NEW JERSEY SHAREHOLDERS PROTECTION ACT: AN ECONOMIC EVALUATION

A Report to the New Jersey Legislature

by

The Office of Economic Policy

STATE OF NEW JERSEY
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New Jersey Shareholders
Protection Act

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TO THE LEGISLATURE:

The Office of Economic Policy is pleased to submit this Report to the Legislature pursuant to section 7 of the New Jersey Shareholders Protection Act (P.L. 1986, Chapter 74, approved August 5, 1986).
This Report reviews the contested issues in unfriendly takeovers and the Legislature's concerns regarding the State's shareholders, employees, and communities. Based on this review and available evidence, we found the protective value of the Act to be minimal, while the likelihood of diminished efficiency of New Jersey corporations to be of concern. We provide a list of possible changes in the Act that we believe would reduce its likely harmful effects.

We are pleased to have had the opportunity to assist the Legislature in reviewing the impact of this important Law.

Respectfully submitted,

Adam Broner

Adam Broner, Director
Office of Economic Policy

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GENERAL CONCLUSIONS

- We have found that public concern about the current wave of unfriendly takeovers in the United States is largely unwarranted.
- Our extensive review of the economic arguments and empirical evidence has convinced us that the New Jersey Shareholders Protection Act will, on balance, adversely affect shareholders.
- The impact of this legislation will, however, be limited in scope since it applies to a small number of corporations employing only two percent of the State's labor force.
- The argument that the prevention of even a single harmful takover, however unlikely its occurrence, may be very important for a particular plant or community should be balanced against the broad prevention of hostile takeovers enacted in the Law. That curtailment of takeovers could have detrimental effects on the working of many corporations.
- Anti-takeover legislation enacted in other states will also adversely affect New Jersey shareholders and employees.
- Although we conclude that the New Jersey Shareholders Protection Act should not be extended beyond its expiration date, we suggest several options that can reduce its negative impact on the State economy.

THE NEW JERSEY SHAREHOLDERS PROTECTION ACT: AN ECONOMIC EVALUATION*

EXECUTIVE SUMMARY

This Report has been prepared by the Office of Economic Policy in fulfillment of section 7 of the New Jersey Shareholders Protection Act of 1986 (The Act).** It attempts to assess the implications of the Act for the State's economy. The Report reviews a wide range of issues raised in the debate about corporate takeovers. It strives at presenting an independent view of this controversial subject based on widely accepted economic principles and available empirical evidence. It is hoped that this Report will assist the New Jersey Legislature in the process of reviewing the extension of the Act beyond its January 1988 expiration date.

The Report consists of three sections. The role of mergers and takeovers in the current process of restructuring United States corporations is discussed in the first section. A brief review of public concerns about hostile takeovers and of the arguments expressed in the legislative debate is the subject of the second section. Empirical evidence on the impact of mergers and takeovers in light of often-raised criticism is presented in the third section. It is followed by a brief outline of some of the options available to the New Jersey Legislature for alleviating the possible undesirable economic effects of the Act.

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*Prepared by the Office of Economic Policy (Dr. Adam Broner, Director) and reviewed by the New Jersey Economic Policy Council.

**P.L. 1986, Chapter 74, approved August 5, 1986. The full text of this Act is reproduced in Appendix I.

I. <u>Mergers and Takeovers -- The Economic Arguments</u>

Mergers and acquisitions as well as friendly and hostile takeovers are important mechanisms of redeploying corporate assets. Takeovers are not limited to situations where incumbent management does not discharge its duties to the satisfaction of corporate stockholders. It is often the case that well-performing corporations are targets of mergers and takeovers. The rationale for the redeployment of assets of such corporations is that it brings about increased efficiency through synergies, economies of scale, and better utilization of resources.

Hostile takeovers accomplished through tender offers also allow competing management teams to offer their services directly to corporate stockholders over the objection of incumbent management. This method of changing managers and restructuring corporate assets is a powerful disciplining instrument in the hands of shareholders in actual as well as potential takeovers. It creates a strong incentive to manage corporations in the best possible way.

To disallow hostile takeovers, whether by changes in the corporate charters or government legislation, can result in less productive use of human and material resources. The enactment of the New Jersey Shareholders Protection Act puts the veto power in the hands of incumbent management which may prevent the company from reaching its full potential for development and growth.

Mergers and takeovers can also in some instances lead to misappropriation of corporate assets, not by design but by miscalculation or misjudgement. Errors of judgement are unavoidable in such decisions as they are in a variety of other economic transactions. Abuses in the takeover process can also happen. However, neither isolated instances of errors or of abuses can be sufficient justification for the abolition of hostile takeovers and their general disciplinary and incentive value.

The possibility of removing entrenched management and the realization of economic efficiencies as a result of takeovers has enormous value for the process of improving competitiveness of U.S. corporations. Without this possibility, our economic system will be weakened and our position on the world economic scene diminished.

We summarize the discussion in this section by emphasizing the following:

- A broad process of restructuring and alignment of the United States economy is currently under way. It has been prompted, to a large extent, by competition from abroad, by the need to preserve U.S. market positions in the world and, ultimately, by the desire to defend our standard of living. This restructuring process is not limited to the area of mergers, takeovers and divestitures, but it is a significant part of it.

- In this effort to preserve, or in many cases to regain, our position in world markets, the effectiveness of managing United States corporations is a significant contributing factor. Labor is another important factor in this restructuring process and it has contributed enormously in the last several years by agreeing to lower wages, more active participation in quality improvements, productivity growth and by establishing more harmonious relations with management.

- The New Jersey economy has performed very well in the last several years, although manufacturing has been its weakest sector and one where many layoffs and plant closings occurred with a resulting sharp reduction in employment. By improving the economy's performance, the State contributes to the national effort to increase competitiveness of U.S. corporations. Therefore, the State government must be responsible in its lawmaking activity to carefully consider whether new corporate statutes are necessary and are helpful in the efforts of the State and nation to improve their competitiveness in the world market. We are not convinced that hindering the process of restructuring New Jersey corporations is, on balance, a positive factor in that process. As the debate indicates, this view is not shared by all.

II. Review of the New Jersey Shareholders Protection Act

In Section II attention is focused on the major concerns in the takeover process that prompted the Legislature to adopt the New Jersey Shareholders Protection Act. Several pertinent issues are analyzed in this section.

- The stipulation that corporate management should consider the interests of stakeholders (employees, suppliers, customers, community at large) in addition to maximizing returns to shareholder. We see serious flaws in such an approach to corporate governance, although we recognize the need to treat fairly all stakeholders. Shareholders are the sole owners of the corporation and should have the right to hire managers loyal to their interests. We see significant harm from depriving owners of their rights which need not be in conflict with the interest of employees, suppliers, customers and communities.

- The acquisition of companies with large amounts of below investment grade bonds and the disposition of assets to redeem the high yield debt instruments (junk-bond bust-up takeovers). When we consider the real dimension of increased leverage nationally, the magnitude involved is not alarming, although junk bonds are increasingly being applied in large corporate takeovers. We argue that even if the increased debt should be considered a matter of concern, any government intervention in this area should be balanced against the negative effect it may also have on the process of restructuring American corporations. We also do not consider the selling of some assets, whether by an independent or newly acquired company, to be inherently wrong or, in most instances, lead to reduced employment.

• Two-tier or partial tender offers and the "coerciveness" of this approach to corporate tender offers. It has been shown that two-tier tender offers are a small and declining part of all mergers and acquisitions; they are most often negotiated with management; a significant combined premium is paid and the second tier price is significantly higher than the pre-offer price even though it is about 20 percent lower than the price for the first tier. It has been shown that management's opinion is being taken into account by shareholders in making decisions whether to tender or not. Although the expert opinion on whether to regulate two-tier tender offers is not unanimous, we think that some measure of assuring a fair price for untendered shares may be justified. A case can be made to adopt "fair price" legislation similar to the one enacted in the State of Maryland which, when a fair price is assured, does not prevent business combinations as in the New Jersey Act.

• The view that the stock market is myopic, i.e., tends to pay attention only to short-term results and thereby undervalues stock prices of companies that engage in long-term planning and investment. It is also argued that management knowing the reaction of the market foregoes decisions which can be beneficial in the long-run. If such myopic strategies are actually pursued, they will surely result in an inferior performance and such companies will become takeover targets sooner rather than later. The observation of stock price behavior casts doubts on this hypothesis. New ventures without any earnings histories are being financed by the equity market. Stock of companies not paying dividends for prolonged periods of time are being bought in the market and often their prices increase because of improved long-term expectations. Companies of the same industry are selling stocks at different price/earning ratios which means that their different long-term expectations for earnings are taken into account.

A major point of interest is whom does the New Jersey Act protect? Its name suggests that it is supposed to protect New Jersey shareholders. First, the Act applies to a very small group of New Jersey corporations, employing approximately 72,000 employees, i.e., about two percent of the State's labor force. Furthermore, shareholders of those corporations residing in the Garden State are certainly, in most cases, a small minority. The likelihood that some of these corporations could be a target for a hostile takeover further reduces the number of possible shareholders to be protected. This same reasoning is applicable to employees who are also claimed to be protected by this legislation.

Apart from the issue of how many New Jersey shareholders are affected by the Act, the question is what exact protection it offers to shareholders, if at all? It is our contention that the Act may deprive the shareholders of a significant price premium that they could realize in a takeover contest. Since we claim that the presumed protection is small, it is equally true that the Act's negative impact may be limited.

We strongly emphasize the general principles involved in this legislation such as the exclusion of shareholders from business combination decisions which severely restricts the role of the corporation's owners. It is indeed a paradoxical situation created under the New Jersey Shareholders Protection Act, that even owners of a majority of shares of a corporation, if they were acquired after the effective date of this Act, cannot affect business decisions that might ensure a healthy and timely rearrangement of assets and improved performance of the corporation.

We can now summarize our dicussion in this section:

• We have reviewed and analyzed the stated concerns of the Legislature in regard to hostile takeovers and found them to be limited in scope and application. Nevertheless, we acknowledged that some of those negative implications may have merit. Even if only a limited number of cases of harmful takeovers can be found, these could be significant in a particular plant or community.

• Even with this, we found the remedies in the Act far too broad in relation to the stated possible harmful situations. Together with the prevention of possible harmful takeovers, the Act prevents or makes it extremely difficult to realize any useful, economically beneficial takeover if not approved by the board of directors.

• Our interpretation is that the Act is clearly tilted toward management by depriving interested shareholders voting and decision power on business combinations. The Williams Act and the current opinion of the United States Supreme Court on the constitutionality of the Indiana Control Share Acquisitions Act stress the importance of the Law's neutrality between the investors' and managements' rights.

• Finally, in terms of scope we find the impact of the Act limited to a handful of larger corporations where the likelihood of a hostile takeover is very limited. However, the relaxation of the disciplinary effect of hostile takeovers may have some broader economic implications and should not be ignored.

We are convinced that there will be negative rather than positive results of anti-takeover laws, and, therefore, conclude that the impact of such legislation in this and other states, although initially small, may grow over time. Our conviction of an adverse impact, on balance, is further enforced by the review of the evidence accumulated by researchers in this field over many years. We summarize this evidence in Section III.

III. Empirical Evidence

We first review the evidence that due to the expected improvement of the application of merging companies' assets, the shareholders realize a hefty price premium.

- There is literally unanimous agreement that, on the average, shareholders of target companies realize between 20 to 35 percent (depending on the time period) price increases of their tendered stocks. Shareholders of bidding companies realize little or no gains. Since bidders are willing to pay these higher prices for a target company's share, there must be expected real, not imaginary, benefits to realize even above the price of acquired shares.

- There is less agreement as to the sources of those benefits. The mainstream experts maintain that the gains come from increased efficiencies, from synergies, economies of scale, reduced costs of operation due to better utilization of material and human resources of the combined companies. Some experts, however, contend that at least part, if not all, of the benefits stem from redistribution to shareholders from employees, customers, suppliers and management. The evidence attempting to prove these latter contentions is sporadic and unconvincing. Some evidence also points to tax gains as a source of shareholder premiums. This incentive for takeovers has been largely removed by the 1986 Tax Reform Act.

- We cite evidence that counters the argument that the stock market is myopic. Institutional owners, who supposedly are especially interested in short-term portfolio results, are not more eager than individuals to tender shares at any premium. Also, the supposition that institutional shareholders avoid stock in companies with larger R&D expenditures is not confirmed by evidence. It is also not true that such companies are more prone to be takeover targets. Moreover, stock price evidence shows that the capital market positively values companies that announce investments in R&D.

• Below investment grade bonds are increasingly being used in takeovers of large corporations. They constitute about one-third of the financing of the largest acquisitions and a very small fraction in takeovers of small- and medium-size companies. The yield of those bonds overcompensates their buyers for the increased riskiness and default experience. Most defaults are not caused by hostile takeovers and an overwhelming majority of so-called junk bonds are used for other than takeover purposes.

• A study by Professor Yago and Stevenson of layoffs, plant closings and takeovers in New Jersey for the years 1978 to 1985 clearly shows that no relationship exists between plant closings and hostile takeovers. In the period 1980-1985 about 95,000 jobs were lost in New Jersey -- only one percent, or 950, were associated with acquired firms. The authors conclude that the image of asset-stripping acquisitions or mergers shutting plants appears to have little empirical foundation in New Jersey.

• There is some proof that the enactment of anti-takeover legislation in the states of New York and Ohio has caused a statistically significant abnormal negative return of stocks of affected companies. A similar study for New Jersey also shows a negative effect of 1.9 percent around the event of May 13, the day after the Senate Labor, Industry and Professions Committee voted in favor of Senate Bill 1539 (The New Jersey Shareholders Protection Act).

Recommendations

In the final analysis, the Office of Economic Policy does not find sufficiently convincing arguments or evidence for the continuation of the current Shareholders Protection Act. However, if this conclusion is not accepted, we offer several options aimed at reducing the negative effects of the Act.

<u>Option 1</u>: Retain the Act but amend it with a provision to allow for an "opt-in" alternative by affected corporations so that the decision will be

back in the hands of the majority of shareholders (including the "interested shareholder").

<u>Option</u> <u>2</u>: Permit the shareholders to decide whether they would allow a proposed business combination with an interested shareholder in which each share will have one vote (including the interested shareholder's stock).

<u>Option</u> <u>3</u>: Permit the shareholders to decide about a proposed business combination limiting the vote to disinterested shareholders (exclude both the "interested shareholders" as defined in the Act plus shares held by the board of directors and officers employed in the corporation).

<u>Option</u> <u>4</u>: Change the definition of the term "business combination" to limit it to transactions between the resident domestic corporation and the "interested shareholder" as defined in the Maryland fair price legislation. Allow for a business combination so defined under a supermajority vote of all shares (e.g., 80%) or two-thirds of disinterested shares. Exempt from supermajority requirements a business combination when certain minimum fair price criteria are met.

<u>Option</u> <u>5</u>: Allow the board of directors to decide about the efficiency and desirability of a business combination with the interested shareholder <u>after</u> (not before) the acquisition of more than ten percent of the shares by one person or group.

<u>Option</u> <u>6</u>: Permit the "opt-out" provision which was initially in the bill.

<u>Option</u> <u>7</u>: Limit the application of the Act to cases financed by more than 50 percent with so-called "junk bonds" or any other reasonable percentage explicitly stated in the law and precisely defined.

Option 8: Require that for any major disposition of assets (e.g., selling a plant or closing it) there should be consultation with representatives of employees and their legitimate claims be satisfied. Insist that concerns and interests of employees (pensions, severance payments, retraining or relocation allowances, rights to be rehired when business improves, etc.) are not disregarded by new owners.

Option 9: Limit the application of the New Jersey Law to corporations that have a minimum number or percentage of shareholders residing in New Jersey. A suitable definition could be the one applied in Indiana and recognized by the Supreme Court as a factor in rendering it constitutional.

Finally, we strongly recommend, although it is beyond the purview of the Shareholders Protection Act, that more attention be devoted to the troubling issue of the continuing employment decline in the State's manufacturing industries. As has been shown, this decline is not the result of mergers or takeovers. Since this decline is much more pronounced in New Jersey than the national trend would indicate, it calls for a careful analysis of the local reasons for that decline and for state actions to stem it. The Office of Economic Policy stays ready to assist the Legislature in such an effort.

THE NEW JERSEY SHAREHOLDERS PROTECTION ACT: AN ECONOMIC EVALUATION

Introduction

The "Shareholders Protection Act" was enacted by the New Jersey Legislature in August 1986 and made retroactive to January 1986 (Chapter 74, P.L. 1986). Its major provisions prohibit business combinations between a resident domestic corporation and an acquirer of more than ten percent of a company's stock within five years unless agreed to by the board of directors prior to that acquisition. There are further restrictions on business combinations after the five year term which require a two-thirds vote of all stock not beneficially owned by the interested stockholders, or the payment of very favorable per share prices. The Law has a January 1988 sunset provision and charged the Office of Economic Policy to evaluate its economic impact on the economy of the State, on resident corporations located in New Jersey and on individual and institutional stockholders in the State.

This Report was prepared in fulfillment of the Legislature's mandate. It takes a broad and independent view on this highly controversial subject by carefully reviewing the arguments and evidence on both sides of the issues. Its conclusions are based on basic economic principles and available evidence developed by researchers on national and state data.

The Office of Economic Policy and the Economic Policy Council have served for over twenty years as economic advisors to the Governor and the Legislature according to the provisions of Chapter 129 of P.L. 1966. The Office and Council develop their independent views in the course of studying particular economic issues and in accordance with well established economic principles.

The first section of this Report outlines basic principles of economic efficiency as they apply to the issue of mergers and hostile takeovers. Section II provides a brief recapitulation and discussion of the provisions of the New Jersey "Shareholders Protection Act", and the justification for its enactment as contained in the Law and as advanced during the legislative process by its proponents. The third section is devoted to detailed analysis of the proponents' arguments and the evidence available in the literature confirming or repudiating those arguments. We summarize the major arguments and evidence and suggest possible improvements of the Law in the Executive Summary.

I. THE ECONOMIC ARGUMENTS FOR MERGERS AND ACQUISITIONS

Publicly traded corporations usually owned by a large number of shareholders are managed on their behalf by teams of hired managers. Shareholders have the opportunity to approve or disapprove of the way the corporation is managed during the annual shareholder meetings. Boards of directors voted in by shareholders during their annual meetings make the basic business and financial decisions during the interim period between annual shareholders meetings. The main duty of the managing team is to assure the best utilization of the company's assets in order to maximize, in the short- and long-run, the return to shareholders' investment. The stock market, by allowing the trading of corporate shares, provides a constant check on the performance of the corporations, which is reflected in the movement of stock prices. A prolonged decline in a corporation's stock price relative to the movement of overall stock prices is, generally, an indication of a deteriorating performance.

Shareholders have the possibility to change the managers through a proxy challenge during the annual meeting. They can propose a different team of managers and directors and solicit the general assembly of stockholders to vote for the competing team. This method of removing an entrenched and badly-performing management is, however, very difficult and rarely successful. The difficulty lies in mobilizing a sufficient number of stockholders to advance a competing team of managers and to prevail at the meeting where current management usually has the advantage and can exert pressure on various blocks of voting shares.

A different, and currently more frequently used, method of changing management is the takeover approach, whether friendly or hostile. In a friendly merger the board of directors of both companies agree to a merger and a new way of deploying the assets of both companies. Quite often the management of the acquired company plays some role in the new company or is sufficiently compensated for the release of its managing role. A similar process takes place in a friendly takeover where shareholders are solicited to tender their shares at a price offered by the acquirer and agreed to by the target management. A hostile takeover differs from a friendly one in that target management does not agree with the offer and the shareholders are approached directly and despite management's recommendation.

It must be emphasized that friendly mergers as well as hostile takeovers are not limited to cases where the current management team does not perform well. It is often the case that well-performing companies are targets for mergers or hostile takeovers. The rationale for such takeovers can be found in the increased efficiency of employing the combined resources of both companies. The 1986 merger of General Electric and RCA is a good example where elimination of duplication in R&D and consolidation of facilities attempts to improve the efficiency of the combined company compared with the two companies remaining independent. Another example is the merger agreement between Purolator Courier and Emery, where the latter proposed to combine large with small shipments on the same planes now being serviced by the two separate companies. In other instances, economies of scale are realized or synergies occur that lead to reduced costs of the entire operation.

Mergers and acquisitions can also lead to less efficient deployment of assets. Errors of judgement are unavoidable in such decisions as they are in the millions of other business decisions. It has become increasingly clear now that some of the conglomerates created in the 1960's and 1970's were ill-conceived, and divestitures of highly-diversified corporations are now in vogue. Many companies have realized that concentrating the managers' abilities on the line of business they know best and selling some subsidiaries will improve their performance and profitability. Goodyear's divestiture of the oil exploration and pipeline and some other previous acquisitions is considered an appropriate change by its management because it will allow them to concentrate on the output of automobile tires -- their main and traditional line of production.

Managers of public corporations have sufficient latitude to make business decisions which, in general, assures proper functioning of the corporation. Nevertheless, this arrangement separates the owners of the corporation from its management and creates what is called the agency problem. The delegation of the corporation's daily operation from the owners to managers creates the possibility that they will operate in their own best interest, not the stockholders'. While the stockholders are concerned primarily with maximizing the value of their investment, management may be interested in other objectives, such as their continued employment by the corporation irrespective of the corporation's perfomance. It may resist, therefore, any attempts at changes, which may lead to their dismissal.

> "Because the shareholders find it difficult and costly to act in concert, and the managers are able to use the resources of the corporation to defend their position, it can be prohibitively expensive and time-consuming for shareholders to replace their management by use of the proxy machinery."*

Hostile takeovers can be an effective way to overcome the potential conflict of interest between management and stockholders. A hostile takeover allows a competing corporation or management team to offer its services directly to the shareholders over the objection of the incumbent management. Thereby, it creates a powerful disciplining tool in the hands of the corporate owners, not only in situations of actual takeovers but as a potential incentive to manage

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*Ginsburg, Douglas H. and John F. Robinson, "The Case Against Federal Intervention in the Market for Corporate Control, The Brookings Review, Winter/Spring 1986.

the corporation in the best possible way. To take away this tool, whether by anti-takeover corporate charter changes or government legislation, is tantamount to reducing the efficient functioning of corporations and to weaken the economy.

This basic economic tenet is recognized even by opponents of some hostile takeovers, although it is hard to reconcile their conflicting logic. CN Communications International, Inc., the firm which promoted the Shareholders Protection Act in the New Jersey Legislature, admits as much.

> "Friendly mergers, in which the boards of directors of both companies support the merger, are essential in a free economy. They allow companies to pool their assets and talent, develop complementary new products, enjoy synergies and economies of scale, and share distribution systems.... <u>Some hostile takeovers, in which a stagnating company is acquired by another, more agressive, corporation which then manages it and hopefully restores it back to health, are also essential to allow the most productive use of resources and the restructuring of industry as our economy evolves.</u>" (emphasis added)*

Nevertheless, the same company advocated the enactment of the law which essentially says that if current management does not agree with a proposed merger, it cannot take place. Hence, the veto power is put in the hands of the incumbent management with the possibility of allowing inefficiencies to develop or to continue and grow. We acknowledge that there can be abuses in the takeover process, to which we will return later, but it is hard to equate the isolated cases of such abuses and the harm they can cause, with removing the general disciplinary and incentive values of hostile takeovers. The possibility of removal of entrenched management has enormous value for improving efficiency, productivity and competitiveness throughout the entire economic system. Without it, economic efficiency losses will occur and our competitive position in the world economy will deteriorate. No isolated cases

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*"Mergers and Hostile Takeovers: An Analysis with Legislative Recommendations, CN Communications International, Inc., Rahway, January 22, 1986.

of abuses can be sufficient to outweigh the loss of efficiency that will inevitably follow from a general prevention of hostile takeovers. Competition -- the fundamental tenet of our economic system will suffer considerably because, without the threat of removal, management's attention to competition will decline. The experience of nations and of economies that do not have the discipline of removing management for bad performance or lack the incentives to constantly improve the deployment of the nation's productive assets, speaks for itself.

> "Scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth. Yet there is an almost continuous flow of unfavorable publicity and calls for regulation and restriction of unfriendly takeovers. Many of these appeals arise from managers who want protection from competition for their jobs and others who desire more controls on corporations. The result, in the long run, may be a further weakening of the corporation as an organizational form and a reduction in human welfare."*

The proponents of such restrictions argue that the constant threat of the so-called "raiders" lead them to concentrate their attention exclusively on short-term results at the expense of long-term planning and research and development. We discuss this issue in a later section of this Report.

An analysis of merger and acquisition statistics indicates that the current accelerated pace of corporate restructuring is not extraordinary when data are examined from the perspective of the last 20-25 years. The following table provides data from two different sources -- the Federal Trade Commission and W.T. Grimm & Co., The FTC data show, for example, a fourfold increase of acquisitions of large firms between 1966 ($9.3 billion) and 1968 ($32.8 billion). The wave of acquisitions subsided after the 1968 peak and fell to a low of $4.1 billion in 1972. During the recovery after the 1973-74 recession, acquisitions accelerated again reaching the $17.0 billion mark in 1979.

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*Jensen, Michael C., "Takeovers; Folklore and Science", <u>Harvard Business Review</u>, November-December 1984, p. 120

Table 1
NUMBER AND VALUE OF MERGER AND ACQUISITION TRANSACTIONS, 1963-84
(values are in billions of dollars)

	FIC Estimates of Acquisitions of Large Firms in Mining and Manufacturing*			W. T. Grimm & Co. Estimates of Merger and Acquisition Activity		
		Value of Assets Exchanged			Value of Consideration Exchanged***	
Year	Number of Transactions	Nominal Dollars	Constant (1983) Dollars	Number of Transactions**	Nominal Dollars	Constant (1983 Dollars
1963	54	2.5	7.6	1,361	n.a.	n.a.
1964	73	2.3	6.9	1,950	n.a.	n.a.
1965	64	3.3	9.4	2,125	n.a.	n.a.
1966	76	3.3	9.3	2,377	n.a.	n.a.
1967	138	8.3	22.5	2,975	n.a.	n.a.
1968	174	12.6	32.8	4,462	43.0	112.2
1969	138	11.0	27.4	6,107	23.7	58.8
1970	91	5.9	13.9	5,152	16.4	38.6
1971	59	2.5	5.5	4,608	12.6	28.3
1972	60	1.9	4.1	4,801	16.7	36.0
1973	64	3.1	6.4	4,040	16.7	34.0
1974	62	4.5	8.4	2,861	12.5	23.4
1975	59	5.0	8.5	2,297	11.8	20.2
1976	82	6.3	10.3	2,276	20.0	32.5
1977	101	9.2	14.1	2,224	21.9	33.7
1978	111	10.7	15.4	2,106	34.2	49.0
1979	97	12.9	17.0	2,128	43.5	57.3
1980	n.a.	n.a.	n.a.	1,889	44.3	53.5
1981	n.a.	n.a.	n.a.	2,395	82.6	90.9
1982	n.a.	n.a.	n.a.	2,346	53.8	55.9
1983	n.a.	n.a.	n.a.	2,533	73.1	73.1
1984:						
9 months	n.a.	n.a.	n.a.	1,899	103.2	99.5
Annualized	n.a.	n.a.	b,a,	2,532	137.6	132.6

*"Large" firms are defined as those with assets of $10 million or more. Excluded from the tabulation are firms for which asset data are not publicly available.

**The W. T. Grimm & Co. tabulations measure only publicly announced transactions and include transfers of ownership of 10 percent or more of a company's assets or equity, provided that the value of the transaction is at least $500,000.

***Includes only those transactions for which valuations data are publicly reported.

n.a. -- not available.

Source: Federal Trade Commission (Bureau of Economics) and W. T. Grimm & Co.

The data estimated by W.T. Grimm & Co. start from 1968 and ended in 1984 and reflected the transfer of ownership of ten percent or more of assets or equity of transactions above $0.5 million. In 1968, these transactions reached $112.2 billion, but fell to $20.2 billion in 1975. The annualized estimate for 1984 was $132.6 billion. The latest transactions involve very large acquisitions. Prior to 1976 the largest single acquisition on record was $3.3 billion. The latest record is $13.3 billion. This is why we observe a declining number of transactions, from 6,107 in 1969 to 2,532 in 1984 according to W.T. Grimm estimates.

These large transactions are concentrated in several leading industries such as oil and gas, banking and finance, insurance, mining and minerals and several others shown in Table 2 below.

Table 2
VALUE OF MERGER AND ACQUISITION TRANSACTIONS, BY INDUSTRY, 1981-83*

Industry Classification of Seller	Nominal Value (billions of of dollars)	Percent of Total	Cumulative Percentage
Oil and gas	44.2	21.1	21.1
Banking and finance	23.4	11.2	32.3
Insurance	16.5	7.9	40.2
Mining and minerals	14.2	6.8	46.9
Food processing	8.0	3.8	50.8
Conglomerate	7.5	3.6	54.4
Transportation	6.8	3.3	57.6
Broadcasting	5.6	2.7	60.3
Retail	5.3	2.5	62.8
Brokerage and investment firms	5.1	2.4	65.2
Other	72.8	34.8	100.0
Total	209.5	100.0	

*Includes only those transactions for which valuation data are publicly reported.

Source: W. T. Grimm & Co.

The chief factor of this latest accelerated phase of mergers is the deregulation in the oil and gas industry, in banking, finance, insurance, transportation (airlines), brokerage and investment industries. These mergers and acquisitions are considered related to competitive pressures requiring more efficient deployment of assets. Similarly, a significant part (about one-third) of current mergers are related to divestiture transactions.

> "Divestitures often occur when firms undo prior acquisitions that did not work out as planned, or when firms decide to raise cash to reduce debt generated by earlier acquisition programs, or to invest in new projects. In addition, many divestitures are cur-ently designed to focus the parent corporation's operations in their most profitable lines of business. This represents a trend away from the conglomerate-type mergers characteristic of the late 1960's and early 1970's and toward less diversified corporate structures that focus on product lines in which the corporation has a relatively strong market position."*

Finally, leveraged buyouts are increasingly being used in the last several years. In 1983, leveraged buyouts amounted to $7.1 billion, or about 18 percent of the market value of all takeovers. According to James Balog of the Drexel Burnham Lambert Corporation:**

> "In the 18 months from January 1984 to mid-1985, nearly 400 of the largest Fortune 500 corporations underwent some type of restructuring effort -- acquisition, diverstiture, spinoff, stock buyback, and 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.

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*Council of Economic Advisors, Report of the President, 1985, p. 195.

**Balog, James, "Financing and Restructuring for a Competitive World," Drexel Burnham Lambert Incorporated, October 1985.

* 80 public companies underwent leveraged buyouts and became privately-held concerns.

* 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.

By way of summarizing the arguments in this section, we wish to emphasize the following: A broad process of restructuring and alignment of the United States ecomomy is currently under way. It has been prompted, to a large extent, by competition from abroad, by the need to preserve U.S. market position in the world and, ultimately, by the desire to defend our standard of living. This restructuring process is not limited to the area of mergers, takeovers and divestitures, but it is a significant part of it.

In this effort to preserve or in many cases to regain our position in world markets, the style and effectiveness of managing U.S. corporations is a significant contributing factor. Labor is another important factor in this restructuring process and has contributed enormously in the last several years by agreeing to lower wages, more active participation in quality improvements, productivity growth and in establishing more harmonious relations with management.

The New Jersey economy has performed very well in the last several years, although manufacturing has been its weakest sector and one where many layoffs and plant closings occurred with resulting sharp reductions in employment. By improving the economy's performance, the State contributes to the national effort to increase competitiveness of U.S. corporations. Therefore, the State government must be responsible in its lawmaking activity to weigh and consider whether new corporate statutes are necessary and are helpful in the State's and nation's effort to improve its competitiveness in the world market. We are not convinced that hindering the process of restructuring New Jersey corporations is, on balance, a positive factor in that process.

II. REVIEW OF THE NEW JERSEY SHAREHOLDERS PROTECTION ACT

There is broad agreement among economists that, notwithstanding some possible failures, the process of takeovers increases efficiency of the economy and therefore should not be inhibited. We will return to a detailed review of the empirical evidence supporting this view in a later section of this Report. In this section we analyze the most frequently raised objections to the current phase of takeovers. We start with the statement of policy in the preamble to the New Jersey Shareholders Protection Act:

> "Resident domestic corporations, as defined in this act, encompass, represent and affect, through their ongoing business operations, a variety of constituencies including New Jersey shareholders, employees, customers, suppliers and local communities and their economies whose welfare is vital to the State's interests".

Several authors have suggested that the board of directors of a target company should consider the interests of not only the shareholders but also non-investor groups such as employees, customers, suppliers and the communities in general. Martin Lipton, for example, advocates that it is reasonable for the directors of a target to reject a takeover, inter alia, because of "adverse impact on constituencies other than the shareholders".*

Opposing this view are, among others, Frank Easterbrook and Daniel Fischel who argue that successful tender offers should not necessarily be deleterious to the corporation's employees, suppliers or creditors.** According to their view, if maintaining good community relations is in the interest of the firm, then the new owners will maintain the existing policies. Even if the new owners change policies regarding employees, location, and so

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*Lipton, Martin, "Takeover Bids in the Target's Boardroom," <u>The Business Lawyer</u>, Vol. 35, November 1979, pp. 122-123.

**Easterbrook Frank H. and Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer," <u>Harvard Law Review</u>, Vol. 94, #6, April 1981.

on, existing managers cannot know in advance whether these policies will be detrimental on balance. Besides, preventing new management from making such decisions which will improve economic efficiency is anti-competitive and detrimental to the economy and social welfare.

Balancing the conflicting interest of various non-investor groups and the shareholders is extremely difficult. According to these authors, the proposed approach:

> "amounts to rejection of the idea that agents (managers) are accountable to their principals (shareholders). So long as it continues to be lawful to form corporations for profit, shareholders are entitled to hire managers dedicated to the shareholders' interest alone. The duty of management is to operate efficiently and thus maximize the return to shareholders. Maximization of shareholders wealth ultimately works to the advantage of workers and suppliers, because shareholders gain only from the firm's mutually beneficial transactions with those persons.... A manager responsible to two conflicting interests is, in fact, answerable to neither. A principle of divided loyalty ultimately would harm everyone by reducing the willingness of people to entrust their money to managers."*

This is the crux of the matter. Millions of people who invested their savings or pension funds under the conditions that management will try hard to maximize the return on their investment, are now confronted with a situation where interests of non-investors are also supposed to be taken into account to the possible detriment of the shareholders. This is a de facto breach of agreement. The other parties (non-investors) are being engaged in the business process through clear contractual arrangements which should also be honored. Implicit long-term contracts, customarily agreed to between management and labor or suppliers should not become the decisive argument in preventing takeovers.**

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*op. cit, pp. 1191-1192.

**For an outline of the importance of implicit long-term contracts, see Andrei Shleifer and Lawrence H. Summers, "Hostile Takeovers as Breaches of Trust," February 1987, draft paper. The authors are professors at Princeton University and Harvard University, respectively. See also, pages 30-31 of this report.

Management has not been consistent in its approach. When the issue is plant closings, relocation, force reduction, consolidation of operation due to friendly mergers, etc., management opposes legislation that will take into account the interests of non-investor groups. Management opposed legislation on six-month pre-notification and severance payments in plant closing situations. A consistent approach would be to unequivocally serve the interests of investors. It is our contention that in an overwhelming number of cases such a position will not be harmful to non-investor groups when those decisions will be viewed from a broader and long-term perspective.

The New Jersey Shareholders Protection Act further declares that:

> "Takeovers of public corporations financed largely through debt to be repaid in the short-term by the sale of substantial assets of the target corporation, in other states, have impaired local employment conditions and disrupted local commercial activity. These takeovers prevent shareholders from realizing the full value of their holdings through forced mergers and other coercive devices. The threat of these takeovers also deprives shareholders of value by forcing the adoption of short-term business strategies as well as defensive tactics which may not be in the public interest. (emphasis added)

It is assumed here that the Legislature does not consider all takeovers harmful or leading to results that it attempts to prevent. The above statement lists several of the Legislature's concerns in the takeover process which, presumably, it intends to mitigate. The first concern seems to be the way some takeovers are financed. It is the assumption of debt which apparently leads to the sale of substantial assets of the target corporation that concerns the Legislature. Proponents of the legislation phrased this type of financing takeovers as "junk-bond, bust-up takeovers".

The term junk-bonds refers to high risk, below investment grade financial instruments, which carry a much higher interest rate than low risk corporate or U.S. Treasury Bonds. In order to limit the use of high-risk bonds in mergers or takeovers, the Federal Reserve Board restricted their use by adopting in December 1985 a new regulation requiring that at least 50 percent of those high risk bonds used in takeovers have collateral similar to margin requirements in stock acquisitions. Nevertheless, the New Jersey Legislature still remains concerned about this form of financing takeovers.

The argument often made against assuming a high degree of debt as opposed to equity or cash financing is that during economic downturns, some of the high debt corporations may not be able to service the debt and may, therefore, default. One can argue that in many instances, larger corporations which result from takeovers will be stronger to weather economic downturns. The acquirers of the majority of the stocks (the raiders) are fully aware of such dangers and are willing to take the risk. Buyers of the corporate bonds are also cognizant of the risks associated with them for which they are being offered a higher interest rate. Many other stockholders of companies that have not been subject to takeovers are exposed to similar risks, especially during a recession. It is hardly justifiable for the government to intervene where the participants are fully aware of the risks involved in the market transaction. There are literally millions of such risky transactions taking place daily where the government does not intervene. There is no good reason why this particular transaction should be singled out. Many corporations, for example, are engaged in leveraged stock buy-back operations which entail assuming significant debt with similar possible consequences as in takeovers. The state government does not intervene in those cases and rightly so.

Another concern expressed in the Act is that the debt incurred during the transaction of a takeover could lead to the sale of substantial assets of the target corporation. However, the selling of the substantial assets of a company does not necessarily lead to impaired employment conditions or disrupted local commercial activity as implied in the legislation. Selling an asset in most cases means only a change of ownership without significant modification of operation. In some instances a change in ownership may also lead to consolidation of operation with other units of the merged companies, or in the extreme case, to cessation of operation. In the latter case there must be a good economic reason for such a decision since otherwise closing a well functioning unit reduces output and profit and, therefore, will not be undertaken by a rational acquirer. It is hard to argue that such changes should be prevented by government even if they may cause some employment reduction in a particular community. In the long-run, preventing such re-alignment and restructuring of assets reduces efficiency and competitiveness of United States corporations. Corporate management usually opposes such unwise government intervention in the operation of companies and the case of restructuring resulting from takeovers should not be an exception. Such a long-term view, if accepted by the Legislature, would be consistent with its concern about myopic business strategies which are discussed later.

Finally, in situations where an acquirer actually does not have sufficient financial resources to take over another company, a shell company is established which issues high yield bonds secured by the assets of the acquired company. After the acquisition, the shell company sells particular pieces of the company in order to be able to redeem the high interest bonds. It has been mentioned already that after the new regulation of the Federal Reserve Board, this is no longer possible, at least not for 50 percent of the value of the acquired company.

However, even if the remaining 50 percent of such junk bond financing remains, in the judgement of the Legislature, a serious concern, the remedy in the Law goes beyond this concern. First, as proponents of the bill argued before its enactment, the Law intended to prevent only junk bond bust-up takeovers, not all hostile takeovers. However, it did not state this explicitly but instead it indiscriminately disallowed business combinations whether financed with junk bonds or fully with cash. Second, even though proponents argue that the Law does not prohibit hostile takeovers (only business combinations with the interested shareholder), in fact the restrictions on business combinations are such that they possibly prevent all hostile takeovers, even those that can be shown to lead to more efficient recombination of assets. This is the major fault with the Law. Apparently, it aims at a very narrow case of a "junk bond bust-up" hostile takeover, but in actuality, it has widespread applications. It prevents useful, economically legitimate takeovers whenever the incumbent board of directors disagrees, and goes even beyond that since the board is not given a chance to reconsider its previous decision (within a five year period) when it sees a beneficial business combination under changed circumstances.

The legislation's statement that:

> "...takeovers prevent shareholders from realizing the full value of their holdings through forced mergers and other coercive devices."

also requires careful consideration. In the majority of cases, takeovers lead to significant stock price increases of target companies as will be documented in a subsequent section of this report.

In 1968, the federal government enacted the Williams Act which regulates takeovers. It provides for a disclosure of an acquisition of more than five (5) percent of a company's shares including the acquirer's intentions regarding any possible combination. It also extended to twenty business days the time during which a tender offer must be open, thus giving the incumbent management and stockholders sufficient time to consider the consequences of the offer and the advantages of a positive response. At the time, the U.S. Congress considered this legislation sufficient to prevent coercion and to assure the shareholders the realization of the full value of their holdings.*

Presumably the Legislature also is concerned here with two-tier prices for tendered stocks -- a high price for the first fraction of the shares and a lower price for the remaining shares. It is argued that shareholders are coerced to tender their shares faced with the possibility of losing an opportunity if they withhold tendering.

But two-tier tender offers are a small part of takeover transactions (about 9% in 1984) and, in most cases, are negotiated with management. Moreover, usually there is a significant premium even on the second tier tendering. A study by economists of the Securities and Exchange Commission came to the conclusion that:

> "Since relatively more target shareholders are able to resist tendering into two-tier and partial tender offers than any-or-all offers, these results contradict claims that shareholders are "stampeded" into tendering into two-tier and partial offers due to their greater coerciveness and also the regulatory change of December 1982 appears to have substantially eliminated the advantage that two-tier offers had".**

The State of Maryland has pioneered the so-called second generation takeover statutes which deal with this problem explicitly. It enacted a fair price law which requires that a business combination with an interested stockholder has to be approved by a supermajority (80% of all votes) and two-thirds of the disinterested shareholders. Unlike the New Jersey Shareholders Protection Act, which formally could also be considered a fair price law, the Maryland act defines the term "business combination" to include only transactions between the target corporation and the interested stockholder. It does

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*Representative Dingell introduced in April of this year a bill providing, inter alia, an extension of this period to sixty days. See the "Tender Offer Reform Act of 1987".

**The regulatory change introduced in December 1982 extended from 10 to 20 calendar days the time to respond to two-tier tender offers, thereby equalizing it with all other offers. We will present more evidence on this subject in the next section.

not include third parties which initially are not associated in any way with the interested stockholder, as is the case in New Jersey.* Furthermore, the Maryland law does not impose a five year prohibition of business combinations if they were not approved by the board of directors <u>prior to</u> the acquisitions of more than ten percent of the outstanding shares of the resident domestic corporation. Instead, as already mentioned, the Maryland law requires the supermajority vote or the payment of a fair price for the second tier acquisition. Although this is also a strong takeover repellent, it at least allows for more flexibility than the New Jersey five year prohibition.

The New Jersey legislation is also concerned with the threat that takeovers are allegedly forcing the adoption of short-term strategies at the expense of long-term planning and research and development efforts. Such a myopic attitude of management, if it existed, could prevent the company from reaching its potential, therefore reducing shareholders value in the long-run, although enhancing earnings in the short-term.

Needless to say, such short-term business strategies, if they are actually practiced, will sooner or later weaken the company's performance and with it the shareholder's value. The market will recognize the fallacy of such a business strategy and the stock price will react accordingly. Instead of preventing the possibility of a takeover attempt, a myopic management strategy will increase the company's vulnerability. It has been argued that the market requires such a short-term approach. However, it is hard to reconcile this contention with the many instances when no dividends or very small, nominal

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*The New Jersey Shareholders Protection Act is internally conflicting since the term "business combination" includes transactions with third parties, i.e., companies initially not affiliated or associated with the interested shareholder. On the other hand, a business combination is prohibited for five years only with the interested stockholders. In other words, it is not clear whether the New Jersey Law allows or disallows, for example, a merger with an outside company that was not, prior to that transaction, associated with the interested stockholder.

dividends are paid, but the price of such shares is increasing. Rather, it suggests that the market is looking for improvements in the long-run of such companies and is valuing its stock appropriately. When the market learns that a company is reducing or abandoning research and development which are vital to its success (for example, for pharmaceutical, electronic or even automobile and machine building companies), it will inevitably lower earning expectations and the price of the stock. As stated by Ginsburg and Robinson:

> "This 'myopic market hypothesis' appears to be false based upon even a cursory observation of stock price behavior. First, if it were true, any new venture, especially one with no earnings history would be unable to raise capital in the public equity markets. They do, of course, and the allegedly short-sighted institutional investors are among the principal purchasers of such offerings. Second, if the market were myopic, different companies in the same industry <u>would not sell at different multiples of their current (or predicted near term) earnings</u> (emphasis added). Unless the market is totally irrational, investors must believe that the long-term prospects of such companies differ significantly."*

Even if the fallacy of such myopic business strategy is ignored by some management, it is not clear what the Legislature's response should be, if any. By removing the threat of hostile takeovers, the legislation does not prevent management from adopting unwise short-term strategies, but it does protect incumbent management who could have made serious mistakes in the past and is not willing or able to rectify them to the benefit of both the shareholders and stakeholders. The value of such government intervention may very well be negative on balance.

Even if government intervention can be made more specific and desirable, the question remains: How should such intervention be formulated to be effective while at the same time not preventing all hostile takeovers? Let us look at the Act's main remedy. It is most fully expressed in the following section:

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*Ginsburg and Robinson supra, p. 12.

"4. Notwithstanding anything to the contrary contained in this act (except section 6 of this act), no resident domestic corporation shall engage in any business combination with any interested stockholder of that resident domestic corporation for a period of five years following that interested stockholder's stock acquisition date unless that business combination is approved by the board of directors of that resident domestic corporation prior to that interested stockholder's stock acquisition date."

If management would like to change its previous decision because of new circumstances, it could not do it within the first five years of a ten percent acquisition by one stockholder. Even after the five year term, no business combination is allowed unless approved by two-thirds of the non-interested stockholders (which excludes from voting even large stockholders who otherwise may be considered the majority owners of the company) or a very high price is paid for the stock. A careful reading of the Act leads one to the understanding that the law restricts <u>all takeovers</u> not agreed to by current management without limiting it to the particular situations that the legislation is concerned about and stated explicitly in its preamble.

As already mentioned, even if one recognizes that there might be cases when government intervention in the merger and acquisition process is justified economically or otherwise, the way this intervention is applied is critically important. In the case at hand, the prohibitions are too general.

A major point of interest is whom does the New Jersey Act protect? As its name suggests, the Law is supposed to protect the New Jersey shareholders. But this is an almost impossible task. Except for closely-held New Jersey companies or small businesses that for the most part are not covered by the Act since their shares are not traded on any of the exchanges, shareholders of larger corporations reside in many states. By selecting a group of companies incorporated in New Jersey with major operations in the State, the Act limits its application to a handful of corporations and the number of New Jersey shareholders claimed to be protected by the Law could be insignificant.* The only effective method to "protect" shareholders could be a national law such as the Williams Act. Alternatively, the same result would occur if all states enact identical statutes. Thus far, the State of Delaware, which incorporates about one-half of all United States corporations, has decided not to enact anti-takeover legislation in this session.**

Apart from the issue of how many New Jersey shareholders are affected by the Act, the question is what exact protection it offers to shareholders, if at all? It is our contention that the Act may lead to depriving a significant premium that shareholders could realize in a takeover contest.*** Proponents of the Act claim, however, that some hostile takeovers could be harmful to shareholders, especially in the long run.**** Also, a number of scholars claim that the price premium of takeover stocks should not be entirely attributed to expected efficiency improvements since some of it may stem from redistribution from employees, supplier, management, etc.*****

However, it is impossible to determine by legislation prospectively those cases of hostile takeovers that may turn out to be deleterious or beneficial. The Act, therefore, delegates this judgement to management of

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*According to a list prepared by CN Communications International, Inc., one hundred and eleven (111) companies are affected by the New Jersey Shareholder's Protection Act; they employ approximately 72,000 people. The number of New Jerseyans holding shares in these companies is unknown, but must be quite small relative to the number of New Jerseyans holding shares overall.

**Information received from a member of the Council of the Corporate Law Section of the Delaware Bar Association.

***Evidence will be provided in the following section of this report.

****The author of this Report had the opportunity to discuss such an opposing view with Dr. Donald Margotta of Northeastern University who cited cases from personal experience when takeovers led to dismantling research laboratories.

*****For an extensive exposition of this view, see Andrei Schleifer and Lawrence Summers, op. cit.

resident domestic corporations. Apart from the issue of disenfranchising the shareholders from making such determinations, the Act unnecessarily limits such business combinations to cases agreed upon prior to the acquisition of ten percent of the shares by an interested shareholder. It prevents management from applying the board of directors' more current judgement as to the economic and financial effects of a proposed business combination, especially in light of the rapid changes in market conditions. A decision made several years earlier is cast in stone and determines the corporations' position under new, unforseeable circumstances, for which that prior decision may be harmful or that a different decision is now appropriate in the light of new information.

We also strongly emphasize that the exclusion of shareholders from such basic decisions diminishes the role of the corporation's owners. It is indeed a paradoxical situation created under the New Jersey Shareholders Protection Act that even owners of a majority of shares of a corporation cannot affect business decisions that might ensure a healthy and timely rearrangement of assets and improved performance of the corporation. It would be a much more evenhanded approach to grant shareholders the right to decide at a special meeting whether to accept a business combination at the time a ten percent share is acquired or at any other time thereafter, as the need arises.

Takeover legislation adopted in other states is also relevant to our discussion since it will impact New Jersey's shareholders and employees. That legislation may affect some plants located in New Jersey. It may allow them to become obsolete and, ultimately, to be discarded instead of being sold and reused in a more efficient way.

New Jersey shareholders of companies affected by anti-takeover legislation in other states may lose a significant premium which is being offered to target companies. The New Jersey State Pension Fund, for example, has realized over $100 million in such premiums from the actual or attempted takeovers of several companies. The more states enact takeover legislation, the more limited will be these gains to the State Pension Fund and all other shareholders in this and other states.*

Whether employees are protected by this Act is also doubtful. The protection of employees is claimed on the grounds that the law prevents so-called bust-up takeovers. But the entire group of companies affected by the Act is very small and employs approximately 72,000 people, i.e., a little above two (2) percent of the entire state labor force. This is the total potential group where takeovers can take place. Of the entire group, likely takeover targets are a much smaller number of the larger corporations (there are sixteen corporations with above 1,000 employees). Out of these, maybe one or two, or maybe none, could have actually become targets for takeover. Whether any of these takeovers would have resulted in any significant reduction of the labor force or even plant closing is also doubtful. Hence, the number of employees who could be protected by the New Jersey Act is small. The alternative risk is that the protection of less-efficient management and the prevention of more efficient employment of corporate assets can cost New Jersey jobs in the long-run since New Jersey's firms may be the losers in a fast-changing world.

A study carried out by Glenn Yago and Gelvin Stevenson of the State University of New York at Stony Brook found no evidence that hostile takeovers caused any of the 913 occurrences of plant closings, contractions or relocations in New Jersey which idled 95,215 during the 1980-85 period.* The

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*Letter to Senator Lesniak from the Director of the New Jersey Division of Investment Mr. Roland M. Macholder, State Labor, Industry and Professions Committee Hearings, May 12, 1986.

**"Mergers and Acquisitions in the New Jersey Ecomomy," Glenn Yago and Gelvin Stevenson, Economic Research Bureau, State University of N.Y. May 8, 1986.

negative impact, however, can be significant. It is not limited to the 111 companies directly affected by the Act. Other New Jersey companies that may find business combinations with the affected companies economically beneficial may be prevented from realizing that benefit if management opposes it.

We can now summarize our discussion in this section:

- We have reviewed and analyzed the stated concerns of the Legislature in regard to hostile takeovers and found them to be limited in scope and application. Nevertheless, we acknowledged that some of those negative implications may have merit. Even if only a limited number of cases of harmful takeovers can be found, these could be significant in a particular plant or community.

- Even with this, we found the remedies in the Act far too broad in relation to the stated possible harmful situations. Together with the prevention of possible harmful takeovers, the Act prevents or makes it extremely difficult to realize any useful, economically beneficial takeover if not approved by the board of directors.

- Our interpretation is that the Act is clearly tilted toward management by depriving interested shareholders, the voting and decision power on business combinations. The Williams Act and the current opinion of the United States Supreme Court on the constitutionality of the Indiana Control Share Acquisitions Act stress the importance of the Law's neutrality between the investors' and managements' rights.

- Finally, in terms of scope, we find the impact of the Act limited to a handful of larger corporations where the likelihood of a hostile takeover is very limited. However, the relaxation of the disciplinary effect of hostile takeovers may have some broader economic implications and should not be ignored.

III. EMPIRICAL EVIDENCE

In this section we review some of the most important arguments relevant to our inquiry and discuss their validity in light of available empirical evidence. Specifically, we review the following issues:

1. Shareholders gains from takeovers and the sources of those benefits.

2. The effect of takeovers or the threat of takeovers on long-term investment and research and development efforts.

3. Financing takeovers with below investment grade bonds and increased leverage.

4. Plant closings, layoffs and asset stripping due to hostile takeovers.

5. Two-tier tender offers and coercion.

Benefits to Shareholders

Proponents of competition in the market for corporate control support their argument with evidence showing that shareholders realize significant premiums from various forms of takeovers.

Opponents of takeovers contend that tender offers and mergers do not generate net gains to society. The undisputable wealth increases to target shareholders are apparently losses to other groups in the takeover process. We will return shortly to a discussion about the sources of gains to stockholders.

First, we review the evidence. Jarrell and Poulsen* studied 663 successful tender offers from 1962 to December 1985. They found the price premiums for stock of these companies were, on the average, 19 percent in the 1960's; 35 percent in the 1970's, and 30 percent for the 1980-85 period.

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*Jarrell, Gregg A. and Annette B. Poulsen, "Bidder Returns," Working Paper, 1987a, Office of Chief Economist, Securities and Exchange Commission.

As explained briefly by Jarrell, Brickley and Netter, the evidence provided here is based on event studies. The event study technique measures abnormal returns (or price changes) around an event after accounting for overall market influence on security returns or prices. It estimates that portion of the stock return or price change at the time of the event that cannot be explained by changes in overall market conditions.

Prior to this latest study, Jensen and Ruback (1983) summarized thirteen investigations which covered takeovers before 1980 and also found that shareholders of mergers and successful tender offers earned premiums of between 16 percent for mergers and 30 percent for tender offers.* Lehn and Poulsen (1987) studied 93 leveraged buyouts which took place between 1980-84.** They found the average premiums to stockholders reaching 21 percent.

Researchers from the Securities and Exchange Commission point out, however, that these premiums probably understate the gains to shareholders. The cited studies measure the premiums from the day of formal announcements of takeover offers. They point out that often rumors or other sources of information, e.g., the requirement to submit schedule 13D to the SEC, reach the market and causes the stock price of target companies to rise in anticipation of a formal announcement.*** Hence, examining price changes from the date of

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*Jensen, Michael C. and Richard S. Ruback, "The Market for Corporate Control: The Scientific Evidence," Journal of Financial Economics, 1983, II, pp. 5-50.

**Lehn, Kenneth and Annette B. Poulsen, "Sources of Value in Leveraged Buyouts," Working Paper, 1987, Office of the Chief Economist, Securities and Exchange Commission.

***Schedule 13D must be filed by purchasers of five percent or more of a corporations's stock and must reveal the investor's identity and intention.

the official announcement understates the true price gains of target shares. Researchers Mikkelson and Ruback* have found that a 7.74 percent average price increase occurred when the filer indicated a possibility of a takeover attempt.

The evidence of returns to shareholders of bidding companies is less unequivocal. According to the evidence provided by Jarrell and Poulsen (1987a), based on data of 440 New York Stock Exchange and AMEX successful bidders between 1962 and 1985, the picture is mixed as shown in Table 3 below.**

Table 3
Cumulative Excess Returns to Successful Bidders for Tender Offers During 1960 to 1985, by Decade

	Cumulative Excess Returns in Percent			
Trading-Day Intervals	All	1960's	1970's	1980's
-10 to +5	1.14	4.40	1.22	-1.10
(t-statistics)***	(2.49)	(4.02)	(2.12)	(-1.54)
-10 to +20	2.04	4.95	2.21	-0.04
(t-statistics)	(3.31)	(3.52)	(2.87)	(-0.04)
Number of Observations	405	106	140	159

During the 1960's shareholders of bidding companies gained an average of about five percent in excess of the average market price change in the immediate period around the public announcement; about two percent in the 1970's, and no premium in the 1980's. The distribution of the gains between shareholders of target and acquired companies depends, to a large extent, on the

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*Mikkelson, Wayne H. and Richard S. Ruback, "An Empirical Analysis of the Interfirm Equity Investment Process," <u>Journal of Financial Economics</u>, 1985, 14, pp. 523-553.

**Reproduced from Gregg A. Jarrell, James A. Brickley and Jeffrey M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," Working Paper, Office of the Chief Economist, SEC, 1987, p. 41.

***A t-statistic close to or above ± 2.0 means that there is a high probability (usually 95 or more) that the obtained result is not accidental.

number of bidders. The larger the number of competing companies for the control of the target corporations, the greater the share of gains accruing to the target company though this may even result in negative returns to the bidders.

The literature also evaluates the impact of failed mergers or tender-offers on stock prices of target and bidding companies. Jensen and Ruback (1983) report that unsuccessful takeover attempts have different results depending on the takeover technique. In failed mergers, the target's stock price falls to about its pre-offer level. In unsuccessful tender offers, the stock price of the target corporation stays above its pre-offer level for about two years. Thereafter, if no other bid takes place within this time period, the target's stock price falls back to its pre-offer level.*

F. M. Scherer (in a joint study with D. Ravenscroft) applies a different method of measuring gains from takeovers, where profitability of affected lines of business two years before and after the takeover is compared with overall profitability of the appropriate industries. Their study dealt with experiences during the 1975-78 years. Profitability deficiencies of approximately equal size were found for hostile takeovers, white-knight acquisitions and friendly takeovers. After some adjustments for higher asset values and depreciation charges, he concluded that there is "no evidence that the acquiring companies managed their acquired assets either clearly worse or clearly better than the average of the industries to which the acquired lines belonged".**

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*Jensen, M. C. and R. S. Ruback, op. cit., pp. 8-9.

**Scherer, F. M., "Takeovers: Present and Future Dangers," The Brookings Review, Winter/Spring 1986, p. 18.

Sources of Shareholders Gains

A variety of hypothesis have been developed which attempt to determine the source of gains to shareholders of target companies. These sources can be summarized as follows:

-- Potential reductions in production and distribution costs, often due to synergies, increased scale of output and better utilization of the combined facilities, personnel and management.

-- Savings of financial resources due to tax gains, avoidance of bankruptcy costs, increased debt which allows for tax deductions of interest payments, etc.

-- Increased market power and monopolistic price setting.

-- Improvements in suboptimal utilization of employees, often called "agency costs" which cause such company's shares to trade for less than the price they would achieve if agency costs were zero. As explained by Easterbrook and Fischel:

> "Shareholders might be able to reap substantial gains from improving the performance of managers as their agents. But this improvement is difficult to achieve, and the difficulty is the reason why outsiders (tender bidders) play an important role". Put differently, "The source of the premium is the reduction in agency costs which makes the firm's assets worth more in the hands of the acquirer than they are worth in the hands of the firm's managers."

-- Breach of implicit long-term contracts. As developed by Shleifer and Summers, this theory stresses the implicit long-term contracts (not actually written contracts) between management and labor or suppliers, etc. who may be remunerated above their current productivity or costs, but are rewarded for previous underpayment or investments they made to better serve the specific needs of the company. Incumbent management keeps these implicit contracts, while new management can breach them and thereby reduce costs. Thus, there is a redistribution from employees and suppliers to shareholders. They also maintain that this may lead to reducing social welfare in the long-run by discouraging company loyalty and customer specific investments.

-- Redistribution from bidding company's bond and stock holders to target shareholders.

It is much easier to enumerate these possible sources of gains to target shareholders than actually estimate these alternative sources of shareholder premiums. Nevertheless, there are numerous studies that attempt to prove or disprove these theories of sources of gains. In what follows we provide a brief review of those empirical studies.

Bradley, Desai and Kim * (1983) concentrated their study on failed tender offers. They found that when failed tender offers were followed by a successful offer within five years, the target's share maintained the initial price increases and appreciated further with the announcement of the later offer. Conversely, when a follow-up tender offer did not materialize within a five year period, the price of the target shares fell back to its original level. Thus, it is not sufficient for the market just to "discover" an undervalued stock price. An actual takeover must take place which then realizes the synergies and cost reduction effects. If mere "undervaluation" of stocks were the cause of price increases at the time of a tender offer announcement, then a takeover defeat should not reverse the stock price to its previous level, which it does according to this and several other studies.**

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*Bradley, Michael, Anand Desai and E. Han Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy?", <u>Journal of Financial Economics</u>, April 1983, II, pp. 183-206.

**Easterbrook and Jarrell (1984), Jarrell (1985) and Ruback (1986) show that targets defeating hostile bids lose nearly all of the value increase caused by the tender offer.

A Kidder Peabody study (1983) asserts the opposite result, namely that shareholders of defeated tender offers benefit from the defeats. Their result is, however, disputed for incorrectly adjusting for overall changes in the stock market.* Using conservative assumptions, Easterbrook and Jarrell estimate that shareholders of defeated targets lose at least an average of 15 percent of their equity value.

Although tax benefits are not a major source of shareholder gains, some authors found that they can play some role in mergers and takeovers. Auerbach and Reishus studied 318 mergers and takeovers during 1968-1983 and found that in a number of transactions the potential transfer of unused tax credits and tax losses influenced the decision to merge.** Similarly, Lehn and Poulsen (1987) investigated leveraged buyouts from 1980 to 1984 and concluded that the premiums are directly related to the tax benefits associated with those transactions.***

However, in general, the role of tax benefits is not considered a significant factor in the majority of large acquisitions (e.g., Auerbach and Reishus 1987). These authors also compared the 1968-1983 mergers with a control group of nonmerging companies and found that the potential increase in interest deductions and unused tax losses have not played a significant role in those acquisitions. Tax losses and credits of acquiring firms and the

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*See Kidder Peabody & Co.-- A study on defeated tender offers submitted to the FTC Advisory Committee on Tender Offers, and Easterbrook, Frank H., and Gregg A. Jarrell, "Do Targets Gain from Defeating Tender Offers?", New York University Law Review, May 1984.

**Auerbach, Alan J. and David Reishus, "The Impact of Taxes on Mergers and Acquisitions," in Alan Auerbach, ed., Mergers and Acquisitions, Chicago, University of Chicago Press, 1987.

***Lehn, Kenneth and Annette B. Poulsen, "Sources of Value in Leveraged Buyouts," Working Paper, 1987. See also, Andrei Shleifer and Robert W. Vishny, "Management Buyouts as a Response to Market Pressure," in Alan J. Auerbach, ed., Mergers and Acquisitions. Ibid., 1987 and Steven Kaplan, "Management Buyouts: Thoughts and Evidence," mimeo, 1987.

possibility of increasing the target firm's assets without paying corporate capital gains have had some effect on mergers. Finally, the role of tax benefits in takeovers has been reduced further in the Tax Reform Act of 1986.*

There are several studies dealing with the issue of increased market power due to takeovers. First, the <u>1985 Economic Report of the President</u> provides information on the reduction of concentration of assets.** In a specific market study for 1950-1980 an increase in competition was found. In 1980 approximately three-quarters of economic activity occurred in effectively competitive product markets; while in 1950 only one-quarter could be so characterized. The implication is that market power has not increased due to mergers and other factors.

Stillman (1983) finds no statistically significant abnormal returns for rival firms in nine out of eleven cases of horizontal mergers which were challenged under the Clayton Act and in which rival firms were named. The rival firms are studied because they are supposed to benefit from increased product prices if market power in the industry increases.***

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*"Corporate Mergers and High Yield (Junk) Bonds: Recent Market Trends and Regulatory Developments". A report by the Congressional Research Service for the Committee on Energy and Commerce, U.S. House of Representatives, Washington, D.C., Decmeber 1986, p. 35.
..."Certain provisions in the Tax Reform Bill of 1986, while not specifically targeted at below-investment grade financing, are expected to affect mergers in general. These involve restrictions on the ability of corporations to use net operating loss and other carryovers after a change in ownership, thus radically reducing the value of those carryovers in certain transactions to a potential acquirer. In addition, repeal of the General Utilities rule permitting liquidating corporations to escape tax on the sale or distribution of appreciated assets is also expected to affect the way mergers and acquisitions are structured, although is not expected to have a significant effect on the total amount of merger activity."

**Council of Economic Advisors, "The Market for Corporate Control," <u>Economic Report of the President</u>, 1985, Chapter 6.

***Stillman, Robert, "Examining Antitrust Policy Toward Horizontal Mergers," <u>Journal of Financial Economies</u>, II (1983), North-Holland Publishing Co.

Ekbo (1983)* studied a larger sample of 126 challenged horizontal mergers and also a number of rivals of unchallenged mergers. Around the time of the announcement of the mergers, he finds that rivals of challenged mergers realize positive abnormal returns which are statistically significant and, therefore, consistent with the market power hypothesis. However, when the price reaction is evaluated at the time of the antitrust challenge, he finds evidence which is inconsistent with the market power hypothesis.

Breach of implicit long-term contracts is a fairly new hypothesis which has not yet been tested extensively. Shleifer and Summers argue that the takeover of TWA was accompanied by significant wage givebacks and hiring of less-experienced stewardesses. They also cite stories of disappointed workers pledging never to trust management in the case of Trans Union. They admit, however, that the TWA case is really not a clear-cut case of implicit contracts since written labor contracts were altered.

A study by Brown and Medhoff (1987) limited to the experience in the state of Michigan shows that wages and employment increased in firms which were targets for acquisition to a greater extent than in other firms. This would suggest that there is no evidence of redistribution of wealth from labor to shareholders, at least in this limited case.**

This concludes our brief review of the sources of gains to target shareholders. It seems to indicate that despite some ambivalence, the majority of studies point to gains to shareholders due to improved application of corporate resources, including but not limiting it to management improvement as the most plausible source of those gains. Nevertheless, tax benefits and redistribution from stakeholders may also play a part in those gains.

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*Ekbo, R. Espen, "Horizontal Mergers, Collusion, and Stockholder Wealth," Journal of Financial Economics, II (1983).

**Brown, Charles and James L. Medhoff, "The Impact of Firm Acquisitions on Labor," Working Paper, 1987.

Is the stock market myopic? We have not followed other economists by including among the sources of shareholder benefits the contention that the stock market is myopic and undervalues corporations that spend resources on long-term investments at the expense of short-term results. We review this issue now in light of the claim that takeovers cause management to concentrate on short-term results at the expense of long-term planning, investment and research and development efforts.

A study by the Investor Responsibility Research Center in November 1985 set out to examine whether institutional ownership tends to encourage takeovers since it is claimed by critics that institutional investors (pension funds, etc.) are preoccupied with short-term performance of their portfolio and rush to tender shares in takeover bids.* The evidence proves the opposite to be true. Institutional ownership in a sample of one hundred (100) takeover targets for the years 1981-84 was 22.2 percent, whereas it was nearly 35 percent for the market as a whole.

The study examined whether institutional ownership affects the size of premiums paid to target shareholders. The issue here is whether the institutions make the premium lower than what occurs in takeovers with less institutional ownership. If so, this would prove that institutions are more eager to tender at any premium. Cheaper takeovers will also encourage more takeovers. The actual data for the same sample of 100 takeovers shows no systematic relationship between institutional share ownership and the premium at the last day of the final highest bid. Thus, the market is not more nor less efficient at valuing takeover targets in the presence or absence of significant institutional ownership.

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*Pound, John, "The Effects of Institutional Investors on Takeover Activity: A Quantitative Analysis," Investor Responsibility Research Center, Inc., Corporate Governance Service, Washington, D.C., November 1985.

A third test was conducted in which a subsample of takeovers was chosen in which institutional owners effectively control the corporation. Among the larger sample of one hundred takeovers, thirty-one (31) had less than ten percent institutional ownership, eight (8) had more than 50 percent of the shares owned institutionally, and a third group consisted of sixty-one (61) companies in which institutions owned between 40 and 50 percent of the shares. The average premiums were calculated for the three subgroups and their differences tested for statistical significance. The results for those groups were:

	Premium
Sample 1. Negligible institutional ownership (average ownership 2.0%)	43.2%
Sample 2. Controlling Institutional Ownership (average ownership 53.8%)	43.8
Sample 3. Institutional ownership between 40 to 50%	45.9
Average premium in full sample	45.4

There is no significant difference between the first and second group, thus indicating no influence of institutional ownership. Even when the ten firms with the highest and ten firms with the lowest premiums were selected, there was no relationship with the degree of institutional ownership. Finally, Pound also tested the contention that the presence of a large institutional ownership tends to reject management's recommendations to resist takeovers. The evidence does not support this contention.

In a much broader investigation by economists of the Securities and Exchange Commission, the issues of management's contentions of being distracted from long-term planning and R&D expenditures were tested. We provide here their conclusions:*

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*Jarrell, Gregg, A., Ken Lehn and Wayne Marr, "Institutional Ownership, Tender Offers and Long-Term Investments", April 19, 1985. (A recapitulation of the issues and the results of their empirical investigation was published in the <u>Wall Street Journal</u>, May 1, 1985 under the heading, "Takeover Threats Don't Crimp Long-term Planning."

"The evidence reported on this study uniformly contradicts the short-term argument. This evidence shows:

- "For a sample of 324 firms in a diverse set of industries, the percentage of equity held by institutional investors (that report to the SEC under Rule 13f) increased from 30% in 1980 to 38% in 1983. During this same period, the average R&D-revenue ratio for these firms also increased from 3.38% to 4.03%. These aggregate data do not support the argument that the growth in institutional ownership of corporate equity is forcing corporate managers to become more myopic.

- "Regression analysis reveals that, holding industry effects constant, institutional investors actually seem to favor firms with high R&D-revenue ratios.

- "In our sample of 324 firms, 88 firms experienced a decline in institutional ownership during this period and 236 firms an experienced an increase in institutional ownership. The average change in R&D-revenue ratio for the two groups of firms, however, was almost identical -- 0.67% for the former group and 0.61% for the latter group. These data refute the argument that increases in institutional ownership cause managers to focus more on the short-term.

- "Regression analysis reveals that, holding industry effects constant, changes in institutional holdings are not correlated with changes in R&D activity.

- "Examination of data on R&D expenditures for 57 target firms (1981-84) reveals that these firms had an average R&D-sales ratio of 0.77%, which was less than one-half of that, 1.66%, for an industry control group in the year immediately preceding the tender offer. These data strongly suggest that investment in long-term projects does not increase a firm's vulnerability to a takeover. It is also noteworthy that an additional 160 target firms during this period reported (in their 10-K's) that their R&D expenditures were 'not material'. We caution against drawing the inference that these firms became vulnerable to a takeover because they were underinvesting in R&D activity. Target firms are smaller than their industry counterparts, and to the extent there are economies of scale in R&D, it is natural to find lower R&D-sales ratios for target firms. In addition, the target firms' R&D-revenue ratio in the year immediately preceding the tender offer is not significantly different from the corresponding ratio, 0.75%, in the previous three years.

- "The average percentage of equity held by institutional investors in 177 target firms (1981-84) for which we were able to obtain ownership data was 19.3% in the quarter immediately preceding the tender offer, as compared with a corresponding average of 33.7% for firms in an industry control group of nontarget firms. These data seem to contradict the assertion that heavy institutional ownership per se gives rise to hostile takeovers.

- "Stock price evidence reveals that the capital market positively values companies that announce that they are embarking on an R&D project. The net-of-market increase in the equity value of 62 firms making such announcements (1973-83) was 0.80% over the two days following the announcement, and this increase is statistically significant. This evidence rebukes the argument that the market penalizes companies that invest in long-term projects and thereby makes them candidates for hostile takeovers."

Junk Bond Financing

A major criticism of the current wave of takeovers is the use of below investment grade bonds ("junk bonds") for their financing. Knowledge of the dimension of the problem is essential in forming one's views whether "junk bonds" could exert a significant impact on the corporation's financial health. John Paulus, chief economist of the Morgan Stanley Bank -- provides pertinent information on this subject.*

The total value of mergers and acquisitions in 1984 and 1985 reached $239 billion, creating approximately $75 billion in premium value to shareholders of target companies. "Junk bonds" accounted for four (4) percent of the total financing. Of the $30 billion "junk bonds" sold in the last two years, only $9.5 billion were used in acquisition and leveraged buyouts. Furthermore, only 700 out of 11,000 public corporations qualify for investment grade debt. Hence, the remaining $20 billion junk bonds reflect normal debt issues used by the 10,300 noninvestment grade public corporations. In the last four years the use of "junk bonds " increased at a 35 percent annual rate. Even at that rapid growth, "junk bonds" accounted for fifteen (15) percent, or $58 billion of the publicly-issued straight corporate bonds.

A comparison of debt-to-equity ratios in seven leading industries in the United States, Japan and Germany shows that the U.S. industries have generally lower ratios than in the other two countries.

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*Paulus, John D., "Corporate Restructuring, 'Junk' and Leverage: Too Much or Too Little?", Morgan Stanley & Co., Inc., March 12, 1986.

He concludes that it is possible that the United States could afford greater leverage, especially in light of the current low inflation rates and the potential inflation increases near the peak of the business cycle. A lower rise in inflation reduces the risk of leverage.

A study by economists of the Securities and Exchange Commission also deals with the dimension of the junk bond problem in the last several years.* Their investigation involves 272 successful tender offers from January 1981 to July 1985 and is based on 14D-1 filings. For the years 1981-84 debt issues accounted for $0.2 billion out of a total of $65 billion in 233 successful tender offers. An enormous increase took place in the first half of 1985 when $2.0 billion of debt was issued out of a total financing of $14.7 billion in 39 cases. In both periods, the dominant source of financing was bank borrowing (about 78-79%).

There is a direct relationship between the size of a tender offer financing and the use of debt. New debt security issues accounted for none of the financing of the thirty smallest tender offers, 0.6 percent for the thirty medium-sized offers, and 32.9 percent of the thirty largest tender offers. They also established that in 1985 hostile takeovers, debt issues accounted for 24.7 percent of the total financing, while only 5.7 percent in friendly takeovers.

They conclude that:

> "There is no cause of excessive concern about current levels of junk bond financing in takeovers. Nor is there justification for new initiatives aimed at curbing the rise of this kind of debt issuance in takeover bids or indeed as it relates to any other aspects of corporate financing activity.

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*Office of the Chief Economist, Securities and Exchange Commission, "Non-investment Grade Debt as a Source of Tender Offer Financing," June 20, 1986.

Finally, Christopher Ma and Garry Weed analyze the returns on junk bonds adjusted for their higher risk than investment grade securities.* They sampled 47 junk bond issues for merger and acquisition purposes with a matching group of 47 regular corporate junk bonds. The period covered is March 1980 to September 1985 and includes bonds with below double-B ratings. A second group of 110 junk bonds was also matched with other bonds of similar characteristics for control purposes.

They constructed two equally weighted portfolios of bonds and calculated their monthly yields. The yield-to-maturity of takeover junk bonds moved closely with that of non-takeover junk bonds. They conclude that:

> "The evidence of overpricing of takeover junk bonds has insufficient statistical significance to warrant any major regulation. Second, as previous studies have demonstrated, low-rated bonds historically have generated higher than usual risk-adjusted returns."

In their study they also refer to a finding by Altman and Nammacher that:

> "the return of junk bonds are five percent more than the return on long-term government securities for the last ten years, after an adjustment for the higher default rate that reduces the return on junk bonds by one percentage point."**

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*Ma, Christopher K. and Garry M. Weed, "Fact and Fancy of Takeover Junk Bonds", Journal of Portfolio Management, Fall 1986, Vol. 13.

**Quoted from a Congressional Research Services report, op. cit., and originally from Edward I. Altman, "Default Rate Experience in the High Yield Debt Market". Presented at the Conference on Investing and Trading In High Yield Debt: Junk or Gem, October 9, 1986, Chicago, Illinois.
"While the dollar amounts of debt in default have grown, the total numbers of companies in default are, nevertheless, very small and those in bankruptcy even smaller." Altman data indicate: --"From 1970 through September 1986 a total of approximately 173 companies with public debt had defaulted. In 1985, eighteen companies defaulted, while from January through September 1986 a total of 28 companies defaulted.
--"For this same period, when considering the rating of the bonds originally issued, no AAA-rated bonds defaulted, 1.65% of defaults were originally rated AA, 6.04% were A-rated, 15.93% were BBB-rated, 14.29% were BB-rated, 43.41% were B-rated, 18.13% were C-rated, and 0.55% were CC-rated.

Takeovers and Plant Closings

The issue of plant closings, layoffs and employee dismissals due to hostile takeovers has played a significant role in adopting anti-takeover legislation. Yet it is probably the least supported by available evidence. The study by Yago and Stevenson of the State University of New York at Stony Brook dealing with those issues in New Jersey is extremely valuable. We draw here extensively from their comprehensive report.*

From 1978 through 1985 there were 843 cases of mergers and acquisitions in New Jersey, 10.1 percent of them were withdrawn; 14.2 percent occurred in banks, S&L's and insurance companies; in 9.8 percent one company or investor group bought a stake in another company; 13.4 percent were repurchases of their own shares, and 17.2 percent were divestitures. Of the remaining 297 cases (35.3%), the authors selected a group of 51 corporations for detailed analysis. According to original survey data of those transactions that accounted for about half of the total value of merger and acquisition (M&A) activity, they found that:

-- "Less than one (1) percent of the total jobs lost in New Jersey were associated in any way with acquired firms.

-- "From 1980-85 permanent layoffs because of plant closings, contraction or relocations occurred 913 times, idling 95,215 workers. There was no evidence in that sample of a plant closing occurring as a result of a hostile takeover.

-- "Merger and acquisitions (M&A) activity involving major New Jersey firms made up only 2.2 percent of the total number and 1.9 percent of the total value of all United States transactions. Most of New Jersey's M&A activity was friendly (81%).

-- "About 55.6 percent of M&A activity in New Jersey was concentrated in manufacturing industries.

-- "Examining data on plant closings and permanent layoffs, we found no evidence that M&A activity leads to plant closings or permanent

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**Yago and Stevenson, "Mergers and Acquistions in the New Jersey Economy", op. cit.

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 U.S. are mainly a function of our eroding international competitiveness.

-- "The study revealed no evidence that unsolicited deals have 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 the sample were accompanied by bids from other sources, and the end result of this bidding was higher stock prices.

-- "Preliminary results from a national study of plant closings by the U.S. Government General Accounting Office show very little relationship between plants closings and M&A activity. (GAO, 1986)

-- "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.

-- "Some firms that have not been acquired have disinvested from New Jersey. New investment in N.J. 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 manufacturing plant for $10 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 transactions 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 closing 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 their plant doors in late 1983 and early 1984."

Finally, they conclude that:

-- "Mergers and acquisitions are an alternative to plant closings. A company needing to shed a division of operation can sell it or close it. Clearly, selling is preferable. Hindering M&A activity could encourage plant closings."

Two-Tier Tender Offers

As mentioned in section two, the New Jersey Act is concerned with two-tier tender offers which may lead to coercion since stockholders are compelled to tender their shares for fear that otherwise they may have to accept a lower, second tier price. The evidence on the impact of two-tier tender offers as opposed to any-or-all offers is based on an investigation by economists of the Securities and Exchange Commission.* The study involves all successful cash offers between January 1981 and December 1984. Data are from the filing of forms 14D and the number of cases is 228. There were 159 any-or-all offers and 69 partial and two-tier offers. The relative frequency of any-or-all offers has increased steadily from 58 percent in 1981 to 80 percent in 1984. The incidence of two-tier offers had fallen to nine percent in 1984.

The major findings of the study are:

"In general, any-or-all offers are more frequent than partial and two-tier offers, with the former accounting for 159 of the total 228 offers, and the relative incidence of any-or-all offers is growing, while the incidence of two-tier offers is diminishing. In addition, the incidence of any-or-all offers is higher among smaller targets, while two-tier offers predominate among moderate-sized and large targets. This empirical regularity may reflect an underlying economic difference between any-or-all and two-tier offers, with the latter types favored by bidders for relatively larger targets. This implies that any regulatory disincentives currently under consideration to partial and two-tier offers may have more important effects for larger takeover targets than smaller targets.

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*Office of the Chief Economist, Securities and Exchange Commission, "The Economics of Any-or-all, Partial and Two-Tier Tender Offers", April 19, 1985.

..."The incidence of negotiated tender offers is increasing. Almost two-thirds of the successful offers commenced in calendar 1984 were negotiated with target management from the start, or they were initiated by negotiated offers. This suggests that the negotiating positions of target managers have steadily improved in recent years so that negotiated tender offers are now the rule rather than the exception.

..."The average premium for the 159 any-or-all offers is highest at 59.6 percent relative to the pre-offer market price. The 38 two-tier offers yield an average blended premium of 54.5 percent.

..."The two-tier offer yields an average first-tier premium of 62.8 percent, virtually identical to the corresponding premium for any-or-all offers of 59.6 percent. The average second-tier premium of 44.8 percent for two-tier offers is less than the first-tier premium, but it is considerably larger than the "implicit" second-tier premium of 12.0 percent afforded by partial tender offers.

..."A higher proportion of outstanding shares are tendered into any-or-all offers (73%) than into two-tier offers (62%) or into pure-partial offers (34%). Since relatively more target shareholders are able to resist tendering into two-tier and partial tender offers than any-or-all offers, these results contradict claims that shareholders are 'stampeded' into tendering into two-tier and partial offers due to their greater coerciveness. In addition, the greater fraction of shares tendered into negotiated tender offers compared to non-negotiated tender offers, suggests that target managements can and do influence the tendering decisions of their shareholders.

<u>Shareholder Effect of State Anti-takeover Legislation</u>

Opponents of state takeover legislation argue that enactment of such laws will lead to a relative decline of the value of shares of affected corporations and, by implication, will make the acquisition of capital resources more expensive. There are three studies that lately tested this proposition. They deal with the impact of similar anti-takeover legislation in the states of New York, Ohio and New Jersey.

All three investigations are event studies and are based on essentially the same methodology of comparing the impact of an event on the stock prices (or returns) of the affected companies over and above what happened generally in the appropriate stock exchanges during the same period. An event can be defined, for example, as the introduction or adoption by a legislative committee of an anti-takeover bill, or its signing by the Governor, etc. We now summarize the findings of those studies.

The New York study was carried out by Laurence Schumann of the Bureau of Economics of the Federal Trade Commission.* The study examines the effects of the New York law on all potential targets, i.e., those subject to the law, which number 94. The New York law has a provision that prohibits for five years anyone buying at least 20 percent of a corporation's share from engaging in any business combination unless approved by the board of directors prior to that acquisition. After the five year term, a business combination would require a majority vote of disinterested shareholders or a "fair price".

In New York State an initial takeover statute was vetoed by Governor Cuomo, who subsequently introduced his own version of the bill. Therefore, the "events" studied were the introduction of the first bill, the Governor's veto and the introduction of the second version, which was passed and signed in December 1985.

The first announcement of a likely passage of the initial version of the bill turned out not to have any statistically significant impact on share returns of the affected corporations. However, the second event -- the Governor's veto -- had a positive effect on the value of the sample firms of about 0.76 percent. This is consistent with the hypothesis that the bill was viewed by the market as not helpful to shareholders.

The Governor's announcement of his version of the bill did have a negative and statistically significant effect on the share values of about 0.97 percent. This decline translates into $1.2 billion of capital loss to shareholders of the affected companies.

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*Schumann, Laurence, "State Regulation of Takeovers and Shareholders Wealth: The Effects of New York's 1985 Takeover Statutes," Bureau of Economics, Federal Trade Commission, March 1987.

The Ohio study was carried out by economists of the Securities and Exchange Commission.* The Ohio corporate law was amended to include a provision dealing with the fiduciary duties of directors who can resist takeovers because of the long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

The sample of affected firms in Ohio initially included 67 corporations, of which 13 were eliminated because they changed their state of incorporation prior to the law change or for other technical reasons. Another group of 17 companies were excluded because more than 30 percent of their shares were already controlled either by an individual shareholder or group. In the case of Ohio there was a relatively small window between the time the law was introduced and passed, because of the events surrounding the attempted takeover of the Goodyear Company. The study concentrates around the event of November 19, 1986 when it became clear that the bill would pass the legislature and be signed by Governor Celeste.

The basic result of the Ohio study is that there was a statistically significant abnormal decline of the stock prices of affected Ohio firms of the magnitude between -1.68 percent to -3.42 percent depending on the length of the window around the November 19 date. Based on the market value of the portfolio of Ohio firms in the sample, these stock price declines amount to a wealth loss of approximately $750 million to $1.53 billion. The study also had a control sample of 17 Ohio firms that already had an owner of more than 30 percent of a company's shares. It is hypothesized that these companies are not influenced by the new law since they can be effectively controlled by a

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*Office of Chief Economist, Securities and Exchange Commission, "Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers," May 18, 1987.

single owner. The results for this control group show no significant abnormal price changes.

The Office of Economic Policy conducted a similar study for New Jersey, assisted by the Office of the Chief Economist, Securities and Exchange Commission. The study included fifty-one (51) corporations subject to the New Jersey Act. It looked at, among others, windows around May 13, 1986, the day after the Senate, Labor, Industry and Professions Committee released S-1539 and the signing of the bill by Governor Kean on August 6, 1986. The length of the "window" varied from twenty days before to twenty days after the relevant dates to one day before and one day after the event. The results of the cumulative abnormal return calculations are presented below:

Cumulative Abnormal Return on New Jersey Corporations
Affected by the Shareholders Protection Act

Window	Event	Cumulative Abnormal Return	t-statistic	
-20 to +20	May 13	1.59%	0.96	insignificant
-10 to +10	"	-1.29	-1.20	"
-5 to +5	"	-1.54	-1.80	significant
-1 to +1	"	-0.55	-1.13	insignificant
-5 to +1	"	-1.36	-1.82	significant
-10 to +1	"	-1.92	-1.91	"
-20 to +20	August 6	0.05	0.03	insignificant
-20 to +10	"	0.01	0.01	"
-5 to +5	"	0.13	0.10	"
-1 to +1	"	0.76	1.10	"
-5 to +1	"	-0.60	-0.55	"
-10 to +1	"	-0.67	-0.60	"

Thus, these results show that the event of adopting S-1539 by the Senate Labor, Industry and Professions Committee had a statistically significant negative effect on stock prices of New Jersey companies subect to this legislation. The abnormal return was 1.9 percent below the market price movement for the ten days around the May 13 date.

RECOMMENDATIONS

In the final analysis, the Office of Economic Policy does not find sufficiently convincing arguments or evidence for the continuation of the current Shareholders Protection Act. However, if this conclusion is not accepted, we offer several options aimed at reducing the negative effects of the Act.

<u>Option 1</u>: Retain the Act but amend it with a provision to allow for an "opt-in" alternative by affected corporations so that the decision will be back in the hands of the majority of shareholders (including the "interested shareholder").

<u>Option 2</u>: Permit the shareholders to decide whether they would allow a proposed business combination with an interested shareholder in which each share will have one vote (including the interested shareholder's stock).

<u>Option 3</u>: Permit the shareholders to decide about a proposed business combination limiting the vote to disinterested shareholders (exclude both the "interested shareholders" as defined in the Act plus shares held by the board of directors and officers employed in the corporation.

<u>Option 4</u>: Change the definition of the term "business combination" to limit it to transactions between the resident domestic corporation and the "interested shareholder" as defined in the Maryland fair price legislation. Allow for a business combination so defined under a supermajority vote of all shares (e.g., 80%) or two-thirds of disinterested shares. Exempt from supermajority requirements a business combination when certain minimum fair price criteria are met.

<u>Option 5</u>: Allow the board of directors to decide about the efficiency and desirability of a business combination with the interested

shareholder after (not before) the acquisition of more than ten percent of the shares by one person or group.

Option 6: Permit the "opt-out" provision which was initially in the bill.

Option 7: Limit the application of the Act to cases financed by more than 50 percent with so-called "junk bonds" or any other reasonable percentage explicitly stated in the law and precisely defined.

Option 8: Require that for any major disposition of assets (e.g., selling a plant or closing it) there should be consultation with representatives of employees and their legitimate claims be satisfied. Insist that concerns and interests of employees (pensions, severance payments, retraining or relocation allowances, rights to be rehired when business improves, etc.) are not disregarded by new owners.

Option 9: Limit the application of the New Jersey Law to corporations that have a minimum number or percentage of shareholders residing in New Jersey. A suitable definition could be the one applied in Indiana and recognized by the Supreme Court as a factor in rendering it constitutional.

Finally, we strongly recommend, although it is beyond the purview of the Shareholders Protection Act, that more attention be devoted to the troubling issue of the continuing employment decline in the State's manufacturing industries. As has been shown, this decline is not the result of mergers ~~of~~ OR takeovers. Since this decline is much more pronounced in New Jersey than the national trend would indicate it calls for a careful analysis or the local reasons for that decline and for state actions to stem it. The Office of Economic Policy stays ready to assist the Legislature in such an effort.

APPENDIX I

P. L. 1986, CHAPTER 74, *approved August 5, 1986*

1986 Senate No. 1539 *(Second Official Copy Reprint)*

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

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

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

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

a. Resident domestic corporations, as defined in this act, encompass, represent and affect, through their ongoing business operations, a variety of constituencies including New Jersey shareholders, employees, customers, suppliers and local communities and their economies whose welfare is vital to the State's interests.

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

c. Takeovers of public corporations financed largely through debt to be repaid in the short-term by the sale of substantial assets 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.**

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

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

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

b. "Announcement date," when used in reference to any business combination, means the date of the first public announcement of the final, definitive proposal for that business combination.

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

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

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

(2) that, individually or with or through any of its affiliates or associates, has (a) the right to acquire that stock (whether that right is exercisable immediately or only after the passage of time), pursuant to any agreement, arrangement or understanding (whether or not in writing), or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise; provided, however, that a person shall not be deemed the beneficial owner of stock tendered pursuant to a tender or exchange offer made by that person or any of that person's affiliates or associates until that tendered stock is accepted for purchase or exchange; or (b) the right to vote that stock pursuant to any agreement, arrangement or understanding (whether or not in writing); provided, however, that a person shall not be deemed the beneficial owner of any stock under this subparagraph if the agreement, arrangement or understanding to vote that stock (i)

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

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

e. "Business combination," when used in reference to any resident domestic corporation and any interested stockholder of that resident domestic corporation, means:

(1) any merger or consolidation of that resident domestic corporation or any subsidiary of that resident domestic corporation with (a) that interested stockholder or (b) any other corporation (whether or not it is an interested stockholder of that resident domestic corporation) which is, or after a merger or consolidation would be, an affiliate or associate of that interested stockholder;

(2) any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions) to or with that interested stockholder or any affiliate or associate of that interested stockholder of assets of that resident domestic corporation or any subsidiary of that resident domestic corporation (a) having an aggregate market value equal to 10% or more of the aggregate market value of all the assets, determined on a consolidated basis, of that resident domestic corporation, (b) having an aggregate market value equal to 10% or more of the aggregate market value of all the outstanding stock of that resident domestic corporation, or (c) representing 10% or more of the earning power or income, determined on a consolidated basis, of that resident domestic corporation;

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

holder, except pursuant to the exercise of warrants or rights to purchase stock offered, or a dividend or distribution paid or made, pro rata to all stockholders of that resident domestic corporation;

(4) the adoption of any plan or proposal for the liquidation or dissolution of that resident domestic corporation proposed by, on behalf of or pursuant to any agreement, arrangement or understanding (whether or not in writing) with, that interested stockholder or any affiliate or associate of that interested stockholder;

(5) any reclassification of securities (including, without limitation, any stock split, stock dividend, or other distribution of stock in respect of stock, or any reverse stock split), or recapitalization of that resident domestic corporation, or any merger or consolidation of that resident domestic corporation with any subsidiary of that resident domestic corporation, or any other transaction (whether or not with, or into, or otherwise involving that interested stockholder), proposed by, on behalf of or pursuant to any agreement, arrangement or understanding (whether or not in writing) with, that interested stockholder or any affiliate or associate of that interested stockholder, which has the effect, directly or indirectly, of increasing the proportionate share of the outstanding shares of any class or series of stock or securities convertible into voting stock of that resident domestic corporation or any subsidiary of that resident domestic corporation which is directly or indirectly owned by that interested stockholder or any affiliate or associate of that interested stockholder, except as a result of immaterial changes due to fractional share adjustments; or

(6) any receipt by that interested stockholder or any affiliate or associate of that interested stockholder of the benefit, directly or indirectly (except proportionately as a stockholder of that resident domestic corporation) of any loans, advances, guarantees, pledges or other financial assistance or any tax credits or other tax advantages provided by or through that corporation.

f. "Common stock" means any stock other than preferred stock.

g. "Consummation date," with respect to any business combination, means the date of consummation of that business combination.

h. "Control," including the terms "controlling" "controlled by" and "under common control with," means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract, or otherwise. A person's beneficial ownership of 10% or more of the voting power of a corporation's outstanding voting stock shall create a presumption that that person has control of that corporation. Notwithstanding the foregoing in this subsection, a person shall not be deemed to have control of a corporation if that person holds voting power, in good faith and not for the purpose of circumventing this section, as an agent, bank, broker, nominee, custodian or trustee for one or more beneficial owners who do not individually or as a group have control of that corporation.

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

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

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

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

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

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

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

(2) in the case of property other than cash or stock, the fair market value of that property on the date in question as determined by the board of directors of that resident domestic corporation in good faith.

l. "Preferred stock" means any class or series of stock of a resident domestic corporation which under the bylaws or certificate of incorporation of that resident domestic corporation is entitled to receive payment of dividends prior to any payment of dividends on some other class or series of stock, or is entitled in the event of any voluntary liquidation, dissolution or winding up of the resident domestic corporation to receive payment or distribution of a preferential amount before any payments or distributions are received by some other class or series of stock.

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

n. "Stock" means:

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

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

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

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

q. "Voting stock" means shares of capital stock of a corporation entitled to vote generally in the election of directors.

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

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

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

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

c. a business combination that meets all of the following conditions:

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

(a) the highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by that interested stockholder for any shares of common stock of the same class or series acquired by it (i) within the five-year period immediately prior to the announcement date with respect to that business combination, or (ii) within the five-year period immediately prior to, or in, the transaction in which that interested stockholder became an interested stockholder, whichever is higher; plus, in either case, interest compounded annually from the earliest date on which that highest per share acquisition price was paid through the consummation date at the rate for one-year United States Treasury obligations from time to time in effect; less the aggregate amount of any cash dividends paid, and the market value of any dividends paid other than in cash, per share of common stock since that earliest date, up to the amount of that interest; and

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

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

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

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

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

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

(4) the holders of all outstanding shares of stock of that resident domestic corporation not beneficially owned by that interested stockholder immediately prior to the consummation of that business combination are entitled to receive in that business combination cash or other consideration for those shares in compliance with paragraphs (1), (2) and (3) of this subsection; and

(5) after that interested stockholder's stock acquisition date and prior to the consummation date with respect to that business combination, that interested stockholder has not become the beneficial owner of any additional shares of stock of that resident domestic corporation except:

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

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

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

(d) through purchase by that interested stockholder at any price which, if that price had been paid in an otherwise permissible business combination, the announcement date and consummation date of which were the date of that purchase, would have satisfied the requirements of paragraphs (1), (2) and (3) of this subsection.

[5.] *_6._* a. Unless the certificate of incorporation provides otherwise, the provisions of this act shall not apply to any business combination of a resident domestic corporation with an interested stockholder if the resident domestic corporation did not have 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 Exchange Act, 48 stat. 892, (15 U. S. C. 78b.) on that interested stockholder's stock acquisition date.

b. Unless the certificate of incorporation provides otherwise, the provisions of this act shall not apply to any business combination with an interested stockholder who was an interested stockholder prior to the effective date of this act unless subsequent thereto that interested stockholder increased his or its interested stockholder's 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 interested stockholder held prior to the effective date of this act.

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

c. The provisions of this act shall not apply to any business combination of a resident domestic corporation with an interested stockholder of that corporation which became an interested stockholder on or after January 12, 1988.

d. The provisions of this act shall not apply to any business combination of a resident domestic corporation with an interested stockholder of that corporation which became an interested stockholder inadvertently, if such interested stockholder (1) as soon as practicable divests itself or himself of a sufficient amount of the voting stock of that resident domestic corporation so that he or it no longer is the beneficial owner, directly or indirectly, of 10% or more of the voting power of the outstanding voting stock of that corporation, **_or a subsidiary of that resident domestic corporation_** and (2) would not at any time within the five-year period preceding the announcement date with respect to that business combination have been an interested stockholder but for that inadvertent acquisition.

*_e. The provisions of this act shall not apply to any business_ combination of a resident domestic corporation **[subject to regulation, in whole or in part, pursuant to]** **which is a "bank holding company" as defined in** the "Bank Holding Company Act of 1956," 70 Stat. 133, (12 U. S. C. § 1841 et seq.) **as amended, or a subsidiary of the bank holding company** with an interested stockholder of that resident domestic corporation.

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

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

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

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