore to sacrifice long-term benefits to increase short term profits. The arguments tend to confuse two separate issues, 1) whether *managers* are shortsighted and make decisions that undervalue future cash flows while overvaluing current cash flows (myopic managers), and 2) whether *security markets* are shortsighted and undervalue future cash flows while overvaluing near term cash flows (myopic markets).

There is much evidence inconsistent with the view that security markets are shortsighted and no evidence that indicates it is true.

1. Even casual observation of the equity markets reveals the market values more than current earnings. It values growth as well. The mere fact that price/earnings ratios differ widely among securities indicates the market is valuing something other than current earnings. Indeed, the essence of a growth stock is one that has large investment projects yielding few short term cash flows but high future earnings and cash flows.
2. The continuing marketability of new issues for startup companies with little record of current earnings, the Genentechs of the world, is also inconsistent with the notion that the market does not value future earnings.
3. McConnell and Muscarella [1986] provide evidence that (with the exception of the oil industry) stock prices respond positively to announcements of increased investment expenditures, and negatively to reduced expenditures. Their evidence is also inconsistent with the notion that the equity market is myopic.
4. The vast evidence on efficient markets indicating that current stock prices appropriately incorporate all currently available public information is also inconsistent with the myopic markets hypothesis. Although the evidence is not literally 100% in support of

the efficient market hypothesis, there is no better documented proposition in any of the social sciences.⁹

The evidence indicates, for example, that the market appropriately interprets the implications of corporate switches from Fifo to Lifo inventory valuation techniques. This accounting change reduces reported current income and yet increases cash flows by reducing taxes. The evidence indicates that stock prices of firms that make such switches increase even though reported earnings decline. Moreover, the increases are positively associated with estimates of the value of the tax savings.¹⁰ The evidence also indicates the market is not fooled by accounting changes that increase reported profits but cause no change in corporate cash flows. Examples are switches from accelerated to straight line depreciation techniques and adoption of the flow-through method for reporting investment tax credits. Here the evidence indicates that "security prices increase around the date when a firm first announces earnings inflated by an accounting change. The effect appears to be temporary, and, certainly by the subsequent quarterly report, the price has resumed a level appropriate to the true economic status of the firm."¹¹

Additional evidence is provided by the 30% increase in Arco's stock price that occurred on announcement of its major restructuring in 1985. This price increase is inconsistent with the notion that the market values only short term earnings. Even though Arco simultaneously revealed that it would have to take a \$1.2 billion write-off as a result of the restructuring, the market still responded positively.

⁹ For an introduction to the literature and empirical evidence on the theory of efficient markets, see E. Elton and M. Gruber, *Modern Portfolio Theory and Investment Analysis*, (New York: Wiley, 1984), Chapter 15, p. 375ff. and the 167 studies referenced in the bibliography. For some anomalous evidence on market efficiency, see Michael C., Jensen, ed., "Symposium on Some Anomalous Evidence Regarding Market Efficiency," *Journal of Financial Economics*, V. 6, Nos. 2-3 (June/September, 1978), pp. 93-330.

¹⁰ See G. C. Biddle and F. W. Lindahl, "Stock Price Reactions to LIFO Adoptions," "The Association Between Excess Returns and LIFO Tax Savings", *Journal of Accounting Research*, V. 20, No. 2 Pt. 2 (Autumn 1982), 551, 588, and S. Sunder, "Stock Price and Risk Related to Accounting Changes in Inventory Valuation," *Accounting Review* (April, 1975), 305-315. W. Ricks, "The Market's Response to the 1974 LIFO Adoptions", *Journal of Accounting Research*, V. 20, No. 2 Pt. 2 (August, 1982), 367-387 presents evidence that firms adopting LIFO experienced temporary price declines in the year of adoption and that these price declines were eliminated within 12 months.

¹¹ R. Kaplan and R. Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," *Journal of Business*, (April, 1972), 225-257.

5. Recent versions of the myopic markets hypothesis emphasize increasing institutional holdings and the pressures they face to generate high returns on a quarter-to-quarter basis. It is argued that these pressures on institutions are a major cause of pressures on corporations to generate high current earnings on a quarter-to-quarter basis. The institutional pressures are said to lead to increased takeovers of firms (because institutions are not loyal shareholders) and to decreased research and development expenditures. It is argued that because R & D expenditures reduce current earnings, firms making them are therefore more likely to be taken over and that reductions in R & D are leading to a fundamental weakening of the corporate sector of the economy.

A recent study of 324 firms by the Office of the Chief Economist of the SEC finds substantial evidence that is inconsistent with this version of the myopic markets argument.¹² The evidence indicates that:

- increased institutional stock holdings are not associated with increased takeovers of firms.
- increased institutional holdings are not associated with decreases in research and development expenditures.
- firms with high research and development expenditures are not more vulnerable to takeovers.
- stock prices respond positively to announcements of increases in research and development expenditures.

Those who make the argument that takeovers are reducing R & D spending also have to come to grips with the aggregate data on such spending which is inconsistent with the argument. Total spending on R & D in 1984, a year of record acquisition activity, increased by 14% according to *Business Week's* annual survey of 820 companies. (The sample companies account for 95% of total private sector R & D expenditures.) This

¹² Gregg Jarrell and Ken Lehn, "Institutional Ownership, Tender Offers and Long Term Investments," (Office of the Chief Economist, Securities and Exchange Commission, April, 1985).

represented "the biggest gain since R & D spending began a steady climb in the late 1970's".¹³ All industries in the survey increased R&D spending with the exception of steel. Moreover, R&D spending increased from 2% of sales (where it had been for five years) to 2.9%.

An Alternative Hypothesis

There is an alternative hypothesis that explains the current facts, including the criticisms of managers, quite well.

Suppose that some managers are simply mistaken, that is, their strategies are wrong, and that the financial markets are telling them they are wrong. If they don't change, their stock prices will remain low. If the managers are indeed wrong, it is desirable for the stockholders and for the economy to remove them to make way for a change in strategy and more efficient utilization of the resources.

Free Cash Flow and the Conflict between Shareholders and Managers

More than a dozen separate forces drive takeover activity, including such factors as deregulation, synergies, economies of scale and scope, taxes, managerial incompetence, and increasing globalization of U.S. markets. One major cause of takeover activity, the agency costs associated with conflicts between managers and shareholders over the payout of free cash flow, has received relatively little attention. Yet it has played an important role in acquisitions over the last decade.

Managers are the agents of shareholders, and because both parties are self-interested there are serious conflicts between them over the choice of the best corporate strategy. Agency costs are the total costs of coordinating the divergent interests that arise in such cooperative arrangements. They consist of the costs of monitoring and bonding managerial behavior (such as the costs of producing audited financial statements and devising and implementing compensation plans that reward managers for actions that increase investors' wealth), and the inevitable costs that are

¹³ "R&D Scoreboard: Reagan & Foreign Rivalry Light a Fire Under Spending", *Business Week* (July, 8, 1985), p. 86 ff.

incurred because the conflicts of interest can never be resolved perfectly. Sometimes these costs can be large. They have amounted to billions of dollars in the oil industry.

Free cash flow is cash in excess of that required to fund all of a firm's projects which promise to earn more than the cost of capital. Such free cash flow must be paid out to shareholders if the firm is to be efficient and to maximize value for shareholders.

The problem is how to motivate managers to disgorge cash to investors rather than wasting it on organizational inefficiencies or low-return projects.

Managers are generally reluctant to pay out resources to shareholders because it reduces their power and subjects them to the monitoring of the capital markets that occurs when they must obtain new capital. Managers also have incentives to over-retain funds for growth because their compensation is positively related to growth. Moreover, the tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates a strong organizational bias toward growth to supply the new management positions that such promotion-based reward systems require.

Managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out current cash that would otherwise be invested in low-return projects or wasted. However, this leaves managers with control over the use of future free cash flows. Promised cash payout in the form of a "permanent" increase in the dividend is weak because future dividends can be reduced.

The Role of Debt in Motivating Efficiency

Debt has important control effects in reducing the agency costs of free cash flow. Buying back stock with newly created debt enables managers to effectively bond their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. Through such debt creation, managers give shareholder-recipients of the debt the right to take the firm into bankruptcy court if they do not maintain their promise to make the interest and principle payments.

Debt for stock exchanges reduce the waste associated with free cash flow by reducing the cash available for spending at the discretion of managers. Debt also creates organizational

incentives to motivate managers and to give them the crisis (threat of bankruptcy) to help overcome normal organizational resistance to retrenchment which the payout of free cash flow often requires; programs must be cancelled, careers must change, and layoffs are frequently required. Debt for stock exchanges also create tax advantages at the corporate and personal levels.

The control effects of debt are not as important for rapidly growing organizations with large and highly profitable investment projects but no free cash flow. Such organizations have a surplus of desirable investments and will experience the monitoring of the capital markets when they raise new funds.

The control effects of debt are more important in organizations which generate large cash flows but have low growth prospects and even more important in organizations which must shrink. In these organizations the pressures to waste cash flows by investing them in uneconomic projects is most serious.

The evidence from leveraged buyouts and from takeover activity in the oil industry supports the argument.

Evidence from Leveraged Buyouts

Many of the benefits of leveraged buyout (LBO) transactions seem to be due to the control effects of debt in situations where the costs of free cash flow are high. In 1984, going private transactions totaled \$10.8 billion and represented 27% of all public acquisitions. The premiums paid on these transactions average over 50% of market value.

Desirable leveraged buyout candidates are frequently firms or divisions of larger firms that have stable business histories and substantial free cash flow (that is, low growth prospects and high potential for generating cash flows)—situations where agency costs of free cash flow are likely to be high.

LBO transactions are frequently financed with high debt; 10 to 1 ratios of debt to equity are not uncommon. The use of strip financing and the allocation of equity in LBOs reveal a sensitivity to incentives, conflicts of interest, and the increased likelihood of bankruptcy in an organization with high debt.

Strip financing, the practice in which risky non-equity securities ranking below senior debt are held in approximately equal proportions, limits the conflict of interest among such risky security holders and therefore limits bankruptcy costs in highly leveraged LBOs.

The Oil Industry

Radical changes in the energy market since 1973 simultaneously generated large increases in free cash flow and required a major shrinking of the petroleum industry. In this environment, the agency costs of free cash flow were large, and the takeover market played a critical role in reducing them.

Following the 10-fold increase in crude oil prices, the consumption of oil and expected future increases in oil prices fell. Real interest rates and exploration and development costs also increased so that the optimal level of capacity in the industry fell. By the late 1970's, the industry had substantial excess capacity in crude reserves, refining, and distribution. At the same time cash flows were huge. For example, in 1984 the ten largest oil companies generated cash flows of \$48.5 billion, 28% of the total cash flow of the top 200 firms.

Consistent with the agency costs of free cash flow, management did not pay out the excess resources to shareholders. Instead, the industry continued to spend heavily on exploration and development activity even though average pre-tax returns were low. Bernard Picchi of Salomon Bros. estimated them to be substantially below 10%. They also launched unsuccessful diversification programs to invest funds outside the industry. These programs, however, generated social benefits because the resources were paid out to target-firm shareholders rather than wasted on uneconomic drilling programs.

Mergers in the oil industry, motivated largely by T. Boone Pickens, have led to large increases in debt, payouts of large amounts of capital to shareholders (albeit target shareholders), reduced expenditures on wasteful drilling programs and reduced capacity in refining and distribution. The benefits have been huge; total gains in the Gulf, Getty and Conoco takeovers alone were more than \$17 billion. More is possible.

Actual takeover is not necessary to induce the required retrenchment and return of resources to shareholders.

- The Phillips restructuring, brought about by threat of takeover, resulted in a \$1.2 billion (20%) gain in its market value. It repurchased 53% of its stock for \$4.5 billion in debt, raised its dividend 25%, cut capital spending and initiated a program to sell \$2 billion of assets.

- Unocal's defense in the Mesa tender offer battle resulted in a \$2.2 billion (35%) gain to shareholders. It paid out 52% of its equity by repurchasing stock with a \$4.2 billion debt issue. The Unocal defense incidentally caused its shareholders to lose the \$1.1 billion higher Mesa offer.

- Arco's voluntary restructuring resulted in a \$3.2 billion (30%) gain in market value. It involves a 35% to 40% cut in exploration and development expenditures, repurchase of 25% of its stock for \$4 billion, a 33% increase in its dividend, withdrawal from gasoline marketing and refining east of the Mississippi, and a 13% reduction in its workforce.

- Diamond-Shamrock's reorganization announcement on 7/10/85 is further support for the theory because its market value fell 2% on the announcement day (and continued falling). Its restructuring involved *reducing* cash dividends by 76¢/sh (-43%), creating a master limited partnership (MLP) to hold 35% of its North American production, paying 90¢/sh annual dividend in partnership shares, repurchasing 6% of its shares for \$200 million, selling 12% of its MLP to the public, and *increasing* expenditures on oil and gas exploration by \$100 million/year.

The theory predicts that value-increasing takeovers occur in response to breakdowns of internal control processes in firms with substantial free cash flow and organizational policies (including diversification programs) that are wasting resources. It predicts hostile takeovers, large increases in leverage, dismantlement of empires which lack economies of scale or focus to give them economic purpose (e.g., many conglomerates) and much controversy as current managers

object to loss of their jobs or the changes in organizational policies forced on them by threat of a takeover. The CBS and Union Carbide restructuring to avoid takeover are also good examples.

The debt created in a hostile takeover (or takeover defense) of a firm suffering severe agency costs of free cash flow need not be permanent. Indeed, sometimes it is desirable to "over-leverage" such a firm. In these situations, leveraging the firm so highly that it cannot continue to exist in its old form generates benefits. It creates the crisis to motivate cuts in expansion programs and the sale of those divisions which are more valuable outside the firm. The proceeds are used to reduce debt to a more normal or permanent level. This process results in a complete rethinking of the organization's strategy and its structure. When successful, a much leaner, more efficient, and competitive organization results.

Securities Industry Association

MERGERS AND ACQUISITIONS

IN

THE NEW JERSEY ECONOMY

The Economic Research Bureau, State University of New York at Stony Brook, is responsible for the contents of this report. This is a report of the Economic Research Bureau, supported by the Securities Industry Association, and does not necessarily represent the views of the Securities Industry Association. This report reflects the views and analysis of the Economic Research Bureau and should not be construed as an official report of the State University of New York.

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HIGHLIGHTS

New Jersey, like many other states, is in the throes of a major economic transformation. From 1980-1985, total employment increased by 11.7%. But at the same time, manufacturing employment fell by 7.9%, costing the state 62,000 jobs. Permanent layoffs occurred 913 times during this period, because of plant closings, contractions, or relocations, idling 95,215 workers. There was no evidence in our sample of plant closing occurring as a result of a hostile takeover. This transition is being caused by increased international competition and the high dollar, and not by M&A activity.

According to original survey data, less than 1% of the total jobs lost in New Jersey were associated in any way with acquired firms. There is no evidence that the change in ownership had anything to do with these reductions in employment. Acquisitions increased the wealth of owners of stock in New Jersey firms by \$1.2 billion.

Merger and acquisition (M&A) activity involving major New Jersey firms made up only 2.2% of the total number and 1.9% of the total value of all U.S. transactions. Most of New Jersey's M&A activity was friendly, reflecting the mutual economic benefits of consolidation.

Moreover, the M&A activity that did occur in New Jersey was concentrated in the hard-hit manufacturing sector. Only 21% of New Jersey jobs are in manufacturing, but 55.6% of major M&As in the state occurred in manufacturing.

In some instances, selling the plant to new owners was clearly an alternative to closing a plant and laying off workers. More generally, M&A activity appeared to facilitate the adjustment to structural change and help restore industrial competitiveness.

Increasing state takeover regulations are an ineffective way to prevent plant closings or retard job loss according to international and domestic studies, as well as the evidence from New Jersey case studies. The preferred strategy is to integrate legislative responses into a broader program to assist and enhance structural adjustment.

States have granted corporations ample opportunity to defend themselves through changes in their charters, and many New Jersey companies have instituted several anti-takeover provisions. Twenty large New Jersey corporations have recently adopted 54 anti-takeover measures.

States should not prevent corporate takeovers or mergers that may result from inefficiencies or changing corporate strategies and market conditions. Well formulated policies should interact--not interfere--with market forces.

1. EXECUTIVE SUMMARY

MERGERS & ACQUISITIONS: AN OVERVIEW

* Merger & acquisition (M&A) activity occurs for a variety of reasons, including changes in financial markets, technology, management, sources of supply, factor costs, and product demand. Corporate reorganizations through M&A activity are symptomatic of complex structural changes affecting industrial competitiveness and employment prospects.

* There is evidence that corporate combinations lead to synergy, increased technology transfers, and economies of scale. Sometimes, however, corporate combinations fail. There are no rigorous, scientific findings that M&A transactions themselves either increase or decrease employment, productivity, profitability, or the pace of technological change in a consistent, significant, or direct way.

* The U.S. is in the midst of the fourth wave of M&As, and most experts maintain that it is about to subside.

THE NEW JERSEY ECONOMY.

* New Jersey, like many other states, is in the throes of a major economic transformation.

* Total employment increased by 11.7% from 1980 to 1985.

* Unemployment fell from its 9.1% peak in 1982 to 5.8% in 1985.

* Employment gains were concentrated in financial and health care services.

* Manufacturing employment fell by 7.9%, costing the state 62,000 jobs.

M&A ACTIVITY AND THE NEW JERSEY ECONOMY.

* M&A activity in New Jersey is a relatively small part of total U.S. activity, but appears to play an important role in facilitating New Jersey's economic transformation.

* M&As transactions involving major New Jersey firms made up only 2.2% of the total number and 1.9% of the total value of all U.S. transactions.

* The majority (81%) of New Jersey's M&As activity was friendly, reflecting the mutual economic benefits of consolidation. The other 19% (6 in number) were unsolicited (which we define as hostile). They ended successfully after the offering terms were improved.

* Permanent layoffs occurred 913 times in the 1980-1985 period due to plant closings, contractions, or relocations, idling 95,215 workers.

* Using original survey data, we were able to identify fewer than 1,000 lost jobs (less than 1% of total job loss) that could be traced in any way to acquired firms. There is no evidence that the change in ownership had anything to do with the reductions in employment.

* Most firms that laid off workers were not involved in M&A activity.

* Mergers and acquisitions are an alternative to plant closings. A company needing to shed a division or operation can sell it or close it. Clearly, selling is preferable. Hindering M&A activity could encourage plant closings.

* Only 21% of New Jersey's jobs are in manufacturing, but 55.6% of major M&As in the state occurred in manufacturing.

* M&As are a necessary part of the adjustment process and probably slow the drop in manufacturing employment.

* M&A activity in New Jersey is a result, not cause, of New Jersey's economic transformation.

* Acquisitions may increase jobs by leading to corporate growth.

* Corporate acquisitions increased the wealth of shareholders of New Jersey corporations by \$1.2 billion.

ECONOMIC ADJUSTMENT AND STATE POLICY

* Policy responses should be flexible and strategic. Responses to industrial restructuring should not prevent corporate takeovers or mergers that may result from inefficiencies or changing corporate strategies and market conditions. Well-formulated policies should interact -- not interfere -- with market forces.

* Increasing state regulations are an ineffective way to prevent plant closings or retard job loss, according to international and domestic studies. The preferred strategy should be to integrate legislative responses into a broader program to assist and enhance structural adjustments.

* Twenty large New Jersey corporations recently have adopted 54 anti-takeover measures. States have granted corporations ample opportunity to defend themselves through changes in their charters, and most large New Jersey companies have instituted several anti-takeover provisions.

* States should consider efforts to improve the workings of capital markets for small firms. This could include new forms of finance and identifying and assisting companies seeking divestiture or reorganization.

* Labor market strategies should encourage and assist rather than retard adjustments. Effective examples include: special training programs, incentives for retraining and relocation, income support, and wage subsidies.

2. INTRODUCTION

Merger and acquisition activity dominates the economic news. Almost on a daily basis, some well-known American company buys another company or is itself acquired. The current merger wave represents an accumulation of the ongoing process of corporate restructuring as the economy moves into new markets and technologies. We are in the midst of the fourth wave of merger and acquisition activity in modern U.S. history: 1898-1908 (horizontal acquisitions characterized by oil trusts); 1922-1930 (vertical integration); 1967-1974 (conglomerate acquisitions); 1980-the present (eclectic combinations) (Scherer 1980). See Illus. 2.1. The number of transactions today is actually smaller than in some past waves. For each year during the 1980s, there were approximately 2,000 deals per year, while during the 1967-74 period, the number ranged from 3,000 to 6,000 per year. What is new today is the size of transactions. In nominal terms, the average value is 48 percent larger (from 1981 through 1984) than in any previous four year period (Council of Economic Advisors 1985).

While the size of some transactions may seem huge, the total value of transactions represented only a tiny piece of the

U.S. economy. In no year between 1965 and 1983 did the total value of mergers exceed 1.3 percent of total U.S. corporate assets (McKinsey 1984: 29-30). See Illus. 2.1A.

Despite the popular image of voracious corporations gobbling up company after company, liquifying their assets, and assuming higher levels of industrial concentration, the fact is that from 1965 to 1983, 69% of acquiring firms made only one acquisition, and only 7% made more than three. Aggregate concentration has remained relatively stable, increasing by no more than 2 percentage points during those years. M&A activity has had no statistically significant impact upon aggregate concentration, and sales and assets concentration ratios have actually declined slightly. The lion's share of variation in aggregate concentration is attributed to internal growth of firms, not changes in business concentration. Moreover, the historical tendency towards higher levels of concentration by the largest firms appears to be eroding in most recent years. (McKinsey 1984)

Nevertheless, this activity has ignited intense debate about the desirability of these transactions. Executives, employees, financial experts, politicians, and most other citizens line up on one side or the other of the questions. Are these deals good for the economy? Do they promote economic efficiency? Do they spur growth? Do they make the U.S. economy more competi-

tive? Do they promote or retard job growth?

Other questions concern the proper role for public policy. How is the public interest best served? Should M&A activity be encouraged or throttled?

These are all critical questions which require systematic empirical analysis. This report addresses the major issues:

- * The size and number of transactions and their relative impact on the New Jersey economy.
- * The characteristics of M&A activity in New Jersey.
- * The reasons for M&A activity in New Jersey.
- * The effects of M&A activity in New Jersey on employment, market efficiency, research and development expenditures, and shareholder wealth.

Then we discuss the most important policy issues that arise from our findings. We view this activity in the broad context of corporate reorganization which is occurring as part of an economic restructuring and adjustment process for service and technology-based industries. Does M&A activity enhance the necessary modernization of New Jersey industry or retard it? In

short, are mergers and acquisitions good for the New Jersey economy, job retention, and job growth--or not?

3. THE SCOPE OF MERGERS AND ACQUISITIONS IN NEW JERSEY, 1978-PRESENT

3.1 The Number, Size, and Types of Transactions

Since the beginning of the current merger wave, there have been 843 episodes of merger and acquisition activity in New Jersey according to the data base we developed for this project from Securities Data Corporation and the Securities Industry Association. 10.1% of these attempts were withdrawn, and another 14.2% occurred in industries regulated by state agencies: banks, S&Ls, and insurance companies. In another tenth of the cases (9.8%), one company or investor group merely bought a stake in another company. In 13.4% of the events, companies bought their own shares on the open market or through self-tender offers.

That left only 297, or 35.3%, where one company bought part or all of another. About half that number, 145 or 17.2% of the total, were divestitures. From that 297, we selected for analysis the 51 largest transactions that accounted for about half of the total value of M&A activity (Appendix). We gathered

further financial and other corporate information from publicly available sources and interviews with principals involved in those corporations.

Twenty-eight of these were divestitures--sales of one or more divisions. The average value of each divestiture was \$281 million. In 23 of these cases, the 4 buyers were other companies. In the other 5, the properties were acquired through leveraged buy-outs by private investors, often including managers from the divisions themselves.

In 16 of the M&A transactions, whole companies were bought. The average value of these transactions was \$394.1 million. Purchasers were other corporations in 12 of those cases, and private investors and managers in the other four. The remaining 6 M&A transactions involved banks.

3.2 New Jersey's Share of Total U.S. Merger and Acquisition Activity.

Transactions involving New Jersey companies or their divisions as acquirees encompass only a small part of M&A activity in the total U.S. economy. From 1978 to the present, mergers and acquisitions in New Jersey were 2.2% of the total number, and their value represented 1.9% of all U.S. transactions. Less than

2.7% of the nation's major hostile takeovers were in New Jersey. These transactions also represent a small portion of total New Jersey corporate assets.

4. CHARACTERISTICS OF MERGER AND ACQUISITION ACTIVITY IN NEW JERSEY

4.1 Mergers and Acquisitions by Industry Sector

M&A activity can occur in any sector of the economy as corporations restructure to pursue new industrial strategies. The number of New Jersey takeovers appear relatively evenly distributed across the spectrum of manufacturing and service industries. The target companies or divisions in most of these deals (25 of 45 or 55%) were involved in manufacturing. Within manufacturing, no more than three takeovers occurred in any of the 15 industrial categories analyzed. Apparel and other finished products and miscellaneous retail trade had three purchases. These were both sectors undergoing rapid consolidation as a response to import penetration. Other sectors with strong M&A activity included communications (dominated by the Metromedia deals), printing and publishing, water transportation, fabricated metal, and apparel and other finished products. These sectors had over 5% of the aggregate value of total transactions. See Illus. 4.1 and 4.2.

Recently, the banking sector's activity has increased, as the financial services industry undergoes rapid consolidation following deregulation and major upheavals in financial markets. Nationally, financial institutions now represent 56% of total acquisition activity and 58% of acquisition value. This development shows how financial institutions have accommodated to pressures of price, performance, and capital needs in the new economic and regulatory environment. Seventy-four percent of the increase in the value of M&A activity nationally can be attributed to financial institutions (McKinsey 1984:4,13). In New Jersey, banking transactions represented 5.5% of the value of M&A activity in the current merger wave.

4.2 Divisional Divestitures.

During the 1960s, conglomerate M&A activity represented a disproportionate number of all transactions as companies sought to increase their value by acquiring firms in unrelated industries. By the late 1970s and early 1980s, however, aggressive companies that had become conglomerates discovered that they were unable to coordinate diverse and unrelated lines of business. Consequently, many conglomerate acquisitions were later spun-off through direct or leveraged buy-outs to private investor groups or managers. Nationally, of the 5,000 mergers tracked by

the Federal Trade Commission from 1950-1976, 25-35% of acquisitions were later sold off or divested as the result of the parent companies' lack of managerial control or performance failures in cumbersome organizational structures (Scherer 1986).

Divisional divestitures were an important part of New Jersey's recent industrial restructuring. The twenty-nine divestitures represented 54% of non-bank M&A activity in New Jersey during the period in question. Thirty percent of total divestiture value (\$1.8 billion) came from 16 transactions in the manufacturing sector. The percentage of manufacturing firms affected would have been much higher without the \$3.1 billion Metromedia divestitures which represented 71% of all the state's nonmanufacturing divisional sales. See Illus. 4.3, 4.4, and 4.5.

4.3 Friendly and Hostile Takeovers.

The most widely reported takeover stories pit an aggressive buyer against an equally determined management group who resist the offer. Some of these deals are termed "hostile," but that is a misleading and perjorative term. In fact, "hostility" is in the eye of the beholder, and different parties may judge the offer differently. A bid may be strongly opposed by management, but favored just as strongly by shareholders. And while

employees often identify with management during a "fight," there is no intrinsic reason for them to favor the status quo. Current managers are no more likely to safeguard their jobs than possible future managers. In fact, an unsolicited offer may be made as part of a strategy, and an offer may be resisted as a bargaining ploy. In economic terms, it is difficult to make a value judgement that hostile takeovers are intrinsically good or bad.

Motives for hostile takeovers may not differ significantly from motives for friendly takeovers. The takeover attempts could be made to increase market share and achieve economies of scale, extend product lines, or limit competition. The only differences may be of strategy--whether or not to inform management before the offer is made. The one motive that almost assures that the takeover attempt will be viewed as hostile is to replace ineffective management.

In New Jersey, from 1978 to present, only six of the non-bank mergers and acquisitions were unsolicited. See Illus. 4.6 and 4.7. (To reiterate, hostile takeovers include all unilaterally initiated tender offers, both those where management of target companies were informed beforehand and where no prior contact was made.) The vast majority--81.3%--of all takeovers in our sample were friendly.

Every one of the six unsolicited M&A attempts in our sample was concluded amicably once prices were increased or terms were otherwise improved. For example, the original (unsolicited) offer that Mark IV Industries, Inc., made for Gulton Industries, Inc., was rejected by the latter's Board as too low. A little later the price was raised and the offer accepted.

Our study revealed no evidence that unsolicited deals had systematically different effects on acquired companies--in terms of employment or profitability--than friendly transactions. The only likely effect was on share prices, and that was beneficial for the target's shareholders. Half of the unsolicited bids in our sample were accompanied by bids from other sources, and the end result of this bidding was higher stock prices.

5. REASONS FOR MERGERS AND ACQUISITIONS: TYPOLOGY AND CASE STUDIES

There are no single causal explanations of why corporations or investors seek to buy other companies or divisions. A company may seek to buy a division of another company as the most efficient way to extend a product line into closely related or synergistic areas. A company may wish to diversify into another industry or gain increased market share in the same industry

through increased market efficiency. Vertical acquisitions may be made to gain control over suppliers (moving down the production chain) or customers (moving up). Other M&A transactions occur when a company wants to expand more quickly into new markets. Finally, financial analysis may reveal undervalued assets that are considered ripe for acquisition and redeployment under a new management structure.

5.1 Product Line Extensions.

Seven of the non-bank transactions in our sample were done to extend the product line within the acquiror's industry. They represented 17.1% of the transactions and 9.9% of the total value. That was the apparent motivation behind Automatic Data Processing Inc.'s purchase of Bunker-Ramo Information Systems. ADP was able to go beyond its traditional business of providing packaged commercial data processing services and time sharing by acquiring a leading supplier of stock price quotations used by brokerages--with 30% of the market. When Emerson Electric Co. acquired Automatic Switch Co. it could broaden its range of electrical and electronic products and systems to include electromagnetic control equipment for operating fluid control systems and electric power distribution. Emerson's application of their manufacturing technology to Automatic Switch could enhance both

companies' development. On the face of it, at least, these combinations seem to have made good economic and business sense.

5.2 Conglomerate Acquisitions.

A national study (Scherer 1986) showed that conglomerate acquisitions--those reaching out to industry sectors where the parent had no experience--tended to be the least successful (in terms of profitability), and often resulted in later divestitures. (These units had an operating income/assets ratio of minus 1%, while nondivested units had average returns of 13%.)

Another seven transactions, representing 9.9% of the total value of transactions, captured a product line in unrelated lines of business. National Distiller Corp.'s 1982 acquisition of Suburban Propane Gas Corp. gave this distiller and wine marketer control over a propane gas distributor.

5.3 Horizontal Acquisitions.

Horizontal acquisitions are purchases of companies or

divisions in the same broad industry group. These are, according to Scherer's findings, "more successful in maintaining their baseline profitability than purely conglomerate acquisitions"--those reaching out to industry sectors where the parent company had no experience (Scherer 1986:6).

The largest number of M&A transactions in our sample were horizontal diversifications. Those 10 (24.4% of the total) represented 37.2% of the total value of transactions. The oil-related transactions, e.g. Drummond Petroleum Ltd.'s 1981 purchase of Union Texas of Canada Ltd. (a subsidiary of Allied Corp.) and Husky Oil Ltd.'s buy of another Allied subsidiary, Uno-Tex Petroleum Corp., are examples of horizontal acquisitions. Another was the purchase of Boorum & Pease Co. by Esselte Business Systems Inc., both suppliers of folders, blank books, and loose leaf binders.

5.4 Vertical Integration.

Purchases of suppliers (known as backward integration) or customers (forward integration) may make sense for some companies. Vertical integration was the apparent reason in only three, or 7.3% of our sample, with about 3.5% of the transaction value. One example was the acquisition by Square D Co., a lea-

ding electrical equipment manufacturer, of Yates Industries Inc., which develops, manufactures, and sells electrodeposited copper foil used primarily in printed circuits.

5.5 Market Extension Acquisitions.

Some companies make acquisitions as a way of extending their market geographically, although they are usually in the same industry. We identified seven market extension acquisitions, making up about 17.1% of the number and 16.4% of the value of transactions. One market extension acquisition was the 1986 purchase of the Deseret Medical Division of Warner-Lambert Co. by Becton Dickinson. This now enables Becton, which manufactures and sells an extensive line of health care products, to sell cardiovascular catheters, infusion sets, and operating room products.

5.6 Going Private.

When divisions or companies are taken private, it is with the goal of running them better, not of incorporating them into the operations of another on-going concern. In these cases, the expected profits come not from synergism, but from a new financial structure, new incentive mechanisms, or new management.

There were seven such transactions in our sample, and they made up 17.1% of the number and 22% of the value. In value terms, they were dominated by the Metromedia management buyout, which was worth \$1.5 billion. More typical were the purchases of Conair Corp. by a management group and of Midland Glass Corp. by a private investment company. See Illus. 5.1 and 5.2.

6. THE EFFECTS OF MERGER AND ACQUISITION ACTIVITY ON NEW JERSEY

Clearly, M&A activities are a diverse lot. They come in all shapes and sizes and occur for a myriad of reasons. But when all the dust has settled, what, besides ownership, really changes? Have mergers and acquisitions created jobs? Have they cost jobs? Have they made the economy more efficient? Are shareholders better off?

6.1 Employment: Job Loss, Job Retention, and Job Creation

Much of the existing economic research regarding M&A activity and industrial organization in general, have focused upon impacts on stock values, research and development, productivity, pricing, profitability, and market share. The impacts of M&A activity upon labor markets have been largely ignored. Yet it is

around the issue of jobs (creation, retention, loss) that much concern regarding business combinations and problems of industrial competitiveness is expressed.

Do mergers and acquisitions cost jobs? Will higher levels of job retention occur if the state regulates takeovers? There have only been a handful of systematic studies in this area, and they generally suggest that attributing structural unemployment to corporate reorganization is a spurious and misleading association. A recent survey by the Conference Board (Berenbeim 1986) examined 212 plant closings and found that only 30% of plant closings were attributable to organizational change (primarily changes in supply and distribution technology, with little effect resulting from M&A activity). Preliminary results from a national study of plant closings by the U.S. Government General Accounting Office also show very little relationship between plant closings and M&A activity (GAO 1986).

The Economic Research Bureau has analyzed the causes and consequences of plant closings and permanent layoffs and economic adjustment policies as a response to this problem. In 1978-84, 1083 plant closings and 370 plant contractions and layoffs occurred in New York State. We found no statistically significant association between closing events and merger and acquisition activity. Plant closings were more closely related to dollar

appreciation, import penetration, taxes, lack of plant modernization, decreased capital investment, and lack of management response to structural and technological shifts in product and consumer markets (Yago et al. 1984, Yago 1986).

Other studies have emphasized the impact of lack of management succession, security, space, energy costs, transportation costs, health care costs, housing costs, quality of life, international restructuring of industrial production and a range of other issues contributing to plant closings.

While many business climate studies (Alexander Grant, Inc.) emphasize labor legislation or business support in ranking a state's response to business location or dislocation, few studies focus upon the contribution the states make to lowering operating costs of firms. Nor do these studies examine the state's role in creating the living environment for private sector employees, even though this is the central issue in business development and job retention. To our knowledge, no studies or business experience suggest that the presence or absence of regulations relating to business combinations have had any impact upon attracting or retaining businesses and the jobs they create.

In our review of site location studies for manufacturing

facilities, a number of factors could be identified as critical. They were ranked as follows: availability of appropriate labor force, availability of low cost utilities, proximity or access via transportation to raw materials and suppliers, access to major markets, community attitudes, state and local regulatory codes and taxes, and incentives for industrial development. Legislative protection against the threat of takeovers is not among them.

The data concerning structural economic change and corporate reorganization in New Jersey are consistent with other research. New Jersey is in the throes of a major transformation. From 1980 to 1985, total employment in New Jersey increased by 11.7%. Gains occurred primarily in financial and health care services. Unemployment has declined significantly from its 9.1% peak in 1982 to 5.8% in 1985. But manufacturing employment fell by 7.9%, costing the state 62,000 jobs. See Illus. 6.1, 6.2, and 6.3.

From the limited plant employment data we were able to obtain by surveying 22 target firms, less than 1% of the 95,215 jobs that were lost to permanent layoffs could be directly attributed to acquired firms. There is also no evidence to suggest that these reductions, or more drastic ones, would not have occurred in the absence of the transactions. For example, management of Gulton Industries (acquired by Mark IV Industries),

Johathan Logan (acquired by United Merchants), Warner-Lambert (whose Deseret Medical Division was acquired by Becton Diskinson), and Ingersoll Rand's Proto Tools unit (acquired by Stanley Tools) indicated that employment was unaffected by those transactions.

M&A activity reflects industrial transformations based upon structural shifts in technology and international trade and indeed is largely a result of it. Though only 21% of New Jersey's jobs are in manufacturing, 55.6% of the M&A activity (and 38.1% of their value) occurred in manufacturing. This strongly implies that M&As are a necessary part of the adjustment process and probably slow the drop in manufacturing employment.

Consider the Allied-Signal case. Since 1979, that company has changed completely, moving out of commodity chemicals and oil and gas--where its sales and price were dependent on economic cycles--and into high value-added businesses which are less cyclical. Over that period, it sold several companies and bought several, while its sales ballooned from \$3.5 billion to \$11 billion. It now focuses on aerospace, electronics, automotive, engineered materials, and speciality chemicals.

The company made six sizeable divestitures during this period, but the divisions that were sold had few if any operations in New Jersey. Bunker-Ramo is located in Connecticut. Interestingly, Bunker-Ramo's new owner, Automatic Data Processing, Inc., is, like Allied-Signal, a New Jersey company. C&D Power Systems, also sold by Allied-Signal, is located in Pennsylvania. Allied-Signal's fluoropolymer business, however, is located in Elizabeth, New Jersey. The sale of the fluoropolymer business had no adverse impact on employment; about the same number of people work there now as did before the sale. If anything, the growth of Allied-Signal has led to more employment at its headquarters and R&D facilities located in Morristown, N.J., where it employs some 2000 people.

Examining data on plant closings and permanent layoffs, we found no evidence that M&A activity leads to plant closings or permanent layoffs. Concerns that M&A activity leads to plant shutdowns do not appear well-founded in the case of New Jersey. The image of asset-stripping acquisitions or mergers shutting plants appears to have little empirical basis. Even though the problem of plant closings is substantial in New Jersey, manufacturing plant closings in the United States are mainly a function of our eroding international competitiveness.

In 1980-1985 (see Illus. 6.4) permanent layoffs occurred 913

times because of plant closings and contractions, dislocating 95,215 workers in New Jersey. The data on plant closings in New Jersey suggest that M&A activity could well be considered an alternative to plant closings. Non-acquired firms were more likely to close than acquired firms. A company that wants to shed a division or a plant has two options--it can sell it or close it. Clearly, selling is preferable to closing from the perspective of both business and public policy.

Non-acquired firms were most likely to close. Recent large plant closings were announced by mostly non-acquired firms: 3-M, Western Electric, Colgate-Palmolive, U.S. Metals, Johns Manville, and North American Phillips, to name a few. 3M's Magnetic Media division and Colgate-Palmolive are consolidating and moving operations to the Midwest. Englehard is opening a new site in South Carolina. Johns-Manville is moving its sealing components and high-temperature insulation operations to newer facilities in Texas and Indiana.

Some firms that have not been acquired have disinvested from New Jersey. New investment in New Jersey manufacturing facilities appears to be independent of takeover activity. Becton Dickinson and Co., a non-acquired firm, built a \$20 million blood collecting systems plant in Plymouth, England, and Schering-Plough Corporation built the world's first commercial interferon manu-

facturing plant for \$106 million in Ireland. It also operates five plants in Puerto Rico employing between 500 and 999 workers. Schering-Plough's worldwide employment dropped from 27,000 in 1981 to 23,000 in 1985.

Only five of the 45 New Jersey sample firms that were acquired or sold one or more divisions were associated with plant closings or permanent layoffs. None of them was the subject of an unsolicited takeover attempt. In four of those cases, the layoffs and M&A transaction were separated by at least a year. Of the nine layoff announcements, four were made at least a whole year before a transaction was announced by that firm; two at about the same time; and three at least a year after. The long lag between the M&A transaction and layoffs or plant closing suggests that they are not related causally, i.e., M&A activity does not cause plant closings.

The five friendly takeovers where closings occurred contain the following examples. Conair closed a plant, laying off 175 people in March 1980, and was purchased in a management buyout that was announced December 12, 1984. Kidde Inc. closed a plant in April through December 1983, and sold several divisions two years later. Ingersoll Rand closed one plant in 1982 and two others about the same time it was announcing a divisional sale, early in 1984. American Cyanamid closed one plant in 1980, sold

a division in late 1984, and closed another plant about a year later. The only other company that shuttered plants after selling divisions was Curtiss-Wright, which sold a division in early 1981 and shut plant doors in late 1983 and early 1984. See Illus. 6.4A.

Those situations were as different as night and day. Curtiss-Wright owned under 15 percent of the stock of Kennecott Corp. when Kennecott, fearing a takeover by Curtiss, launched an unfriendly takeover attempt for Curtiss. The effort was unsuccessful, but after the dust settled, the two companies had reached a negotiated settlement: Curtiss sold its Kennecott shares to Kennecott, which also got Curtiss's Dorr-Oliver Inc. division in exchange for its Curtiss shares. This was a forced sale, an example of a company selling a piece of itself to retain its independence.

Curtiss-Wright's closings of its Woodbridge plant was entirely different. It was due to a shift in government procurement policy and a changing market. The post World War II plant was a very large and highly specialized one, built to make reciprocating engines for civilian and military aircraft. During the Korean War, it reached its peak employment of nearly 22,000 people, turning out jet engines. When the war ended, the product mix shifted to overhauling jet engines and gas turbines, and they

needed fewer employees. Then military contracts were not renewed, and the workforce shrunk to 600. Since this was a service business with no customer base, there was nothing to sell. So Curtiss-Wright offered early retirement to most employees, who averaged 58 years of age, and laid off the rest. It then turned the facility into a condominium-industrial park, which is now fully rented for warehousing and light manufacturing.

The temporal pattern of acquisitions and plant closings show that mergers are an alternative to plant closings--that they are a preferred solution by companies under financial pressure. It appears that plant closings often occur when attempts at selling the company or division fail. In short, mergers and acquisitions often prevent plant closings and save jobs. Therefore, to hinder merger and acquisition activity could encourage plant closings.

Acquisitions are a very important source of corporate and employment growth. Oftentimes, acquisition of a firm or division satisfies corporate strategic needs for establishing new production capacity at a discounted cost compared to new plant construction and equipment costs. Through the savings afforded by acquisition, as compared to the prohibitive costs of new construction, investments can be made in plant modernization or marketing distribution that might otherwise not have occurred. National data compare the net plant investment (open-close and

relocation) to net plant acquisition. Illus. 6.5 indicates that in urban, suburban, and rural regions, the bulk of new corporate plants are acquired--not built--by the companies that operate them. As Friedland (1984) has shown, for every plant built by a corporation in cities, three were acquired; in suburbs two were acquired for every plant opened; and in rural areas the same pattern held. In short, corporations acquire the bulk of their new operating plants. In largely urban regions like New Jersey, corporate plant activity would have declined more precipitously if not for acquisition activity. Corporations acquire and continue to operate many times the number of plants that are added through new plant investment.

To be sure, there are instances where firms that fall on hard times close plants, lay off employees, and sell assets. And sometimes those sales precede layoffs, as in the dramatic case of International Harvester. From 1979 to mid-1984, the company sold, closed, or consolidated 27 facilities and slashed employment to 21,000 from 94,000. When it sold its Agricultural Equipment Division to J. I. Case, some 3,400 employees went along. Some 70 percent of these were eventually laid off (Berenbeim 1986:25).

The sale and acquisition of that division was not the cause of the layoffs. In retrospect, these large layoffs seem to have

been inevitable, due to the hard times buffeting the farm industry, high interest rates, and the strong dollar. They would undoubtedly have occurred without the sale.

Moreover, the data did not show any consistent evidence of plant closings by acquiring firms. A company is not likely to buy a division or plant from another company with the idea of closing it. Either the original parent company would keep the plant, or the acquirer would pay a low enough price that the plant could be a money-maker for the new owner.

Still, some M&A transactions may be for the primary purpose of buying market share. For example, in 1985, Data Decisions, an information and evaluation service for the data processing industry, located in Cherry Hill, was purchased by McGraw-Hill Corp. Of Data Decisions' 100 or so employees, approximately seven were kept for sales, and another 20 to 25 for editorial work. McGraw-Hill got all the assets and customers and kept one product. In the short run, this acquisition cost jobs. But even in this case, it is not certain that these jobs would have survived without the acquisition. It is possible that those same jobs would have been eliminated without the acquisition.

6.2 Shareholder Wealth.

National data show that M&A activity greatly increases the prices of shares of the target companies (Booth 1986). And it is no different for New Jersey companies. We calculated the change in the stock price of the target company from one month before the announcement date of the offer to the day after, and multiplied that difference by the number of shares outstanding. We found that M&A activity from 1978 to the present increased the wealth of people and pension funds and other institutions that hold stock in New Jersey companies by \$1.2 billion. See Illus. 6.6. A total of 1,905,000 New Jersey citizens owned stock in 1985, according to the New York Stock Exchange.

Numerous recent studies emphasize the impact of M&A activity upon corporate value (as indicated by stock price) as management and investor groups compete over corporate assets. Bradley (1980, 1984) demonstrated that shareholders as a class enjoyed takeover premiums of \$260 million per offer in the period 1981 through 1984, an average 53.4% premium received by shareholders of the target firms. There is no significant difference between hostile or friendly tender offers in generating this premium (Office of the Chief Economist, SEC, 1985).

In a similar study, Schipper and Thompson (1983) found

takeover premiums between 33-53% in a longitudinal study of 39 firms announcing and carrying out acquisitions. The authors found that new merger regulations by and large increased the cost of acquiring activities. Regulation thus burdens both acquirer and acquiree firms and could divert investment capital from more productive allocations, they say.

Even hostile takeovers show no evidence for the claims that takeover entrepreneurs reduce the wealth of other stock-holders. In a study of 36 takeovers by six investors or groups, evidence was found that management increased the value of corporate assets and that there was a statistically significant increase in stockholder wealth (Holderness and Sheehan 1985).

Bradley, Desai, and Kim (1984) also show that mergers are good for the shareholders of target firms, and that biddings among multiple buyers increase those returns. They also show that target shareholders have done relatively better than shareholders of bidding firms since 1970, when many state and federal laws were passed regulating tender offers.

6.3 Mergers, Acquisitions and Market Competitiveness.

There is no scientific data that would allow us to determine

how mergers and acquisitions affect the acquired or acquiring companies. One study of profitability, productivity, and technological change shows no consistent or statistically significant change after a merger or acquisition (Cowling 1980). Another study found that when accounting adjustments are factored out (e.g., inflated asset values), acquiring companies neither improved nor significantly worsened the baseline profitability of their acquisitions. (Scherer 1986: 6-7). In addition, cross national studies of M&A activity also indicate no consistent pattern of merger impacts on either economic efficiency or market power (Mueller 1985:306).

The inconclusiveness of national and cross national data suggest that organizational change in and of itself is not an independent cause of change in market performance of the firm. How well management acquits itself in the aftermath of a merger or divestiture transaction is the key element of the strategic success of business combination. In some of our case studies of merger transactions, firm efficiency was clearly improved.

7. PUBLIC POLICY ISSUES: RESPONSES TO STRUCTURAL ADJUSTMENT

7.1 Introduction.

Takeovers, relocation, closings, openings, and retention of

industrial plant activities are part of the process of structural economic change where labor and capital resources are reallocated in response to permanent changes in technology and international trade that affect market conditions. Understanding the process of structural economic and industrial organizational change in New Jersey and the nation is crucial in formulating effective public policy. M&A activities are responses to--not causes of--fundamental changes in financial markets, firm technology and management, sources of supply, factor costs, and market demand. There are a variety of types and possible causes and consequences of M&A activity. Corporate reorganization through M&A activity is symptomatic of the complex structural changes affecting industrial competitiveness job creation, retention or loss; but there is no consistent pattern of significant effects directly attributable to the transaction itself.

Policy responses should be flexible and strategic. Unintentionally, measures could create rigidities in industrial mobility or artificially stimulate demand; this inhibits economic growth. The focus of various policy responses to industrial restructuring should not be to prevent corporate takeovers through M&A activity that may result from internal market or firm exigencies, for example, inefficient and uncompetitive management, labor, or technological production practices. Inhibiting corporate restructuring and reorganization, and the new industrial strategies

that might emerge, could prove economically costly and result in higher unemployment in the long run. Well thought out policies would interact--not interfere--with market forces.

Motivating new legislative initiatives in many states such as New Jersey is the attribution of job loss and industrial migration to M&A activity. In reviewing structural economic changes and policy responses to them in U. S. and Western European regional governments, the Economic Research Bureau has identified three major strategies of public policy response:

- regulatory
- capital market
- labor market.

7.2 Regulatory Strategies.

State legislative responses to manufacturing job loss based upon regulatory strategies have attempted to restrict both business combinations and plant closings through mandatory advance notice and disclosure requirements. There is no evidence that such mandatory regulations, based upon the questionable and spurious attribution of plant closings to business combination changes, have had any salutary effect upon retaining jobs. Maine and Wisconsin have mandatory notification procedures. Minnesota, Connecticut, Missouri, and Wisconsin attempt, through varying

provisions, to restrict tender offers. In examining plant closing measures in Western Europe, mandatory notification had no discernible impact on reducing the long-term incidence of plant closings and structural unemployment.

States have traditionally had the power to regulate domestic incorporations and mergers particularly regarding appraisal rights. Aside from the constitutional issues regarding possible interstate commerce restriction, the social and economic impact of such regulations should be carefully considered. Certainly, information and monitoring of economic performance of states is vital to avoiding plant closings. Voluntary measures in Massachusetts, now being considered in New York, address that concern better than mandatory regulations.

States grant to companies the power to govern themselves, and numerous New Jersey and other corporations have been taking advantage of that power to adopt antitakeover measures. See Illus. 7.1. The most common defense is "blank check preferred stock," which gives Boards the power to issue a certain number of shares of preferred stock at any time and to set the voting, conversion, and other rights when they issue it. Such measures are in place at 16 of the 20 largest New Jersey firms (based on employment and sales (Illus. 7.1)), and at 328 of the 500 largest companies in the U.S. Next most common are severance agreements

for executives and classified Boards, which usually stagger the terms of office. Eleven and ten of the top New Jersey companies have these, respectively. Eight have adopted fair price amendments, guaranteeing all shareholders the highest price paid by an offeror during some specified period before the tender offer began. Seven have reduced shareholder rights and delegated those rights to the Board. One of the New Jersey top 20 has approved anti-greenmail provisions (requiring shareholder approval before buying a large block of shares at above-market prices without making the same offer to all shareholders) and two have included poison pills (rights granted to shareholders in the event of certain takeover attempts that make the takeover prohibitively expensive).

7.3 Merger Transactions Involving Some of the 124 Companies Affected by the Proposed New Jersey Legislation.

Six of the 124 corporations which would be affected by the proposed legislation have been acquired or had divisions acquired in the past several years. Half of them involved companies regulated by state agencies. Two were banks: Franklin Bancorp, taken over in 1985 by United Jersey Banks, a bank holding company, and Statewide Bancorp., bought in 1984 by Midland Banks Inc., a multi-bank holding company. Another transaction, South Jersey Industries Inc.'s purchase of New Jersey Resources Corp., occurred between two public (and therefore publicly regulated) uti-

lities. It followed New Jersey Resources Corp.'s successful defense against a tender offer by NUI Corp.

Schering-Plough sold two divisions, DAP Inc., which manufacturers speciality paints and caulking, and nine radio stations. Ingersoll-Rand Co. sold one division, the Proto Tools Unit. SPS Technologies Inc. attempted to purchase the Power Tools Division, but the try failed. In 1985, Merck & Co. sold its Baltimore Aircoil Co. division, located in Baltimore, to Amsted Industries, Inc.

A comprehensive policy response to economic adjustment and industrial restructuring should address the causes of job loss, plant closings, and retaining and expanding existing plants. It should also facilitate--not restrict--labor markets. In short, any legislative response must be part of a broader program to assist and enhance economic structural adjustment and change.

7.4 Capital Market Strategies.

Investment oriented approaches to economic adjustment are a relatively new form of state policy response. They focus upon strategies for job creation and job retention in response to declines in industrial competitiveness which are caused by

disinvestment, declining productivity, and lack of strategic management. These capital market strategies focus upon the availability, cost, and allocation of capital to firms. Formerly, public policy measures concentrated upon such labor supply-side issues as training, education, and placement. Often, training programs were criticized for failure to link their training to labor demand, thereby training dislocated workers for jobs that did not exist. A renewed interest in investment-oriented measures that encourage job creation and retention could focus upon this policy lacunae.

To restore industrial competitiveness, firms need to consider changes in product mix, output levels, human resources management, manufacturing technology, production processes and information systems.

Some states have begun to consider a variety of measures aimed at assisting companies meet the challenge of restructuring. These measures include advisory services for coping with managerial and technological changes, and help in finding investment resources for financial and corporate reorganization. Capital costs, agency costs (marketing, management and engineering consulting, auditing), transactions costs, and operating costs (labor compensation, energy, rent) associated with such reorganizations are often too high for small and medium sized firms. These costs

can be absorbed through public and private intermediaries targeted to those industries and firms. Such assistance, not unlike that provided through extension services in the agricultural sector, can be appropriate for manufacturing industries as well.

Debt and equity financing may be required by firms and industries seeking to regain competitiveness. For alternative ownership and new business combinations, a variety of state economic development financing instruments could be coordinated with new industrial strategies. Plant modernization and improved distribution systems, moreover, could help allocate human and capital resources to more profitable products and markets in partnership with private sector financing.

Where plant re-tooling and modernization are unrealistic, financial, technical, and management resources currently available through public authorities, government, and universities may help redeploy assets within the State. Plant reuse, for example, could be planned through industrial facilities marketing and financing. Identifying and marketing companies seeking divestiture or reorganization are an additional information resource state agencies have begun to pursue in Massachusetts, New York, Michigan, and California. Many regional governments in Western Europe (particularly in Italy and West Germany) have also begun to develop more active investment-oriented roles.

7.5 Labor Market Strategies.

A variety of employee-oriented measures could improve firm and job retention more directly than takeover regulations. Enhanced employment services for job-seeking assistance, special training and relocation assistance, temporary wage subsidies to facilitate re-employment, income maintenance and public sector job creation are all measures operative in many states.

Employee services are particularly important. Information and skill barriers to re-employment or employment upgrading are intensified according to the age, skill concentration, and previous job experience of dislocated labor. Special training programs, incentives for re-training and relocation, and mobility assistance can help labor markets adapt.

Income support and wage subsidies have been used in Australia, Canada, The Netherlands, Japan, and West Germany. The attributes of more successful programs have included making receipt of benefits contingent upon pursuit of employment or training alternatives.

In any program, joint labor-management consultation has been central in achieving the goal of enhancing labor market efficiency. Inter- and intra-firm transfers can be facilitated by effec-

tive labor market policies by state and local governments. In general, programs succeed that do not delay the adjustment process through regulation, but provide incentives for workers and firms to adjust to structural economic changes in ways that avoid layoffs or plant closings--when possible--and pursue new opportunities--when necessary.

Conclusion

The conclusion to be drawn from these studies is that M&A activity increases the wealth of shareholders of target companies, and have no demonstrable negative or positive effect on real economic performance. They have little generalizable effect on employment, profitability, or productivity. Some mergers increase economic efficiency, while others are disappointing and result in later divestitures. Therefore, any generalized restrictive regulation of corporate mergers and acquisitions would be inappropriate, as it would retard good as well as bad transactions.

The appropriate way to deal with economic problems is to attack them directly. Legislating an end to plant closings or takeovers, for example, may only reduce investment in the state and lead to inefficiencies and a reduction in international

competitiveness. Still, those adjustments can be made more efficiently, by participating in and facilitating capital and labor market adjustments to structural changes in industrial and corporate organization.

Traditionally, policy responses to structural economic changes in firms, industries and regions rely too heavily upon restrictive regulations that embed market rigidities in labor and capital markets. Incentives that promote new economic directions through employee and investment oriented approaches to economic development could remove barriers to job and firm creation--lack of information on site location, skills, costs, and investment. Takeover regulations are at best redundant, given the self-protection corporations can afford themselves through their own corporate governance. At worst, they attempt to ascribe simple and single causes to plant closings and job loss that are misleading and result in symbolic rather than substantive policy response to structural economic change.

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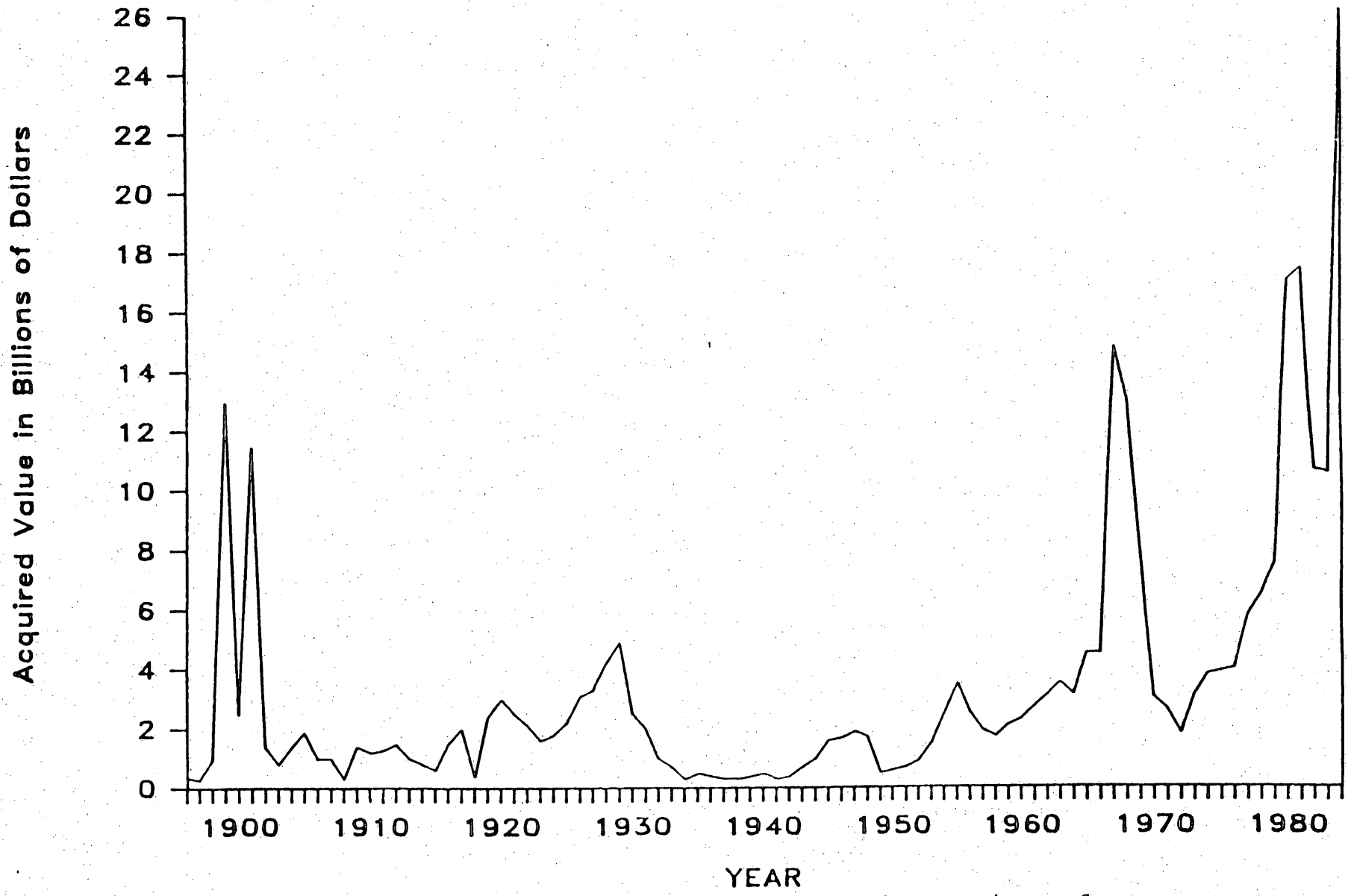
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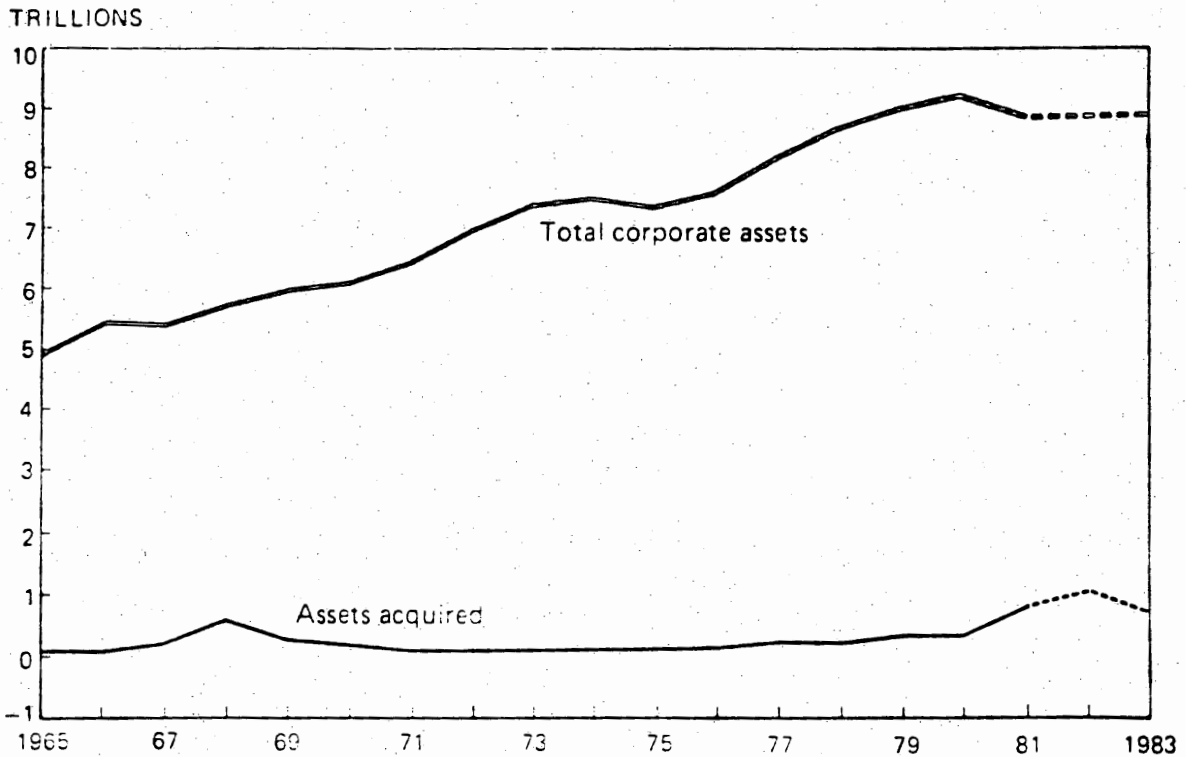
1895 - 1984



SOURCE: T.M. Scherer, Industrial Market Structure and Economic Performance, 1980; Federal Trade Commission

ILLUS. 2.1A

TOTAL ASSETS ACQUIRED IN DOMESTIC MERGERS OF \$100 MILLION OR MORE
 COMPARED TO TOTAL U.S. CORPORATE ASSETS, 1965-83*
 1983 Dollars



	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
Total Corporate Assets (\$ Trillions)	4.9	5.4	5.4	5.7	6.0	6.1	6.4	7.0	7.4	7.5	7.4	7.6	8.2	8.7	9.0	9.2	8.9 (est.)	8.9 (est.)	8.9 (est.)
Assets Acquired (\$ Trillions)	0.11	0.10	0.22	0.59	0.31	0.19	0.11	0.11	0.11	0.15	0.11	0.13	0.26	0.24	0.32	0.33	0.82	1.15	0.76
% Total	0.2	0.2	0.4	1.0	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4	0.4	0.9	1.3	0.9

*Excludes 170 acquired companies for which data were unavailable. All exhibits refer to domestic transactions unless otherwise stated. All exhibits include transactions of \$100 million or more in acquired sales or assets in 1983 dollars.

Source: For total corporate assets, IRS, Statistics of Income: 1981-83 data estimated.

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ILLUSTRATION 3.1

TYOLOGY OF MERGER & ACQUISITION ACTIVITY
IN NEW JERSEY, 1981-1985

	Number	Percent
Withdrawn	85	10.1
Banks, S&Ls, Insurance Co.s	120	14.2
Purchase of a stakehold	83	9.8
Repurchase or self tender	113	13.4
Divestiture	145	17.2
Merger	297	35.3
TOTAL	843	100.0

Source: Securities Data Corp., Economic Research Bureau

ILLUSTRATION 3.1A

MOST SIGNIFICANT MERGERS AND ACQUISITIONS IN
NEW JERSEY 1978-PRESENT, BY TYPE

<u>Type</u>	<u>Number</u>	<u>Transaction Value (\$000)</u>	
		<u>Total</u>	<u>Average</u>
Companies	17	4,787,983	281,646
Divestitures	28	6,156,642	219,880
Banks	6	632,838	105,473
Terminated	10	2,303,817	230,382
Total	61	13,881,280	227,562

Source: Securities Data Corp., Economic Research Bureau

ILLUS. 4.1

**MAJOR MERGERS AND ACQUISITIONS IN NEW JERSEY
1978-PRESENT, BY INDUSTRY SECTOR**

	Number	Value of Transaction (\$000)	Percent
Divestitures			
<hr style="border-top: 1px dashed black;"/>			
Manufacturing	16	1,804,237	29.03
NonManufacturing	13	4,410,800	70.97
Sub-Total	29	6,215,037	100.00
Acquisitions			
<hr style="border-top: 1px dashed black;"/>			
Manufacturing	9	2,361,612	49.93
NonManufacturing	7	2,367,976	50.07
Sub-Total	16	4,729,588	100.00
Total			
<hr style="border-top: 1px dashed black;"/>			
Manufacturing	25	4,165,849	38.06
NonManufacturing	20	6,778,776	61.94
Grand-Total	45	10,944,625	100.00

Source: Securities Data Corp., Economic Research Bureau

ILLUS 4.2

**MAJOR NONBANK ACQUISITIONS IN NEW JERSEY, 1978-PRESENT
BY INDUSTRY AND TRANSACTION VALUE**

Industry	Transactions			
	Number	%	Aggregate Value (\$000)	%
Apparel & Other Finished Prod.	3	11.54	470,458	6.80
Business Services	2	7.69	261,269	3.78
Communication	1	3.85	1,500,000	21.69
Electric & Electronic Machine	2	7.69	173,437	2.51
Chemical & Allied Product	1	3.85	242,889	3.51
Fabricated Metal Product	2	7.69	481,179	6.96
Health Services	1	3.85	162,955	2.36
Machinery, except Electrical	2	7.69	75,534	1.09
Instruments	2	7.69	109,784	1.59
Misc. Retail	3	11.54	786,418	11.37
Printing & Publishing	2	7.69	749,896	10.84
Real Estate	1	3.85	121,251	1.75
Stone, Clay & Glass Product	1	3.85	39,214	.57
Tobacco Manufacturer	2	7.69	115,332	1.67
Water Transportation	1	3.85	588,713	8.51
Total	26	100.0	6,916,329	100.0

Source: Securities Data Corp., Economic Research Bureau

ILLUS. 4.3

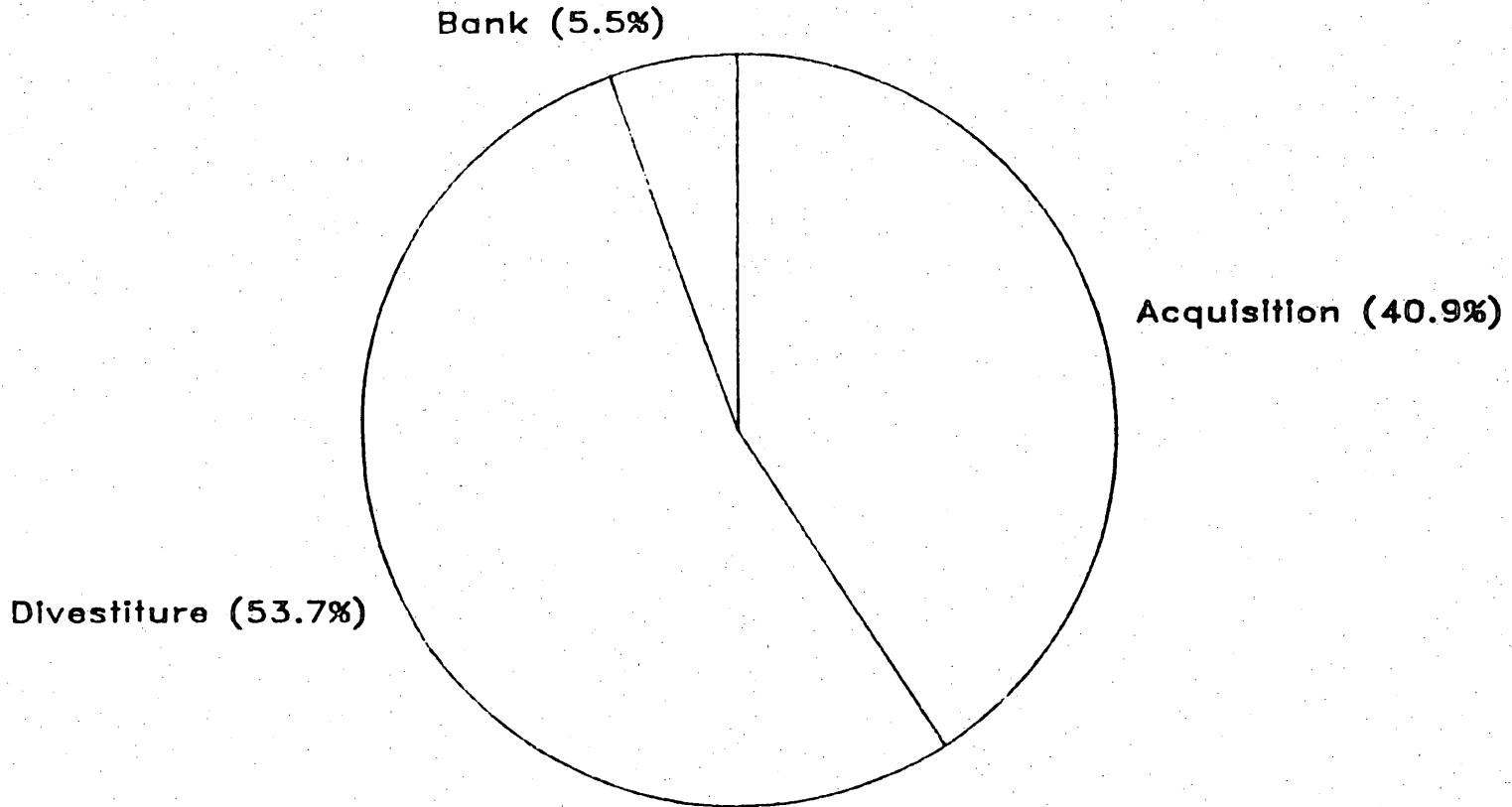
**MAJOR MERGERS AND ACQUISITIONS IN NEW JERSEY
1978-PRESENT, BY TYPE OF TRANSACTION**

Type	Number	Value of Transaction	Percent
Acquisition	16	\$4,729,588	40.85%
Divestiture	29	\$6,215,037	53.68%
Bank	6	\$632,838	5.47%
Total	51	\$11,577,463	100.00%

Source: Securities Data Corp., Economic Research Bureau

MAJOR MERGERS AND ACQUISITIONS IN N.J.

1978-Present, by Type of Transaction



Source: Securities Data Corp., Economic Research Bureau

11511

ILLUS. 4.5

CORPORATE GOALS OF MERGER AND ACQUISITION ACTIVITY IN NEW JERSEY

	Number	Percent	Aggregate Value (\$1,000)	Percent
Vertical Diversification	3	7.3	369,107	3.5
Horizontal Diversification	10	24.4	3,962,696	37.2
Product-Line Extension	7	17.1	1,069,213	10.0
Conglomerate Acquisitions	7	17.1	1,059,180	9.9
Management Buyout	7	17.1	2,444,158	22.9
Market Extension	7	17.1	1,745,063	16.4
Total	41	100.0	10,649,417	100.0

Source: Securities Data Corp., Economic Research Bureau

ILLUS. 4.6

HOSTILE vs. FRIENDLY TAKEOVERS IN NEW JERSEY, 1978-PRESENT
(\$000)

	Number	Percent	Aggregate Value of Transaction	Percent
Friendly	26	81.3	6,314,957	74.70
Hostile*	6	18.7	2,139,160	25.30
Total	32**	100.00	8,454,117	100.00

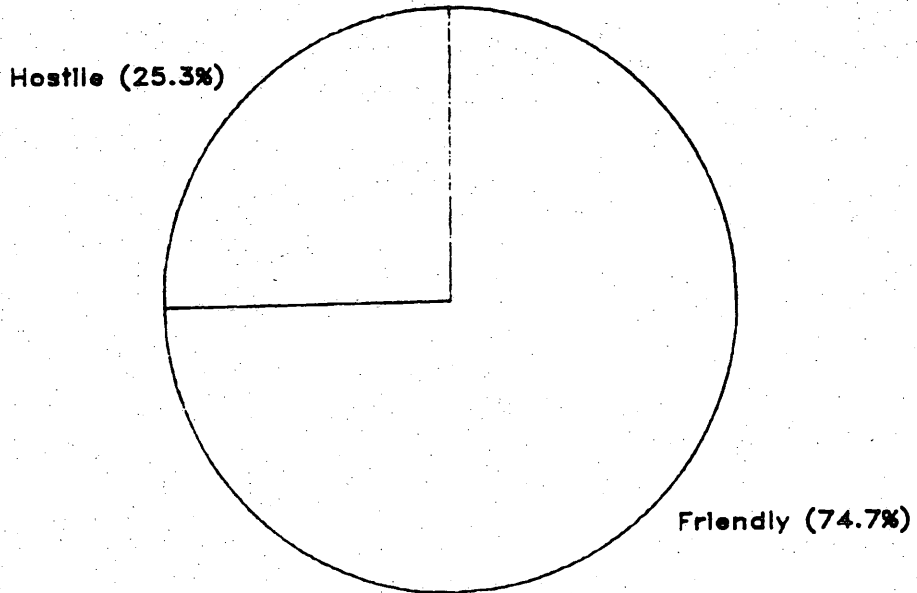
* Hostile takeovers include all unilaterally initiated tender offers, both those where executives of target companies were informed beforehand and where no prior contact was made.

** Major M&A transactions less divisional divestitures.

Source: Securities Data Corp., Economic Research Bureau

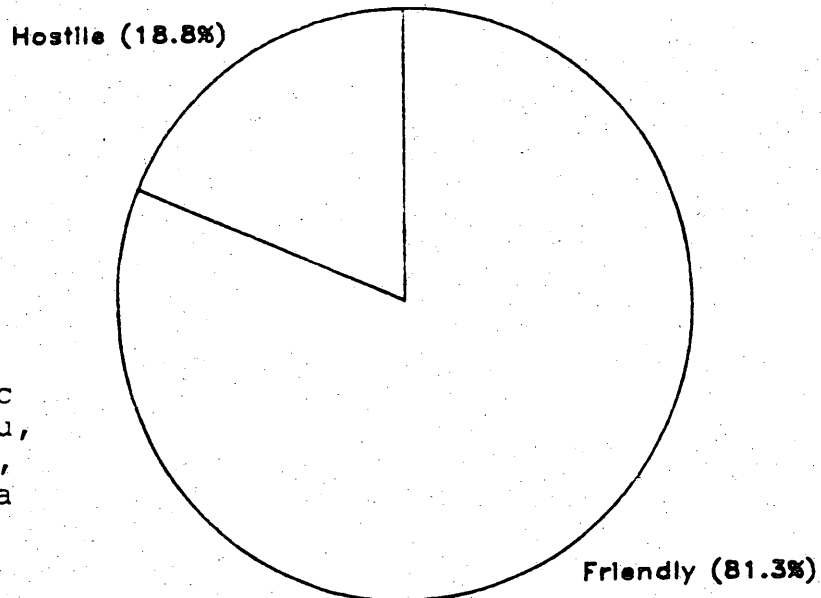
Aggregate Value of Corporate Takeovers

New Jersey, 1978-Present



Number of Corporate Takeovers

New Jersey, 1978-Present



Source: Economic Research Bureau, McKinsey & Co., Securities Data Corp.

ILLUSTRATION 5.1

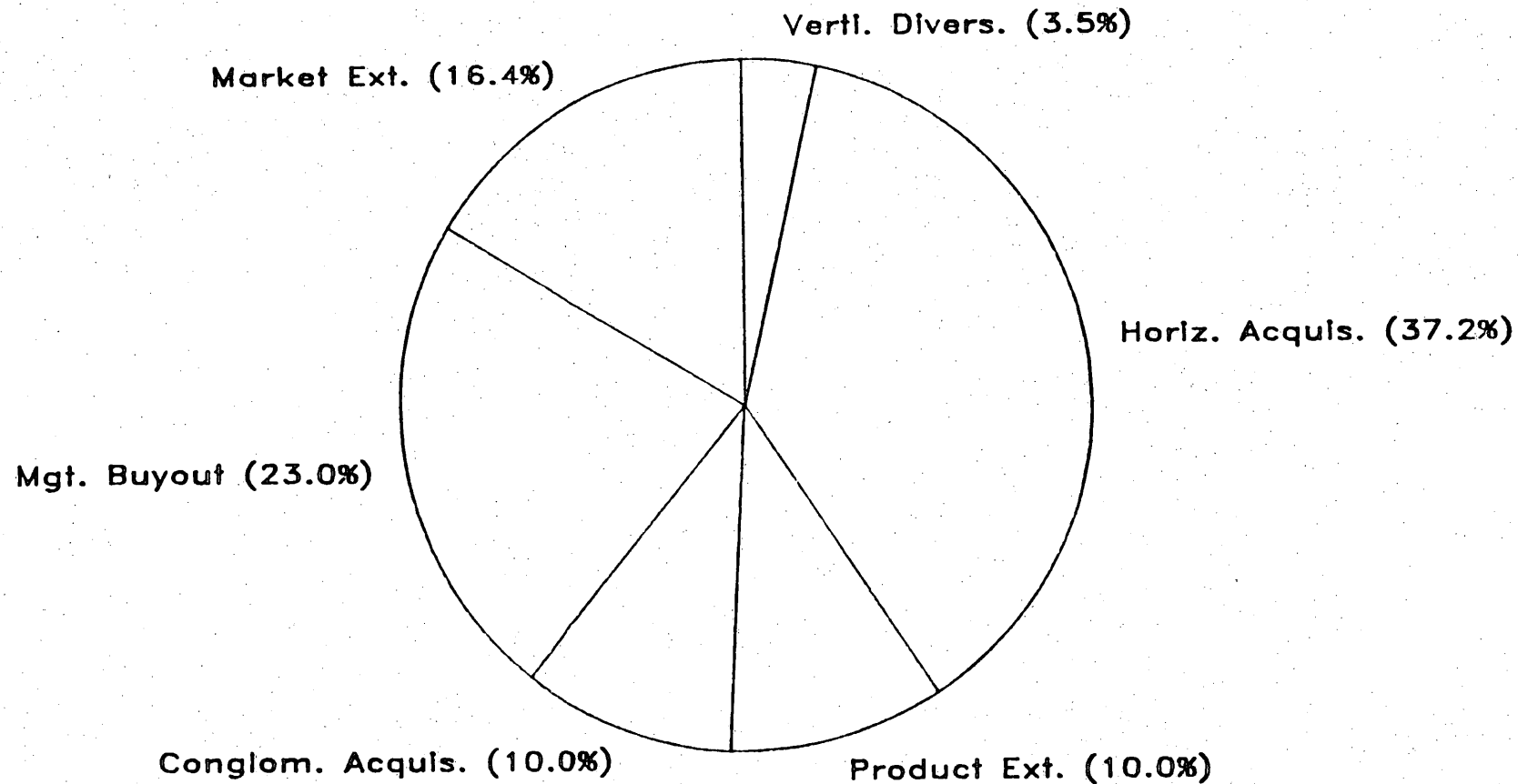
CORPORATE GOALS OF MERGER AND ACQUISITION ACTIVITY IN NEW JERSEY

	Number	Percent	Aggregate Value (000)	Percent
Vertical Diversification	3	7.3	\$ 369,107	3.5
Horizonatal Acquisitions	10	24.4	3,962,696	37.2
Product-Line Extension	7	17.1	1,069,213	10.0
Conglomerate Acquisitions	7	17.1	1,059,180	9.9
Management Buyout	7	17.1	2,444,158	22.9
Market Extension	7	17.1	1,745,063	16.4
Total	41	100.0	10,649,417	100.0

Source: Securities Data Corp., Economic Research Bureau

MERGERS & ACQUISITIONS IN NEW JERSEY

1978-Present, by Corporate Goals



130X

ILLUSTRATION 6.1

Employment in New Jersey, 1978-1985
(seasonably adjusted data)

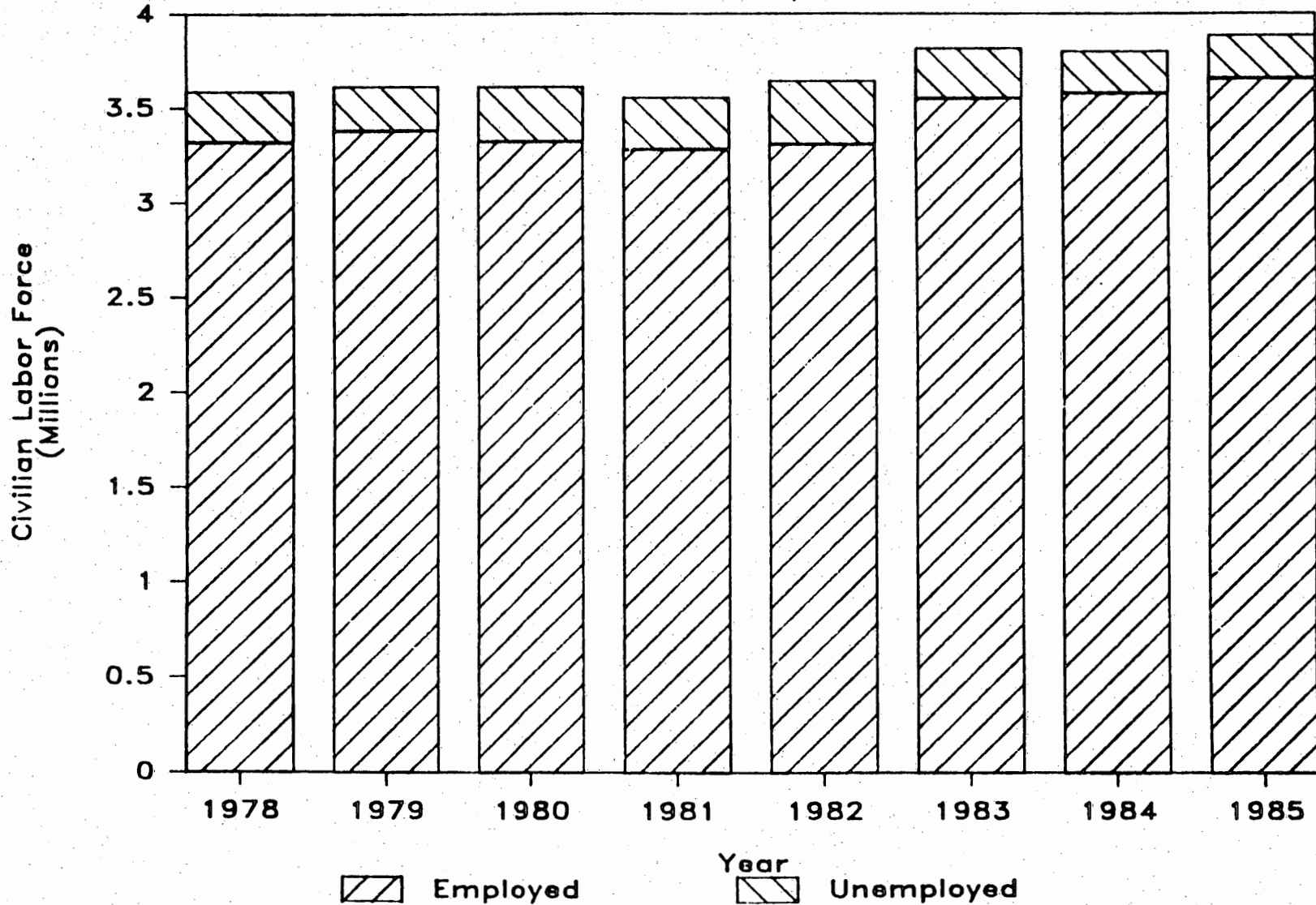
Civilian Labor Force (000)

<u>Year</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Total</u>	<u>Unemployment Rate</u>
1978	3326	266	3592	7.4%
1979	3386	232	3618	6.4%
1980	3328	287	3615	7.9%
1981	3285	273	3558	7.7%
1982	3314	333	3647	9.1%
1983	3554	262	3816	6.9%
1984	3582	219	3801	5.8%
1985	3661	225	3886	5.8%

Source: State of New Jersey Department of Labor, Division of Planning and Research: Covered Employment Series

Civilian Employment Status

State of New Jersey, 1978-1985



X 111 /

Source: State of New Jersey Department of Labor, Division of Planning and Research:

ILLUSTRATION 6.3

Non-Agricultural Employment by Major Industry Division
State of New Jersey, 1980-1985

<u>Year</u>	<u>Manufacturing (000)</u>				<u>Non-Manufacturing</u>		<u>Total Non-Agricultural</u>		
	<u>Non-Durable</u>	<u>%</u>	<u>Non-Durable</u>	<u>%</u>	<u>Total</u>	<u>%</u>	<u>Total</u>	<u>%</u>	
1980	384.3	12.56	396.8	12.97	781.0	25.52	2279.4	74.48	3060.4
1981	374.7	12.09	396.4	12.79	771.1	24.88	2327.8	75.12	3098.9
1982	350.1	11.32	379.6	12.27	729.6	23.59	2363.1	76.41	3092.7
1983	341.6	10.79	373.5	11.80	715.1	22.59	2450.0	77.41	3165.1
1984	346.2	10.40	380.5	11.43	726.8	21.83	2602.6	78.17	3329.3
1985	341.8	10.00	377.3	11.03	719.3	21.03	2700.0	78.97	3419.1

Source: State of New Jersey Department of Labor, Non-Agricultural Employment Services; Economic Research Bureau

ILLUS. 6.4

PERMANENT LAYOFFS IN NEW JERSEY, 1980-1985

<u>Year</u>	<u>Events</u>	<u>Number of Workers</u>
1980	88	17,291
1981	187	21,669
1982	137	13,133
1983	118	12,882
1984	173	12,580
1985	210	17,660
Total	913	95,215

Source: State of New Jersey Department of Labor,
Division of Planning and Research

ILLUS. 6.4A

MERGERS, ACQUISITIONS, PERMANENT LAYOFFS, AND PLANT CLOSINGS
IN NEW JERSEY, 1978-PRESENT

Company	Date of M&A Announcement	Date of Plant Closing or Layoff Announcement	Number of Jobs Lost
American Cyanamid (Division)	10/11/84	12/27/85 12/80	40 150
Conair	12/12/84	3/80	175
Ingersoll- Rand (Proto Tools)	2/29/84	3/ 2/82 1/ 3/84 2/21/84	25 19 15
Curtis-Wright	1/28/81	11/83-1/84	400
Kidde, Inc.	10/11/85	4/83-12/83	1947

Source: State of New Jersey Department of Labor, Division
of Planning and Research; Economic Research Bureau

ILLUSTRATION 6.5

CHANGES IN U.S. MANUFACTURING PLANT ACTIVITY, 1970-1980
(number of plants)

	Net New Plant Investment	Net Plant Acquisition
Urban	- 42	611
Suburb	236	913
Rural	310	728

Source: Adapted from Schmenner (Making Business Location
Decisions. Englewood Cliffs, N.J.: Prentice-Hall, 1982)

ILLUSTRATION 6.6

EFFECTS OF ACQUISITION OF NEW JERSEY FIRMS
ON SHAREHOLDER WEALTH

<u>Acquired Co.</u>	<u>Shares</u> (000)	<u>Price</u> (MB)	<u>Price</u> (DA)	<u>Difference</u>	<u>Change in</u> <u>Total Value</u> (000)
Applied Data Research	\$ 6,652	\$16.750	\$31.625	\$14.875	\$ 98948.5
Automatic Switch Co.	8,301	47.750	42.500	-5,250	-43580.3
Perg Enterprises Inc.	4,897	16.000	22.625	6,625	32442.6
CGA Computer Inc.	3,407	10.500	11.875	1,375	4684.6
Childrens Place Inc.	1,479	18.750	27.000	8,250	12201.8
Conair Corp.	9,649	18.250	22.125	3,875	37389.9
Jonathan Logan Inc.	7,067	20.625	24.000	3,375	23851.1
Keuffel & Esser Co.	1,727	23.000	28.500	5,500	9498.5
Liggett Group Inc.	8,436	38.375	67.375	29,000	244644.0
Metpath Inc.	7,084	15.250	20.650	5,400	38253.6
Metromedia Inc.	27,960	25.250	35.625	10,375	290085.0
Midland Glass Co.	3,138	9.250	11.500	2,250	7060.5
Prentice-Hall Inc.	9,934	44.875	72.250	27,375	271943.3
Resistoflex Corp.	1,722	11.500	20.750	9,250	15928.5
Suburban Propane Gas Co.	5,281	31.000	49.750	18,750	99018.8
Yates Industries Inc.	2,706	17.750	36.375	18,625	<u>50399.3</u>
Total					1192769.7

Remarks:

1. Price (MB) = Price per share, a month before
 2. Price (DA) = Price per share, the day after
- The price (DA) of Metpath Inc. was not available,
its price (DB) is used instead.

Source: Securities Data Corp., Securities Industry Association, Economic Research Bureau

ILLUSTRATION 7.1

ANTITAKEOVER MEASURES ADOPTED BY 20 LARGEST
CORPORATIONS* IN NEW JERSEY

	<u>Fair Price</u>	<u>Anti-Greenmail</u>	<u>Class. Board</u>	<u>Pref. Stock</u>	<u>Sever. Agree.</u>	<u>Poison Pill</u>	<u>Reduce Sh.Rts</u>
Allied-Signal			X		X		X
American Cyanamid	X		X	X			X
C.R. Bard	X		X	X	X	X	X
Becton Dickinson	X		X	X	X		
CPC International				X			
Campbell Soup				X			
Chubb				X	X		
Emerson Electric				X			
Engelhard			X		X		
Federal Paper			X	X			
Foster Wheeler	X		X	X	X		X
Great Atl. & Pacific Tea					X		
Ingersoll-Rand			X	X	X		X

*Based on corporate employment and sales. Terms are defined in the text

Antitakeover Measures Adopted by 20 Largest
Corporations in New Jersey (continued)

	<u>Fair Price</u>	<u>Anti-Greenmail</u>	<u>Class Board</u>	<u>Pref. Stock</u>	<u>Sever. Agree.</u>	<u>Poison Pill</u>	<u>Reduce Sh.Rts.</u>
Johnson & Johnson	X			X			
Merck	X	X	X	X			
Schering-Plough	X		X	X	X	X	X
Squibb	X			X			
Toys "R" Us					X		
Union Camp				X			
Warner-Lambert				X	X		
<hr/>							
NJ Total	7	2	10	16	11	2	6
National Total	146	33	206	328	214	43	170

Source: Securities Industry Association, Investor Responsibility Research Center, Inc., Economic Research Bureau

**STATEMENT OF RICHARD M. STOKES
BEFORE THE SENATE LABOR, INDUSTRY
AND PROFESSIONS COMMITTEE
REGARDING S-1539
MAY 12, 1986**

Atlantic City Electric Company
1199 Black Horse Pike
Pleasantville, N.J. 08232
609-645-4100

Capitol Plaza Hotel
240 W. State Street
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609-393-4044

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS RICHARD M. STOKES, SENIOR LEGISLATIVE REPRESENTATIVE, ATLANTIC CITY ELECTRIC COMPANY. ATLANTIC ELECTRIC, AN INVESTOR-OWNED PUBLIC UTILITY ORGANIZED UNDER THE LAWS OF NEW JERSEY, PROVIDES FOR THE GENERATION, TRANSMISSION, DISTRIBUTION AND SALE OF ELECTRIC ENERGY IN SOUTHERN NEW JERSEY.

ATLANTIC ELECTRIC IS A FINANCIALLY HEALTHY NEW JERSEY COMPANY, NOT PRESENTLY INTERESTED IN ACQUIRING OTHER COMPANIES IN OR OUTSIDE OF NEW JERSEY. BECAUSE OF THIS WE FEEL WE ARE IN THE UNIQUE POSITION OF PROVIDING AN IMPARTIAL VIEW REGARDING S-1539.

ATLANTIC ELECTRIC SUPPORTS S-1539 AND URGES THIS COMMITTEE TO FAVORABLY RELEASE THE BILL.

THE LEGISLATION WOULD PROHIBIT ANY NEW JERSEY RESIDENT DOMESTIC CORPORATION AFTER AN ACQUISITION OF 10% OR MORE OF ITS VOTING STOCK, FROM COMBINING WITH THE ACQUIRER FOR A PERIOD OF FIVE YEARS UNLESS THE COMBINATION HAD BEEN APPROVED BY THE TARGET COMPANY'S BOARD OF DIRECTORS PRIOR TO THE 10% STOCK ACQUISITION. AFTER EXPIRATION OF THE FIVE YEAR PERIOD, A MERGER COULD ONLY BE EFFECTED IF APPROVED BY A TWO-THIRDS VOTE OF THE DISINTERESTED SHAREHOLDERS OR IF ALL SHAREHOLDERS RECEIVE A FAIR VALUE FOR THEIR STOCK.

THIS BILL WOULD, IN EFFECT, PROVIDE A GREATER OPPORTUNITY TO REVIEW THE FULL IMPLICATIONS OF THE MERGER ATTEMPT. WE FIND THIS REVIEW PROCESS IMPORTANT IN DETERMINING THE FULL EFFECTS OF A FRIENDLY OR HOSTILE TAKEOVER.

ATLANTIC ELECTRIC REVIEWED THE POSSIBILITY OF MERGING WITH DELMARVA POWER AND LIGHT COMPANY, A DELAWARE-BASED UTILITY COMPANY, IN 1984. AFTER SIX MONTHS OF DETAILED STUDY, WE DETERMINED THAT SUCH A FRIENDLY AFFILIATION WAS NOT COST EFFECTIVE FOR OUR CUSTOMERS, AND THE AFFILIATION TALKS WERE

CALLED OFF. THIS TYPE OF A REVIEW PROCESS WHERE THE ADVANTAGES AND DISADVANTAGES COULD BE COLLECTIVELY REVIEWED BY ALL PARTIES WOULD ALSO BE BENEFICIAL IN A HOSTILE TAKEOVER. MERGERS HAVE SIGNIFICANT ECONOMIC CONSEQUENCES AND AFFECT THE LIVES OF THE CUSTOMERS, SHAREHOLDERS, EMPLOYEES, AND THE COMMUNITIES THEMSELVES. SOLID REVIEW OF THE EFFECTS OF A MERGER IS IMPORTANT TO ALL INVOLVED.

ATLANTIC ELECTRIC BELIEVES THAT AN ACQUISITION MUST BE VIEWED IN LIGHT OF THE BENEFITS TO CUSTOMERS, SHAREHOLDERS, EMPLOYEES, AND THE COMMUNITIES. THIS LEGISLATION SERVES AS AN IMPORTANT PUBLIC POLICY STATEMENT THAT THE SO-CALLED "BUST UP TAKEOVERS" PROVIDE LITTLE BENEFIT TO SOCIETY. THEREIN, THE RAIDER USES THE ACQUIRED COMPANY'S ASSETS TO PROVIDE SOME OR ALL OF THE DEBT SERVICE ON THE BONDS USED TO ACQUIRE THE COMPANY. THE REASON FOR THE TAKEOVER IS NOT TO OPERATE THE BUSINESS IN A BETTER FASHION OR TO MAKE IMPROVEMENTS IN THE INDUSTRY, BUT, RATHER, TO TAKE ADVANTAGE OF THE ASSETS OF THE CORPORATION FOR A QUICK SALE. THIS HAS SERIOUS FINANCIAL AND OPERATION IMPLICATIONS TO THE STABILITY OF THE COMPANY. NOT ONLY WILL THE DEBT STRUCTURE OF A COMPANY BE EXCEEDINGLY TAXED, BUT THE PROFITABLE BUSINESS DIVISIONS ARE USUALLY SOLD OFF TO PAY FOR THE ACQUISITIONS. THE REMAINING BUSINESS STRUCTURE HAS LITTLE CAPABILITY TO PROVIDE FOR SOUND DEVELOPMENT IN EXISTING COMPANY ACTIVITIES OR EXPANSION OF NEW ONES.

IN OUR REVIEW OF THE LEGISLATION, HOWEVER, WE WOULD RECOMMEND THAT SECTION 5(C) BE EXTENDED FROM 45 DAYS TO 90 DAYS IN ORDER TO PROVIDE SUFFICIENT TIME FOR CORPORATIONS TO OPT OUT OF THE PROVISIONS OF THIS LEGISLATION, SHOULD THEY DESIRE TO DO SO. WE FEEL THAT 45 DAYS IS NOT SUFFICIENT FOR MOST COMPANIES TO MAKE A DECISION ON THIS ISSUE AND TO TAKE THE APPROPRIATE ACTION.

WITH THIS ONE MINOR CHANGE, ATLANTIC ELECTRIC SUPPORTS S-1539 AND
URGES THIS COMMITTEE TO FAVORABLY RELEASE THIS BILL.



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COMMISSION

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KARL WEIDEL

March 6, 1986

Honorable Richard A. Zimmer
119 Main Street
Flemington, New Jersey 08822

Dear Assemblyman Zimmer:

You have requested an informal legal opinion on the constitutionality of Senate Bill No. 707 of 1986 and Assemblyman Bill No. 1953 of 1986, both of which bear the same short title: "New Jersey Shareholders' Protection Act." As the result of the analysis set forth below, you are advised that S-707 and A-1953 of 1986, if enacted and challenged on constitutional grounds, may be found to be preempted by the Williams Act and probably violate the Commerce Clause.

I Background: Relevant Legislation and Case Law

Any constitutional analysis of a takeover law should begin with a review of Edgar v. Mite Corp. et al., 457 U.S. 624 (1982) which brings into focus the necessary federal legislation and constitutional issues. In Mite, the Court found the Illinois Business Take-Over Act, Ill. Rev. Stat., ch. 121 1/2, para. 137.51 et seq. (1979), unconstitutional in several respects. The Court began its Supremacy Clause analysis with the Williams Act, 82 Stat. 454 (15 U.S.C. §78m(d) et al.) which is an amendment to the Securities Exchange Act of 1934, and noted that Congress did not amend section 28(a) of the 1934 Act,

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15 U.S.C. §78bb(a), which reads in pertinent part:

Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any state over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

This section reveals that Congress did not explicitly prohibit states from regulating takeovers; and therefore, implicitly, allowed state regulation to the extent that it does not actually conflict with the Williams Act. That act, passed in 1968, was the:

congressional response to the increased use of cash tender offers in corporate acquisitions, a device that had removed a substantial number of corporate control contests from the reach of existing disclosure requirements of the federal securities laws. 457 U.S. at 632 quoting Piper v. Chris - Craft Industries, Inc. 430 U.S. 1, 22(1977).

The Williams Act attempted to fill this regulatory gap by imposing several requirements. First, it requires, upon the commencement of the tender offer, the offeror to file with the SEC and send to the shareholders of the target company detailed information about the offer including information about the offeror, its background, source of funds, purpose of the purchase including any plans to liquidate the company or make major changes in its corporate structure, and the extent of the offeror's holdings in the target company. Second, stockholders who tendered their shares are allowed to withdraw them during the first seven days of the offer and at any time after 60 days from the commencement of the offer if the offeror has not yet purchased the shares. Third, all shares tendered must be purchased for the same price; if an offering price is increased, those who have already tendered receive the increase in price. 15 U.S.C. §§78n(d)(1), 78n(d)(7) and regulations thereunder.

The Court made findings in Mite which resulted in its becoming the landmark case relating to corporate acquisitions. Among its findings, the Court stated that "[T]here is no question that in imposing these requirements, Congress intended to protect

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investors," quoting Piper supra, at 35. 457 U.S. at 633. The Court continued: "But it is also crystal clear that a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder," and that "Congress disclaimed any intention to provide a weapon for management to discourage takeover bids," 457 U.S. at 624 quoting Rondeau v. Mosinee Paper Corp, 422 U.S. at 58. The Court further found that the Illinois Act frustrates the objective of the Williams Act by providing the target company with additional time within which to take steps to combat an offer, and that the precommencement notification to incumbent management provided them with a powerful tool.

The Illinois Act also frustrated the Williams Act by allowing management, or the Secretary of State to halt the offer pending a hearing on the sufficiency of the disclosure, and by allowing the Secretary of State to pass on the "fairness" of the offer. Justice White, writing for the plurality¹, agreed with the Court of Appeals (7th Cir.) that these provisions afforded management a "powerful weapon to stymie indefinitely a takeover," 457 U.S. at 637.

The second major part of a constitutional analysis of a takeover law concerns the Commerce Clause, U.S. Const. Art 1, §8, cl. 3. In Mite, the Court reviewed the case law construing this constitutional provision and enunciated the standard to be used:

Not every exercise of state power with some impact on interstate commerce is invalid. A state statute must be upheld if it "regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental ... unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." Pike v. Bruce Church, Inc., 397 U.S. 137, 142, 90 S. Ct. 844 847, 25 L. Ed. 2d 174 (1970), citing Huron Cement Co. v. Detroit, 362 U.S. 440, 443, 80 S. Ct. 813, 815, 4 L. Ed. 2d 852 (1960).

1. It should be noted that Justice White found that the Illinois Act was preempted by the Williams Act. The majority of the Court could only agree that the Act violated the Commerce Clause.

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The Commerce Clause, however, permits only incidental regulation of interstate commerce by states; direct regulation is prohibited. Shafer v. Farmers Grain Co., 268 U.S. 189, 199, 45 S.Ct. 481, 485, 69 L. Ed. 909 (1925). 457 U.S. at 640.

The Court also recognized that the states traditionally regulated intrastate securities transactions, and that the enactment of "blue-sky" laws have withstood Commerce Clause challenges because they deal with the disposition of securities within a state, and therefore, only incidentally affect interstate commerce. It was further noted that §28 of the Securities Exchange Act, 15 U.S.C. §78bb(a) was designed to save state blue-sky laws from preemption. 457 U.S. at 624.

The Illinois Act, however, differed substantially from state blue-sky laws in that it directly regulated transactions that take place across state lines. The Court consequently found that the Act violated the standard set forth above in two respects. First, it directly regulated interstate tender offers; and second, the burden the Act imposed on interstate commerce was excessive in light of the local interests it purported to further. In reaching this finding the Court noted that the Act could be applied to regulate a tender offer which would not affect a single Illinois shareholder². This caused the Court ultimately to find the Act unconstitutional under the Pike test and to pronounce:

While protecting local investors is plainly a legitimate state objective the state has no legitimate interest in protecting non-resident shareholders. Insofar as the Illinois law burdens out-of-state transactions, there is nothing to be weighed in the balance to sustain the law. We note, furthermore, that the

2. The Illinois Act defined "target company" as a corporation of which Illinois shareholders own 10% of the class of securities subject to the takeover offer or for which any two of the following conditions are met: the corporation has its principal office in Illinois, is organized under Illinois laws, or has at least 10% of its stated capital and paid-in surplus represented within the State.

Act completely exempts from coverage a corporation's acquisition of its own shares. 457 U.S. at 644.

In addition to the burden imposed by the Act's sweeping extraterritorial effect, the Court found that:

The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest-valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced. 457 U.S. at 643.

The last argument which was rejected by the Court was that the State of Illinois had an interest in regulating the internal affairs of a corporation incorporated under its laws. The Court reasoned that tender offers "contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company". 457 U.S. at 645 quoting Great Western United Corp. v. Kidwell, 577 F. 2d at 1280, n. 53.

In summary, while the Court could not agree on the preemption issue, it did agree that the Illinois Business Take-Over Act violated the Commerce Clause by imposing significant burdens on interstate commerce that were not outweighed by actual benefits received by the State.

II. Senate Bill No. 707 of 1986³

S-707 amends various sections of the "New Jersey Business Corporation Act" and also supplements Title 14A of the New Jersey Statutes.

3. S-707 of 1986, sponsored by Senator Van Wagner, was pre-filed for introduction in the 1986 session, and introduced and referred to the Senate Labor, Industry and Professions Committee on January 14, 1986.

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This bill represents a second attempt to enact a takeover law that can withstand constitutional attack⁴. The sponsor's statement indicates that the purpose of the bill is to assure that all shareholders of New Jersey corporations are treated fairly and equitably when transactions are proposed or occur, and is similar to the law recently enacted in Pennsylvania⁵ but not yet challenged.

Section 2 of the bill amends N.J.S.A. 14A:6-14, the fiduciary duties of the board of directors section, by allowing the board to consider non-constituent concerns in making business decisions. The amendatory language reads:

In discharging their duties, directors may consider the effects of any action upon employees, suppliers, and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.

This language attempts to expand the business judgment rule which traditionally has been a judicial doctrine that gives great deference to the decision making process of the board of directors. This amendment is intended to give management even more latitude in making decisions when confronted with takeover attempts by considering non-traditional or "social conscience" factors. This section of the bill, by itself, does not pose a constitutional problem. The courts will decide on a case by case basis whether the expansion of the rule is

4. In Kennecott Corporation et al v. Smith, 507 F. Supp 1206 (1981) the United States District Court for the District of New Jersey found the "New Jersey Takeover Bid Disclosure Law," P.L. 1977, c. 76 (C. 49:5-1 et seq.) unconstitutional, relying on the law's similarity to the Illinois Act and reasoning of the Court of Appeals (7th Cir.) in the Mite case.

5. Pennsylvania's law is a codification of articles of incorporation amendments, which are known in the industry as "shark repellents," and designed to aid incumbent management in deflecting takeover bids. 89 Dick. L. Rev. 401, "The 1983 Amendments to Pennsylvania's Business Corporation Law: Unconstitutional? MITE Be".

valid. This section in conjunction with the other sections of the bill, however, does present a constitutional problem.

Sections 3 through 5 of the bill amend sections of the business corporation law that deal with fundamental changes in a corporation (i.e. merger and consolidation; sale, lease, exchange or other disposition of all the assets of the corporation; and voluntary dissolution of the corporation)⁶. These sections basically provide that upon approval by the board of any fundamental change proposal, a majority of the shareholders entitled to vote must approve the transaction without counting the votes of "interested shareholders" which are defined as those who are parties to the transaction. These provisions, in essence, require a supermajority vote on certain transactions by disenfranchising interested shareholders. As with the previous section, these sections, by themselves, do not present clear constitutional issues but do so in conjunction with sections 6 through 10 of the bill.

Sections 6 through 10 of the bill contain new material and concern "control transactions" and "controlling persons" which are defined in the bill as follows:

a. "Control transaction" means the acquisition, by a person or group, or a group of persons acting in concert, of the status of a controlling person.

b. "Controlling person" means a person or group, or a group of persons acting in concert, which has voting power over voting shares of a corporation which would entitle the holders thereof to cast 30% of the aggregate number of votes which all holders of voting shares of the corporation would be entitled to cast in an election of directors of the corporation ...

Sections 7 and 8, specifically, provide shareholders the right to demand that a "controlling person" purchase their shares at a "fair value" plus a control premium⁷.

6. N.J.S.A. 14A:10-5; N.J.S.A. 14A:10-11; N.J.S.A. 14A:12-4.

7. This mechanism is also called a right of redemption or mandatory bid provision.

When the threshold 30% voting control is reached, the controlling person must notify each shareholder of record within 10 days. Within 20 days of this mailing any shareholder can make a demand upon the controlling person for the fair value of his shares, which is determined by the prescribed formula as for dissenting shareholders but which shall also include:

a consideration of all relevant factors attendant to the control transaction, including an increment representing a proportion of any value payable for acquisition of control of the corporation, Section 8 b.,

and which is payable in cash.

The bill does provide for exemptions to the control transaction requirements which include (1) controlling shareholders prior to enactment if they do not increase the percentage of their holdings (Section 6 b.); (2) agents, banks, brokers, trustees and the like whose principals individually do not control 30% (Section 6 b.); (3) persons who inadvertently become controlling persons and divest (Section 10); (4) subsidiary corporations (Section 10); and (5) corporations who opt out of these sections by bylaw amendment or articles of incorporation amendment (Section 9). It should also be noted that these sections apply only to corporations which have a voting class of shares registered under the "Securities Exchange Act of 1934," 48 Stat. 881 (15 U.S.C. §78a et seq.).

The amendatory sections of S-707 which include the expanded fiduciary duty, supermajority and fair price provisions do not present a direct conflict with the Williams Act. First, they do not contain any of the flawed components of the first generation disclosure laws which included: interfering with the timing of a tender offer; involving a state agency which could delay an offer; and burdensome pre-offer disclosure. Second, they do not apply to tender offers directly but only to interested shareholders who attempt a total acquisition in a two-step transaction. These sections, arguably, even enhance investor freedom to accept or reject an offer⁸.

8. 89 Dick. L. Rev. at 429.

The "control transaction" sections also present no direct conflict with the Williams act. If a tender offer is actually made and the 30% threshold is reached, however, these sections could be found to indirectly conflict with the intent of the federal tender offer law which permits a tender for 30% or more, but less than all, of a corporation's shares⁹.

The effect of these sections is to deter tender offers, specifically two-step transactions¹⁰, because shareholders can exercise their redemption rights "within a reasonable time" after the threshold is reached, and because the offeror loses control of the cost of a total acquisition as he may have to purchase at a premium more shares of the target than desired¹¹. In Agency Rent-A-Car, Inc. v. Connolly, 686 F. 2d 1029 (1st Cir. 1982) the Court suggested that the Williams Act might preempt state regulation of tender offers if a challenger could show that the state law halted an excessive number of offers. Although this proof would be difficult, because courts have been willing to find state statutes unduly burdensome on interstate commerce if a single offer is stopped, producing extensive evidence of many halted offers is arguably unnecessary¹².

A conclusion that can be reached in the preemption analysis is that a court may find the control transaction sections of the bill together with the supermajority and fair price requirement, by favoring incumbent management, in indirect conflict with the Williams Act policy of neutrality. It should be noted however, that to make this finding a court would be relying on the plurality opinion of Mite and not the concurring opinions which maintained the position that the neutrality policy does not imply a congressional intent to prohibit all state regulation of tender offers, even if the state law protects interests

9. The Business Lawyer; Vol 40, November 1984 at p. 119, "The Pennsylvania Shareholder Protection Act: A New Approach to Deflecting Corporate Takeover Bids."

10. Two-step transactions often involve a partial tender offer for some of the target's shares and then a subsequent merger which yields holdout minority shareholders a lower price for their shares, and are thus "squeezed out."

11. 89 Dick. L. Rev. at 425-426.

12. Ibid. at 430-431.

which include those of the target's management¹³.

Commerce Clause analysis of a takeover statute rests on the Pike balancing test mentioned in part I of this opinion. Courts have consistently applied the Pike test, which balances the state's interests and benefits against the burden imposed on interstate commerce. As the short title of S-707 indicates, investor protection is the bill's main purpose. The Court found in Mite that protecting investors is a legitimate interest of a state, but only if regulated within a state. Despite the teachings of Mite and the minimal extraterritorial effect that S-707 may have, the bill still suffers from overbreadth. A stock purchase that triggers the control transaction provision can occur anywhere, even wholly outside New Jersey.

In APL Limited Partnership v. Van Dusen Air, Inc., Fed. Sec. L. Rep. (CCH) par. 92,331 (D. Minn., 1985) 92,187. The court further defined the Pike test and stated that:

to the extent that a statute which burdens interstate commerce fails to further the state's desired result, that statute will not result in any local benefit to a state.

Recognizing that the Minnesota Control Share Acquisition Act would apply even if there were no Minnesota shareholders, the Court found the Act created an impermissible conflict with the Commerce Clause as no local benefits could arise from the statute's application to nonresident shareholders.

S-707 in this respect only provides illusory investor protection. The supermajority provisions and the mandatory redemption provision seem to protect investors in New Jersey corporations. This they may do if a takeover attempt occurs. In effect, however, the provisions deter takeover attempts. It can also be argued that the value of the shareholder's investment in a corporation will drop if a takeover procedure is not

13. Mite 457 U.S. at 646-47.

available¹⁴. A hostile takeover is often the preferred method of acquiring control when target management opposes the attempt. Ironically, what seemed to be investor protection can be viewed as a harm.

The sponsor's statement to S-707 also indicates that the amendments contained in the bill "are an amplification of traditional statutory corporate conflicts of interest and dissenter's rights concepts and are consistent with the public policy of New Jersey." Assuming that New Jersey is advancing an interest in regulating the internal affairs of local corporations, the bill would meet strong authority to the contrary. S-707 applies to tender offers which the Supreme Court has said do not fall within the ambit of a corporation's internal affairs. Mite, 457 U.S. at 624.

New Jersey could also assert that S-707 represents an interest in keeping corporations within this State. This has been found to be a legitimate interest; however, less restrictive alternatives are available to protect this interest, such as tax incentives for charitable deductions, environmental legislation and civic involvement programs. Great Western United Corp v. Kidwell, 577 F. 2d 1286 (5th Cir. 1978).

Considering the balance of the burdens and benefits which would result from the enactment and administration of S-707, it can be concluded that it will be struck down upon a Commerce Clause attack. The approach is overbroad because it would regulate transactions that occur entirely outside of New Jersey. The bill also deters tender offers and prevents shareholders the opportunity to tender their shares at a premium. The control transaction provision of the bill also is based on the questionable assumption that a person who acquires 30% of a resident corporation, whether that person is a resident or not, is likely to engage in activities that are deleterious to a corporation or the business climate. Shareholders are not protected from a tender offer by incumbent management, an exception that would tend to undermine the justification for the burdens the bill would impose on interstate commerce¹⁵.

14. 89 Dick. L. Rev. at 433 and 435.

15. Mite, 457 U.S. at 644.

III. Assembly Bill No. 1953 of 1986¹⁶

A-1953 also supplements Title 14A of the New Jersey Statutes, but this bill takes a different approach to discourage hostile takeovers and is similar to legislation enacted in New York in December 1985¹⁷ which also has not yet been challenged. The bill prohibits any New Jersey resident corporation from entering into a "business combination" with an "interested stockholder" for a period of five years after the interested stockholder acquired 10% of the voting stock unless the business combination is approved by the target company's board of directors prior to the 10% acquisition. After the five-year period, the business combination could occur only if approved by a 2/3 vote of the disinterested shareholders, or if all shareholders receive a fair value for their shares as determined by formula.

A "business combination" is defined, basically, as certain transactions between a resident domestic corporation and any interested stockholder including: (1) any merger or consolidation; (2) any sale, lease, exchange, mortgage, pledge, transfer or other disposition having an aggregate market value of 10% of the assets of the resident corporation; (3) the issue or transfer by the resident corporation of any stock with an aggregate market value of 5% or more of the aggregate market value of all outstanding stock; (4) the adoption of any plan or proposal for liquidation or dissolution; (5) any reclassification of securities or recapitalization; or (6) any receipt by an interested stockholder of any loan, advance, guarantee, pledge or other financial assistance or tax advantage.

"Interested stockholder" is defined, basically, as any person that is the beneficial owner of 10% or more of the voting power of the outstanding stock of the resident domestic corporation, or is an affiliate or associate of the resident domestic corporation who at any time within the five-year period prior to the date in question was the beneficial owner of 10% of the voting power of the outstanding stock.

16. A-1953 of 1986, sponsored by Assemblyman Villane, was introduced on February 10, 1986 and referred to the Assembly Financial Institutions Committee. The bill was transferred to the Assembly Economic Development and Agriculture Committee on February 13, 1986.

17. See sponsor's statement.

The bill also provides several exclusions similar to those found in S-707. These include corporations who do not have a class of voting stock registered with the SEC, corporations who opt out by amendment to the corporation's bylaws or articles of incorporation, inadvertent acquirors of 10% of the voting stock, and others.

The intended effect of this bill is to encourage a potential acquiror to negotiate a proposed merger with the target company's board of directors, and to discourage "hostile, asset stripping takeovers.¹⁸" The definitions of "business combination" and "interested stockholder" in conjunction with the operative five-year bar (section 3) indicate that the bill is specifically aimed at leveraged transactions including two-step transactions that use the assets of the target corporation to finance the acquisition.

A preemption analysis of A-1953 would follow the same reasoning and result as with S-707. A-1953 does not directly conflict with the Williams Act because it does not affect the timing of an offer, require burdensome disclosure or interject a state agency's opinion as to the fairness of a tender offer. The issue then, again, becomes whether the bill if enacted would frustrate the purposes of the Williams Act. The sponsor's statement to the bill clearly announces a purpose which the plurality in Mite found impermissible. The bill favors incumbent management when confronted with a takeover attempt by giving them an effective veto over business combinations that are often necessary to a takeover when the acquiror wants to use realistically the corporate assets to finance the takeover of the corporation¹⁹.

This inhibition of takeovers limits the ability of shareholders to tender their stock. If the policy of neutrality that favors a market approach to takeovers is adopted by a court then this bill if enacted would probably be found preempted by the Williams Act.

The bill also does not present a direct impact on interstate commerce; it does not prohibit the tender of shares of nonresidents. Its provisions do present, however, indirect restraints on interstate commerce

18. Id.

19. The National Law Journal, "Mergers and Acquisitions," Feb. 24, 1986 at p. 30.

by precluding takeovers that require certain business combinations. In addition, the five year bar on business combinations may restrict the movement of assets²⁰ among the states which a court could find to be a burden.

The five year prohibition on certain business combinations can be analogized to the denial of voting or transfer rights for one year imposed by the Minnesota Control Share Acquisition Act which was attacked in APL Limited Partnership v. Van Dusen Air Inc.²¹. The court's analysis could be applied to A-1953 if challenged. In Van Dusen Air Inc. the court stated that it has the constitutional duty to determine whether:

state-desired benefits can, in fact, result from the statute and only those which are not "speculative" may be placed in the scale to be balanced against the burden on interstate commerce²².

This analysis asks the question whether New Jersey's interest in preserving intact local corporations will in fact be promoted by the bill, and produce benefits that can be weighed against the burden on interstate commerce. The court in Van Dusen Air Inc. cited many questionable assumptions of the Minnesota Act. Some of these can also be attributed to A-1953. The first is that all leveraged takeovers, or hostile takeovers, have an adverse economic impact on a corporation, its shareholders and the State.

Second, all business combinations or 10% share acquisitions, not just highly leveraged or economically harmful transactions, are subject to board of directors approval. The effect of this provision seems to be overbroad by permitting the board wide discretion in deciding what transactions to approve. Also the board appears to be able to use leveraged buyouts or freeze-outs that can also cause the harms sought to be prevented. If the board is not generally subject to the statute, this omission may undermine the justification for the statute's burdens. See Mite 457 U.S. at 644.

20. Id.

21. Fed. Sec. L. Rep. (CCH) para. 92,331. (D. Minn., 1985), 92,187.

22. Id.

As with S-707, this bill could be criticized as not representing a less restrictive alternative such as limitations on the use of debt in certain transactions or different state tax policies. The bill also gives New Jersey no better argument to buttress the internal affairs doctrine that was rejected in Mite and Van Dusen Air Inc. Takeover legislation that has an extraterritorial impact cannot be said to further an interest in the internal affairs of corporations which are traditionally regulated by the states.

A-1953 raises an additional constitutional issue. Section 7 of the bill contains a retroactive effective date. This section has the effect of undoing business combinations that occurred prior to enactment. This raises an impairment of contracts issue. Article 4, §7, para. 3 of the State Constitution states:

The Legislature shall not pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts...

In Fidelity Union Trust Co. v. New Jersey Highway Authority, 85 N.J. 277 (1981) the Supreme Court reviewed the relevant step in the analysis of impairment of contracts which would apply to A-1953:

The next step in the analysis is whether the impairment is reasonable and necessary to serve an important public purpose. Necessity is met if the objectives could not have been achieved by a less drastic alternative. Reasonableness depends upon the extent of the impairment and upon whether the circumstances giving rise to the impairment were foreseeable when the contract was made. Citing United States Trust Co. v. New Jersey, 431 U.S. 1 (1977). 85 N.J. at 288.

Chief Justice Burger in a concurring opinion in United States Trust Co. emphasized that "the State must demonstrate that the impairment was essential to the achievement of an important state purpose." Id. at 32²³.

From this analysis and the previous discussion of less burdensome alternatives, an acquiror with the proper

23. The impairment argument applies equally under Art. 1 §10 of the United States Constitution.

facts²⁴ could demonstrate an impairment of a contract, or several contracts of substantial financial impact. Considering further the analysis of illusory interests and speculative benefits, the State would be hard pressed to demonstrate an important state purpose that could not be addressed by a less drastic alternative.

IV. Conclusion

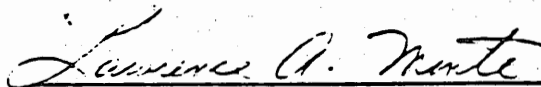
Based on the foregoing analyses, you are advised that S-707 and A-1953 may be found to be preempted by the Williams Act and probably would be found unconstitutional under the Commerce Clause. You are further advised that A-1953 may violate the impairment of contracts clause under the federal and State Constitutions.

24. The facts would have to include a tender offer or "business combination" taking place on or after January 23, 1986 and before the date of enactment of A-1953.

Very truly yours,

Albert Porroni
Legislative Counsel

By:



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PATRICK J. WITMER

DIRECTOR OF LEGISLATIVE AFFAIRS

NEW JERSEY STATE CHAMBER OF COMMERCE

TESTIMONY

BEFORE THE

NEW JERSEY SENATE

ON THE SUBJECT OF

SHAREHOLDER PROTECTION LEGISLATION

MAY 12, 1988

Mr. Chairman, members of the Committee, my name is Patrick J. Witmer and I am Director of Legislative Affairs for the New Jersey State Chamber of Commerce. As the representative of an organization which is committed to fostering the best possible economic climate for New Jersey, I am pleased to be able to address this issue today. The Board of Directors of the New Jersey State Chamber of Commerce has studied this issue thoroughly over the past six months. The State Chamber fully supports S-1539. We feel that it is crucial in preserving the strength of the State's resident corporations and ensuring that economic growth continues throughout New Jersey.

The rise of the hostile takeover, which results in stripping the assets of the target corporation to guarantee the raider a profit, is an alarming phenomenon to the business community. We see companies' futures being sacrificed to the short-term profits of a raider when they are taken over. A dismantled company loses its identity, its ability to compete nationally and internationally, and its potential for growth. The people who work for it lose jobs, security, community leadership and morale.

Even if companies are only threatened with a takeover, the resulting poison-pill strategies, management preoccupation and lowered employee morale damage companies severely. American business as a whole also suffers since the pervasive fear of takeovers makes companies hesitant to spend money on growth programs such as research and development.

The State Chamber wants to avoid damage of this kind in New Jersey, and it has never been more important to do so. The State's economy is healthy and growing, and our resident corporations are a key factor in that growth. It is vital that we protect these companies and the people who depend upon them. S-1539 would ensure that their growth and the State's future growth are not harmed by the hostile takeover wave.

Finally, I want to note that this legislation would not interfere with corporate business practices in the State. The bill is very specific: it is designed to stop only asset-stripping takeovers that rely on liquidating the target to finance the acquisition. It would not impede mergers, proxy battles or even hostile takeovers whose intent is managing and improving the target. The State Chamber is confident that this bill will put to rest the danger now facing us without interfering with corporate growth and reallocation of resources.

Thank you for the opportunity to convey the State Chamber's support for this legislation. I will be happy to answer any questions.

