CORPORATE GOVERNANCE: THE ROLE OF BOARDS OF DIRECTORS IN TAKEOVER BIDS AND DEFENSES

A ROUNDTABLE DISCUSSION

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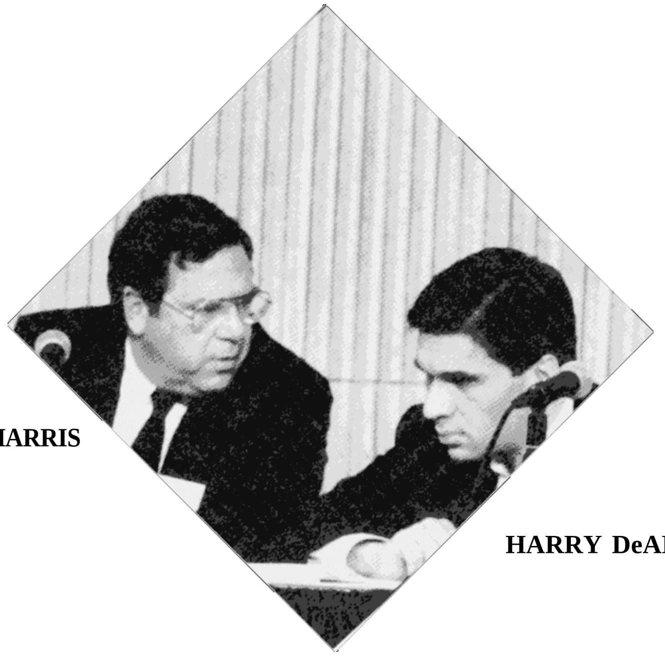

IRA HARRIS

HARRY DeANGELO

HARRY DeANGELO: Good morning, and welcome to the Corporate Governance Forum sponsored by the Harris Center here at the University of Michigan. My name is Harry DeAngelo. I am Director of the Harris Center and I will be moderating today's discussion.

Let me begin with a brief introduction of the topics we will talk about today and of the panelists who will discuss those topics. Our general subject is the role of the board of directors in dealing with takeover bids. Our general objectives are, first of all, to clarify the issues faced by the board in responding to bids and, second, to identify sensible responses by the board in particular situations they face.

The discussion will divide into two parts, The first will deal with takeover defenses -more specifically, with poison pills and the "just say no" defense. The second part will focus on two issues: (1) the role of proxy contests and tender bids as mechanisms through which outside stockholders can influence incumbent managers to alter corporate policies; and (2) the role of special committees of independent directors in mitigating conflicts of interest faced by top management when selling or buying their company.

We are privileged to have with us today a uniformly outstanding and distinguished group of corporate governance experts. I would like to introduce all of them at the beginning of our discussion.

JOHN WILCOX is managing director of Georgeson & Company, which has served for many years as advisers to both incumbent management and dissident shareholders in proxy contests.

JOSEPH GRUNDFEST is currently Commissioner of the U.S. Securities and Exchange Commission. Joe has been a leader in bringing economic-based analysis to regulation of our securities markets.

MARTY LIPTON is senior partner of the law firm Wachtell, Lipton, Rosen & Katz.

LOWELL SACHNOFF is senior partner of the law firm Sachnoff Weaver & Rubinstein.

ARTHUR FLEISCHER is partner in the law firm Fried, Frank, Harris, Shriver and Jacobson.

Each of these last three gentlemen, as you all know, has served prominently as counsel to participants in numerous corporate control transactions over a many-year period.

ROBERT MONKS is president of Institutional Shareholder Services, Inc., which advises institutional investors on matters of corporate governance. Bob and his firm have clearly been leaders in the recent upsurge in institutional investors' involvement in corporate governance matters.

GUS OLIVER is a general partner of Coniston Partners. Gus and his partners are shareholder activists who take positions in publicly traded companies and attempt to influence managers to alter policies in a way that they view as beneficial.

DAVID BOIES is a partner in the law firm Cravath Swain & Moore. David served as counsel to Texaco during its difficulties with Carl Icahn, including the proxy contest last year.

DAN CARROLL was co-chairman with Sam Heyman in his celebrated proxy contest that resulted in the transfer of control of the GAF corporation a number of years ago. Within the last year or so, as an independent director of GAF corporation, Dan has been a lone voice on the board arguing that the offer by Heyman to take the firm private was less than adequate.

IRA HARRIS is a partner at Lazard Frères. As you all know, Ira is the person whose efforts have gone a long way to make events like the current one possible for us here at the business school.

JOHN WILCOX.

■ POISON PILLS OPERATE IN A CONTEXT WHERE SHAREHOLDER DEMOCRACY IS ALREADY VIOLATED. IN EFFECT, SHAREHOLDER DEMOCRACY ENDED IN THE CONTEXT OF TENDER OFFERS WITH THE PASSAGE OF THE WILLIAMS ACT IN 1968, ALMOST 20 YEARS BEFORE MARTY LIPTON CREATED POISON PILLS. THAT ACT SAID THAT SHAREHOLDERS DO NOT HAVE VOTING RIGHTS, WHEN CHANGES OF CONTROL TAKE THE FORM OF A CASH TENDER OFFER.

–JOHN WILCOX–

PART I: POISON PILL RESOLUTIONS

With that as introduction, I will now turn the floor over to John Wilcox.

JOHN WILCOX: Thank you, Harry. My subject is poison pill rescission proposals. These are proposals presented primarily by institutional investors that call for either rescinding poison pills or putting their adoption to a vote of shareholders.

Let me start by saying that newspaper accounts of shareholder rights plans almost always include a thumbnail description that goes somewhat along these lines: "A poison pill is a device which is designed to make takeovers prohibitively expensive." Or, "Poison pills are designed to give management unlimited authority to prevent takeovers from happening, and thus are a management entrenchment device." Or, "Poison pills are a device that takes away the shareholder's right to sell his stock at a premium." This is the way poison pills are generally perceived by the media, politicians, and the public generally.

Rarely do you hear the other side of the story. Rarely do you hear that poison pills are designed to protect shareholders from takeover abuses such as front-end-loaded, two-tier offers. Or that they are intended to take the coerciveness out of cash tender offers. Or that they provide a means of giving the board of directors the time and leverage necessary to seek higher premiums for shareholders after a takeover bid. Or that they are designed to provide a more level playing field in a situation that is already badly tilted in favor of offerors.

Shareholder proposals to rescind poison pills are based on the popular perception of pills as management entrenchment devices designed to hurt the shareholder interest. Here is the language from the rescission proposal of TIAA-CREF: "Pills deprive shareholders of their basic right to decide whether to sell their shares at advantageous prices in a tender offer."

To examine such proposals on their merits, we have to look at two issues. First is the economic question: What is the impact of poison pills on shareholder value? Second is the governance question, or the shareholder democracy issue: What is the impact of poison pills on the rights of shareholders?

Let's examine the economic question first. There has always been a view that poison pills are harmful to the shareholder interest because they cause stock prices to be lower than they would otherwise be. A number of years ago, when we started hearing this argument too often–and when companies with pills actually appeared to be receiving higher premiums during takeovers than companies without pills–my firm decided to do a study to test this claim. It was a very simple study. We looked at all of the takeovers that occurred over a period of a year and nine months–between the end of 1985 and just before the crash in the fall of '87. And we found that, on average, in those situations where a takeover occurred, the premium paid to acquire companies with poison pills was almost 70% higher than the premium paid for

companies that did not have poison pills.

That study was very roundly challenged. It obviously contradicted the common perception of poison pills I have described. There was a very heated response, particularly from the academic economic community. Our firm was called names. I was called names. It was a very interesting, somewhat emotional, outpouring of criticism.

Our study was criticized for not taking into account cases where a takeover had not occurred. It was said by the critics that we should have factored in all those companies where poison pills prevented takeovers from occuring because it is in those situations that the harm to shareholders is done.

So we decided that we would study that issue as well. We did a second study in which we took a group of 100 companies that had poison pills, again during the same time period. Then we created a control group of 100 companies that did not have pills; and we tried to match them up as closely as we could in terms of industry and market cap. Then we looked at their stock price performance over the same year and nine months. We found that the performance of the two groups was basically about the same, although marginally better for companies that had poison pills in place.

So, as a result of our studies, we don't claim that poison pills are responsible for the stronger performance of the companies that have them. But our studies do demonstrate that the presence of the pill does not, by itself, diminish shareholder value, regardless of whether or not a takeover occurs. In my view, then, the answer to our first question, the economic question, is that poison' pills do not harm shareholder value.

Now, let's look at the second question: the impact of poison pills on shareholder rights. Here I am very willing to admit that poison pills, because of the way in which they are implemented, make an end-run around shareholder voting rights. They do so by design. They implement a significant change in a company's takeover posture without the consent of shareholders. They are thus undemocratic.

But let me point out that tender offers are also undemocratic. Poison pills operate in a context where shareholder democracy is already violated. In effect, shareholder democracy ended in the context of tender offers with the passage of the Williams Act in 1968, almost 20 years before Marty Lipton created poison pills. That Act said that shareholders do not have voting rights when changes of control take the form of a cash tender offer. The Williams Act chose to view tender offers narrowly as market transactions-financial transactions between buyers and sellers. It chose to ignore the impact of tender offers on corporate control. In so doing, it violates the fundamental principle of shareholder democracy. Ask yourself, what other change of control can be effected without shareholder approval? A cash merger, an exchange offer, a statutory merger, a sale of assets– they all require the vote of shareholders with the accompanying disclosures and the time for shareholders to think about the issues. But not a tender offer.

ART FLEISCHER: But isn't a tender offer equivalent to a request for a shareholder vote? It asks each shareholder to declare his position by either tendering or rejecting the bid.

WILCOX: Well, Art, I don't think that argument has ever prevailed. The old Wall Street rule that if you didn't like how a company was run you could simply sell your shares has always been discredited on issues where shareholders traditionally have had voting rights. A change of control is an area where they traditionally have had voting rights.

GUS OLIVER: John, I assume, then, you wouldn't have any problem with having a vote on tender offers?

WILCOX: No, I wouldn't. In fact, the next thing I wanted to discuss is the English procedure for responding to takeover bids. In the English system shareholders may sometimes be allowed to make two separate decisions when they receive a tender offer. One, they can vote for or against it. And two, they can, independently of their first decision, tender or not tender their shares. So, a shareholder who feels the offer is inadequate, or who would rather see the company remain whole, can both tender his shares and vote against the offer-and hope that the majority will vote with him. Under this system, the shareholder is not coerced into tendering his shares by the fear that he'll be shut out if the majority goes against him.

JOE GRUNDFEST: But, John, if you've got an any-and-all cash bid with a promise to take out any stockholder who doesn't tender at the offer price, you don't have the problem you're talking about.

WILCOX: But can we trust offerers to make their initial bid at the best price?

GRUNDFEST: If you don't think it's made at the best price, you vote against it by not tendering. It's that simple, and the nontendering shareholder is not penalized because he gets taken out at the tender price. If the shareholder is willing to sell his shares, then he ought to be able to do so.

WILCOX: But he would also like more money if it were available.

GRUNDFEST: You can always negotiate for more. And, at some point, the shareholders may think the price is just fine.

WILCOX: Shareholders cannot negotiate.

PRIOR TO THE PILL, THE ADVANTAGE WAS VERY MUCH ON THE SIDE OF THE BIDDER, WHAT THE PILL HAS DONE IS TO RESTORE THE BALANCE OF POWER AND, IN SO DOING, TO ENABLE TARGET MANAGEMENTS TO MAXIMIZE VALUE FOR THEIR SHAREHOLDERS.
–ARTHUR FLEISCHER–

GRUNDFEST: Managements can negotiate for them.

WILCOX: Not if they don't have the time and leverage to do so and that's what pills provide.

DAVID BOIES: John has identified a fundamental problem here. Individual shareholders can't negotiate. And management can only negotiate if it has some way of controlling the negotiation, controlling the auction. The pill may give management the power to control the auction and, thereby, give management the power to negotiate a better deal. But, in so doing, the pill does take power away from shareholders.

One of the problems I have with this discussion is that we're talking about shareholder democracy as if it were a political question. The division of power between shareholders, managers, raiders, targets, and other participants is an economic question. It's a question of how we should direct and regulate economic activity, not political activity. What the pill does is to take the power to negotiate away from shareholders, who really can't use it, and gives it to management to negotiate on their behalf. Whether that is desirable or undesirable (and what restrictions, if any, to place on the use of the pill) is a question of how we want to manage our economy, not whether or not we believe in political democracy.

FLEISCHER: That is exactly the point. The pill transforms a system in which the shareholders are really captives into one in which management can become an effective bargaining agent for its shareholders.

BOIES: But, in saying this, let's also acknowledge the conflict of interest between shareholders and management that may exist in such situations. So, if you could create an ideal system, you would want one which retained the positive effect of collective action by (or on behalf of) shareholders but eliminated the negative effect of having that collective action controlled by someone, like management, which has conflicting interests.

WILCOX: There is also a conflict of interest between shareholders and the offeror- because the offeror is not out there to do a charitable act for the shareholders. He wants to get the company as cheaply as he can.

BOIES: I agree that empowering somebody to negotiate for shareholders collectively is probably a good thing for the shareholders. But the question arises, To whom do you give that power? Under our current system, the person or group to whom you give the power–namely, incumbent management–has interests which may conflict with those of shareholders. Management may want to keep their jobs. They may not want to see a raider (if you want to call him that) come in and buy the company.

So, there is a tension here between two desirable aims: giving somebody the power to negotiate for the shareholders to get them the best price (which they probably cannot do individually); and giving that power to people who are either disinterested enough that they will not–or sufficiently constrained that they cannot–use that power to benefit themselves at the expense of the shareholders.

MARTY LIPTON: Alternatively, power could be given to management with the provision for a shareholder referendum if shareholders do not like what management is doing.

FLEISCHER: Let us look at the evidence. The fact is, in the last two or three years, there hasn't been a company that has been the subject of an all-cash bid for all of the shares that was not either sold or substantially restructured. Therefore, the fear of management entrenchment in tender offers is more imaginary than real. The constraints provided by law and the responsiveness of corporate boards have in fact not allowed the pill to be misused to the extent people have expected or contended.

In short, the odds are very strongly against the probability of a target company remaining independent. Historically, it has been about one out of five target companies that has achieved that objective-and that has been over a long period of time. Over the last two or three years, the percentage is even less than that, as bidders have come to understand how restructurings function and how to price deals in the face of restructurings.

In dealing with this very key question of the balance of power and the recognition that the shareholders do need a bargaining agent, it seems to me that, prior to the pill, the advantage was very much on the side of the bidder. What the pill has done is to restore the balance of power and, in so doing, to enable target managements to maximize value for their shareholders.

WILCOX: I agree, Art. It seems to me one of the great ironies that this allegedly undemocratic device, the poison pill, has effectively served to increase the power of shareholders in responding to takeover bids. Because what ultimately happens in these situations is that tender offers become more like proxy fights. In recent years, we have repeatedly seen shareholder votes on these tender offers become a major factor in takeover battles,

Let me now make one or two additional points about shareholder proposals for rescinding pills. First, let me say that the whole phenomenon of shareholders' using Rule 14a-8 for proposals–whether it's a poison pill rescission proposal or a confidential voting proposal or some other issue-is a very healthy sign in terms of shareholder democracy. We should be glad to see shareholders using the proxy process whether or not we feel Rule 14a-8 proposals are an adequate way of accomplishing specific ends,

I AM TROUBLED BY THE FACT THAT SWEPT IN WITH A POISON PILL ARE ALMOST INVARIABLY A WHOLE SERIES OF UNPRETENTIOUS BUT TERRIBLY IMPORTANT, ENTRENCHMENT PROVISIONS: LITTLE CONTACTS, LITTLE INSURANCE ARRANGEMENTS, ALL MANNER OF LITTLE SUBTLETIES WHICH I THINK BEFOUL THE WATER SURROUNDING THE POISON PILL.

–DAN CARROLL –

I would also like to make one last comment about poison pill rescission proposals. I have made this suggestion before, and it has been greeted by thundering silence. If you accept the proposition that poison pills do not reduce shareholder value (which I believe to be the case) and that they are therefore *in* the shareholder interest, I question whether, under ERISA, a fiduciary is within its rights in voting *against* them. The ERISA rules require that in voting proxies a fiduciary consider only factors that affect the value of the plan's investment. In effect, I would argue that a fiduciary is actually violating the interest of the shareholders in proposing the rescission of a poison pill. Perhaps Bob Monks would like to comment on that?

BOB MONKS: I will respond to the question with the same playful humor that stimulated it.

When fiduciaries begin to select *only* stocks that go up in value-only then will I feel any confidence in prescribing a mandatory position about governance provisions. On the issue of "pills," it should be understood that shareholders are being deprived by them of one of the essential components of ownership: the right to sell their property to a willing buyer at an agreed-on price. To justify an encroachment on this right will require levels of argument and proof that far exceed any provided to date.

LOWELL SACHNOFF: John, if you take your argument to its logical extreme, then you would require every outside director to insist that all companies have poison pills. If one accepts your claim that poison pills are good for shareholders and other living things, then every company should have one. So, once you get on that slope, where do you stop?

WILCOX: Corporate directors are not necessarily subject to the ERISA standard, but . . .

SACHNOFF: But they're fiduciaries and the pills are good for shareholders. And fiduciaries, of course, lead their lives solely to protect the interests of shareholders. In that case, they had better insist that every company adopt a poison pill-and the more toxic the better.

WILCOX: Well, over 1000 companies now have them, according to my count.

FLEISCHER: I would say it is irresponsible for a board of directors not to have a poison pill. When you can buy an option for nothing in this life, you are really foolish not to do so.

SACHNOFF: Joe, do you think the SEC will soon pass a regulation requiring all companies to have poison pills?

GRUNDFEST: I personally think that will happen right after we pass a law requiring that people eat Chilean grapes.

WILCOX: I have one final thought on institutional investments and shareholder democracracy. The basic assumption of our system of shareholder democracy is that we have a widely dispersed group of beneficial owners with all sorts of different interests. And in order to find out what the will of the shareholders is, we poll them and we have a collective decision-making process.

My concern is that in the past ten years we have seen a fundamental change in the nature of investment and in share ownership. We now have a concentration of voting authority in a group of people who are not themselves beneficial owners. These people do not ask the owners whose money they are investing what their views are on these issues. They are middlemen, these institutional investors. They are money managers. They are held to a very narrow and strict financial standard. And it is getting to a point now where they control the voting power of corporations. I would like to just leave us with the question of whether our system of shareholder democracy can function with that degree of concentration.

MONKS: I'd just like to comment briefly here. I want to urge everybody here to be witnesses. You are probably familiar with the havoc caused by the time-honored practice of setting up "designated enemies," We have just finished with our first speaker in this program, and it has already become clear that the designated enemies are the "owners." So, for now, I simply urge you to be witnesses, but I'll come back to this point later.

WILCOX: But, Bob, can institutions really be considered "owners"?

DAN CARROLL: I would like to make a brief comment on the pill. I have served on several boards, and I am troubled by the fact that swept in with a poison pill are almost invariably a whole series of unpretentious, but terribly important, entrenchment provisions: little contracts, little insurance arrangements, all manner of little subtleties which I think befoul the water surrounding the poison pill.

WILCOX: I don't disagree.

FLEISCHER: I think what Dan Carroll is referring to here are so-called "golden parachutes." Let me suggest briefly that these contracts can serve a number of important corporate purposes, including providing management stability.

When we talk more generally about these issues of corporate governance, we have to ask ourselves: Under what circumstances should we insist that the power pass from the board of directors to the shareholders, who can then exercise a direct franchise?

MONKS: Can we agree not to use the word "democracy" again? Because I don't think we've had one shareholder-one vote since before World War I. We have had one share-one vote, but that is certainly not democratic by any stretch of the imagination.

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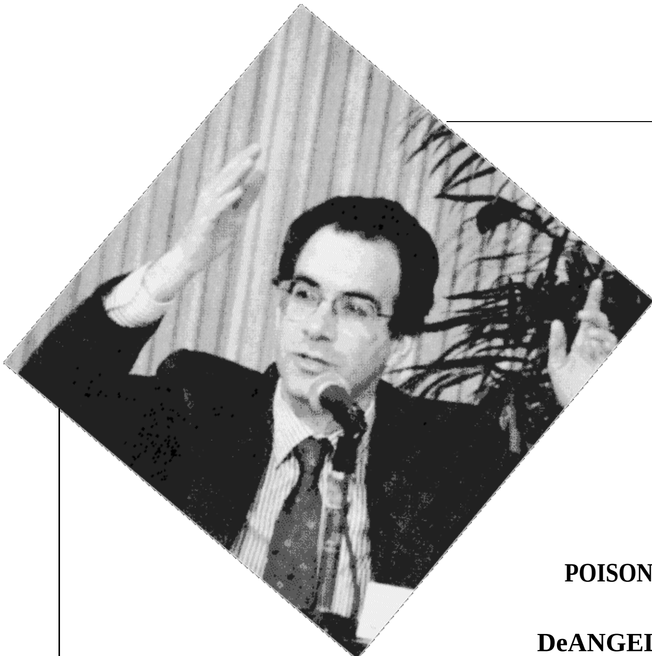

JOSEPH GRUNDFEST

POISON PILLS: COUNTER POINT

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I THINK THERE'S AN EVEN BETTER ALTERNATIVE FOR RESOLVING THESE ISSUES AND THAT'S ONE THAT RELIES ON THE MECHANISMS OF SELF-GOVERNANCE. THERE IS NO REASON, WHETHER GROUNDED IN LOGIC OR EXPERIENCE, THAT EVERY COMPANY IN AMERICA NEEDS TO BE GOVERNED BY THE SAME RULES IN THE OPERATION OF A CONTEST FOR CORPORATE CONTROL. COMPANIES ARE DIFFERENTLY SITUATED AND THERE ARE GOOD REASONS WHY IT SHOULD BE MADE EASIER TO TAKE OVER SOME COMPANIES THAN OTHERS.
–JOE GRUNDFEST–

DeANGELO: Why don't we give Joe Grundfest a shot at the poison pill?

GRUNDFEST: Thanks, Harry. It's a thrill to be here at the Rumeal Robinson School of Business Administration at the University of Michigan. When Mr. Schembechler heard that I had checked into the Campus Inn, and when he found out that I have never lost as a coach in NCAA post-season competition, he invited me in for a discussion about a position here on the athletic faculty.

Now, if you believe that story, then I think you'll believe a lot of the statistics' about poison pills we've heard so far. Because, quite simply, it's absolutely true that I have never lost coaching in the NCAA finals. I would also argue that we have just heard some assertions about why poison pills are good for stockholders that are just as accurate, and follow exactly the same kind of logic, as my assertion about my record as an NCAA basketball coach.

In terms of knowledge of statistics, this is a fairly sophisticated audience. People here are comfortable with notions of statistical significance, and are probably familiar with the distinction between correlation and causality. So what I'd like to do is to take a little bit more careful look at some of the issues raised by the Georgeson poison pill study.

I want to admit, right up front and without any compunction, that I have a free-market orientation. I don't think that's anything to be embarrassed about. But I do have to confess that recent experience persuades me there is a relatively small portion of the marketplace that could benefit from substantially greater regulation. The area that needs greater regulation involves the use ofstatistics in the takeover debate. There should, at a minimum, be some requirements of peer review. With such requirements, we could not possibly hear numbers bandied about the way some of the statistics have been presented here this morning.

In particular, there are two big, but very convenient, mistakes that people like to repeat. The first big, but very convenient mistake is to rely on statistics that purport to demonstrate that companies do better in the long run for their stockholders if a takeover bid is defeated. That assertion is just wrong, wrong, wrong. That assertion is made by one of my colleagues on this panel and by a fairly well-known investment bank. But, let me assure you, if that investment bank applied the same method they used in those studies in running their arbitrage desks, they would be bankrupt in a month.

The second mistake, and that's the one that I'll concentrate on for now, is the idea that poison pills are good for stockholders. Let me start simply by saying this: If the Georgeson study proves that poison pills are good for stockholders, then I can also demonstrate that pregnancy causes sex.

Let's turn to the Georgeson study that Mr. Wilcox described earlier. That study took a sample of companies with and without poison pills and then examined the difference in their stock price performance between January 1, 1986 and November of '87. Do I have this right, John?

WILCOX: Yes, but I think we ended with September of '87. We stopped there because we didn't want to get into the Crash.

GRUNDFEST: I didn't want to get into the Crash either, but they didn't give me a choice.

But, in any event, the study examined the change in stock price of the poison pill sample from January of '86 all the way up to September of '87. Then it took a sample of companies without the pills, and looked at their stock price performance over the same period. And, because it found that the stock prices of companies with the pill went up more than the prices of companies without the pill, they said, "Well, you see, the pill is not so bad."

Now, if you go back and look at the numbers a little bit more carefully, you will see there is something suspect about all this. If you look at the companies that are part of the pill group, their annualized rate of appreciation prior to the adoption of the pill is 45.8%. However, after the adoption of the pill, their annualized rate of appreciation is 28.1%. Now look at the non-pill group. Their annualized rate of appreciation was 27.8% before the adoption of the pill, and afterwards it was 27.0%. These numbers demonstrate that the extra performance observed in the pill group -and you do get extra performance in the pill group-occurs before the pill is adopted. Therefore, unless causality runs in reverse through time, the pill does not cause stock prices to go up.

FLEISCHER: Is it possible that the companies that adopt the pill are the subject of takeover speculation and that some of that speculation is dampened when the pill reduces the probability of a takeover succeeding?

GRUNDFEST: Yes, absolutely. The stock price run-up might actually be caused by something else and it may well be, as you suggest, that once the pill is adopted the game is over; the run-up stops.

FLEISCHER: Joe, turn away from statistics for a moment. . .

GRUNDFEST: I know the statistics make you uncomfortable. . .

FLEISCHER: . . .and look at the real world. I occasionally represent what are called raiders. And when we review a potential target company, we look at what are the problems in effecting a change of control of that company. First, we review all the standard shark repellants. Then we look to see whether the company has a pill.

In my experience there has never been a situation where a raider did not go after a company because it had a pill. Now why is that the case? Because anyone who engages in a potential takeover transaction with a company that doesn't have a poison pill and assumes that the company will not adopt one is absolutely irrational. There is no basis whatsoever for assuming that a company that does not have a pill will not adopt one.

Therefore, whether or not a company has a pill is really in a sense a function of its level of preparedness. If I looked at a company with no shark repellants and no pill, I would tell my client that we do not have to be as aggressive in bidding for that company because they have not focused on maximizing shareholder value. Even if they adopt a pill, if they have not already taken certain other supplemental steps, such as a staggered board, they are going to be in a more vulnerable position.

GRUNDFEST: Unfortunately the data don't bear that out.

FLEISCHER: I can't quarrel with you on the statistics. I can only recount the experience that I've been through and I suspect others have also.

My experience tells me that, if the company ends up in a sale mode, the pill is going to increase shareholder value. As you know, pills have a "flip-in" feature, which means that if somebody buys more than 20% he suffers an economic penalty. I have told boards of directors that if they sat by and let a third party acquire control in the marketplace, that's almost a per se abdication of their responsibility as directors. In so doing they have failed to make the acquisition premium available to all the shareholders.

OLIVER: The basic problem with your argument, however, is your assumption that pills will actually be used only as a negotiating tool. The concern of stockholders–and it's one that Bob Monks and I as stockholder representatives share – is that, in fact, boards of directors don't use the poison pill for the purpose that you're implying they will use it for.

GRUNDFEST: Is it a negotiating device or is it a showstopper? If it's a negotiating device that's fine. If it's a showstopper, then there's a problem.

FLEISCHER: But, as I said earlier, experience is demonstrably to the point that it is simply a negotiating device.

OLIVER: I just don't think that's right. There are several recent examples that contradict that statement.

FLEISCHER: I am painfully aware of those examples; but that doesn't change my thinking.

GRUNDFEST: I think Gus is right here. Let me try to fill out this point – unfortunately, again, by resorting to some statistics based on the Georgeson study. The Georgeson study, you will recall, concluded that pills don't deter takeovers and therefore don't harm shareholders. They reached that conclusion by comparing the number of takeovers consummated between a matched sample of firms with pills and firms without pills. Ten of the firms with pills were taken over and 12 non-pill companies were taken over; and because there's no statistically significant difference there, they concluded that the pill does not deter takeovers.

The problem with that calculation, however, is that the *ex ante* probability of a takeover may not be the same for the pill and the non-pill companies in these samples. We tried to adjust for this factor by determining not only how many companies in their two samples were actually taken over, but also how many received bids (not necessarily all cash) and then remained independent, and how many were rumored takeover targets based on newspaper stories. We discovered that, among the pill companies in the Georgeson study, 10 were actually taken over, 9 received bids and remained independent, and 8 were rumored targets that didn't receive bids. Among the non-pill companies, 12 were actually taken over, only one received a bid and remained independent, and only 4 were rumored targets. So, if you look at the ratio of the number of companies that were actually taken over to the number of potential targets, that's 10 out of 27 for the pill companies, and 12 out of 17 for the non-pill companies. And that's a statistically significant difference (with a Z-statistic of 4.76).

And, if you look only at the firms that actually received bids, then you see that 10 out of 19 of the pill companies were taken over, whereas 12 of 13 non-pill companies were taken over-which difference, again, is very statistically significant, (In this case, the 2 zooms to 6.28.)

Therefore, contrary to the results claimed by the Georgeson study, it does appear that one can find a deterrent effect correlated with-and, I would argue, caused by-the adoption of the poison pill. The Georgeson group tries to argue, as they did to me in a letter, that their studies are not designed (and I'm quoting now) "to examine whether or not shareholder rights plans cause higher premiums in takeovers or improved market performance." And they go on to explain how they're very careful in wording their studies to avoid any suggestion of causality.

Well that's cute, because if there's no suggestion of causality, and if there's no intention to suggest causality, then why do we care about the Georgeson poison pill study at all? If there's no causality, their findings represent nothing more than a statistical coincidence, "a spurious correlation" It's as if you found that companies whose boards of directors are all totally bald tend to get higher prices for their shares over time. And, on the basis of that finding, you then advised that all board members shave their heads.

So, either you've got causality, in which case we have to examine the mechanism of action, or you've got nothing. One mechanism of action, as Art was suggesting earlier, is that the pill gives shareholders greater bargaining power. If used responsibly by management, the pill may in fact resolve the potential prisoners' dilemma faced by shareholders when confronted with a bid. In this case, the pill would be good for shareholders in a causal sense. But, if you're denying causality, then you're making a statement that is analytically meaningless because what you're saying, in effect, is that there is no cause-and-effect relationship. Instead we have the kind of correlation that brings to my mind of one of my favorite little facts.

Did you know that there is a very strong negative correlation between the annual birth rate in Britain from 1875 to 1920 and the annual production of pig iron in the United States? It is, in fact, a negative 0.98. Yes, it may be hard to believe, but it's true that there was once almost a perfect negative correlation. Does that mean that British births drove down U.S. iron production, or vice versa? Of course not. Correlation does not necessarily imply causality. Thus, if there is no causal relation between adoption of the poison pill and stock price movements, as Georgeson asserts, then the findings of the Georgeson study are about as meaningful as the relationship between the English birth rate and U.S. production of pig iron,

Georgeson is therefore going to have to fish or cut bait. They're either going to have to say, "There is a causal relationship and we're proud of it; here's the mechanism of action and here's how it works." Or they have to say, "There's no causality, we have a spurious correlation, and let's talk about pig iron and birth rates."

WILCOX: Let me make one comment on that. There is a burden-of-proof issue here. We conducted our studies because a lot of negative things were being said about poison pills without anyone really examining the evidence. We did our studies simply to show those statements were wrong.

The kind of study that we conducted is a statistical analysis that cannot by its nature demonstrate causality. One thing it clearly demonstrated, however, was that the efficient market methodology of looking at a stock price movement for a period of 24 hours after announcement of a poison pill adoption-which showed a slight decline in the market value-that methodology was not accurate in foretelling what would happen to companies over the long term after poison pills were adopted.

So I don't need to make a claim that poison pills by themselves cause higher value. But I can make the claim that, on the basis of our studies, the statements that poison pills are harmful to the economic interests of shareholders are wrong.

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I PERSONALLY BELIEVE THAT THE LAW SHOULD BE THAT IF A BOARD OF DIRECTORS, ACTING REASONABLY AND IN GOOD FAITH, DETERMINES THAT THE LONG-TERM VALUES OF A COMPANY ARE ATTRACTIVE–EVEN THOUGH IT IS FACING AN ALL-CASH OFFER FOR ALL SHARES AND EVEN IF IT IS CLEAR THAT IF THAT OFFER IS REJECTED THE COMPANY'S STOCK WILL NOT IMMEDIATELY SELL IN THE MARKET FOR THE AMOUNT THAT HAS BEEN BID FOR THE COMPANY–IN SUCH CASES THE FIRM DOES HAVE THE RIGHT TO "JUST SAY NO" AND USE THE PILL TO PREVENT THE TENDER OFFER FROM BEING CONSUMMATED WITHOUT PROPOSING ANY ALTERNATIVE TRANSACTION.
–MARTY LIPTON-

MARTY LIPTON

PART II: THE 'JUST SAY NO" DEFENSE

DeANGELO: Let me interject here. One important issue that has come up here is the question of whether poison pills are used as show-stoppers. We never really answered that question, and I think it would be useful for us to turn now to our discussion of the "just say no" defense–because consideration of this defense forces us to address directly the issue of whether the pill is used to stop the show or as a bargaining tool. So why don't we turn to Marty Lipton and then we'll move on to Lowell Sachnoff.

LIPTON: The pill has existed now for about five years. Over the years, many of the issues surrounding pills have been litigated, but there are some issues that still remain and are pending right now in the courts.

Four years ago, the Delaware Supreme Court decided the *Unocal* v. *Mesa Petroleum* case and the *Moran v. Household International* case. In *Unocal* the Court took the position that the standard to be applied to the action of the board of directors of a target company in defending against takeover was an "enhanced" business judgment rule. In effect, the Court indicated that, under certain circumstances, it would be prepared to intervene and "second guess" the board of directors with respect to the reasonableness of the defensive action taken in response to a takeover bid. In *Household*, the Court decided that it was within the business judgment of the board of directors to adopt the pill. But the Court's ruling left open the question of how the pill would be used by a board of directors in response to a specific takeover bid. So, starting with those two propositions some four years ago, we have now built a rather extensive jurisprudence in a relatively short period of time.

During the last two and a half years, in virtually every instance where a court has faced a question regarding the validity of a pill, it has held that the pill was valid. But in making such decisions, the courts have avoided the more basic legal issue. Courts have said, in effect, "The poison pill is being used here as a bargaining device to get a better price," or "It is being used to defend against a coercive two-tier offer," or against open market purchases or some other takeover tactic that the court felt was abusive to shareholder rights. Then, starting with the *Federated Department Stores* case, the courts have said, "We are not going to get into the issue of the legality of the pill as long as it is being used as a shield against an inadequate offer and as a gavel to auction the company for a higher price."

This state of affairs left considerable doubt as to whether the pill could be used to "just say no" to a hostile offer: Can you use the pill to avoid a transaction that would result in the company being acquired while also avoiding a defensive restructuring? As a practical matter, it seemed that this issue was not going to be resolved in the near future.

One reason this issue has not arisen, as Arthur indicated before, is our experience that directors have been very responsive to the will of the shareholders. When there is a high premium bid for all the shares of stock of a company, generally the directors (if not in 99 out of 100 cases, then in 49 out of 50) have engaged in some other transaction designed to create additional value for the shareholders. So even though the original bid did not succeed, the shareholders generally have been satisfied.

The takeover movement has recently led, of course, to the popularity of recapitalizations and restructuring. In a restructuring, rather than have the company acquired by a third party, it remains a public company, with the equity remaining in the hands of the existing shareholders. In addition, the public shareholders are paid a very substantial portion of the previous value of the equity of the company, generally in a combination of cash and securities. This has become one of the principal methods of dealing with a typical hostile tender offer.

This development has led to the two Delaware decisions that essentially gave rise to the issue of the "just say no" defense: first, *Interco* and then Pillsbury, The problem with both of these cases is that they are just "two-bit" cases. I mean that the differential in value between the alternatives offered to shareholders is so small that it is almost impossible to conceive of a court saying, "I'm going to let the board make that decision, or I am going to step in and make that decision for them." In such cases the most likely response for a court is to sit back and say, "Let the shareholders decide."

In *Interco*, you had a situation where the company was keeping a pill in place in order to ensure that its own recapitalization plan, with a theoretical value of $76 a share, would win over a cash bid of $74 a share for all of the shares. The court said that the recapitalization was the equivalent of a sale of the company, and if the board of directors was determined to sell the company, then it had to be a free and open auction. In that case, according to the *Interco* court, you cannot use a pill to make the recapitalization plan prevail over the third party's bid. Instead, the court said that the shareholders should be allowed to choose between the recapitalization and the cash bid.

Pillsbury was a similar situation. There, shareholders were also faced with competing offers, and a narrow range of choices: a third-party bid for $66 per share and a recapitalization valued at $68. Essentially, in both *Interco* and *Pillsbury*, there was a two dollar per share differential which the market had discounted; so there was virtually no real difference between the transactions in the market.

The real problem with those two cases is not what they decided but what was said in each decision. Both cases were generally interpreted as saying that a pill could not be used for a purpose other than creating additional time and leverage in the negotiation process. If there was a cash bid for all of the shares of stock of the company, the board of directors would have to redeem the pill after a reasonable period of time. Even if the board had concluded that the offer was inadequate, the board could not use the pill to stand in the way of the offer and keep the company independent and unrestructured.

Now there are two additional decisions since then. The first, *TW Services*, was another Delaware case. Chancellor Allen used the decision to raise the question regarding redemption of the pill. In *TW Services* he said, in effect, "It is not at all clear that what we were saying in *Interco* and *Pillsbury* is that you must redeem the pill in every case, even when you have a cash bid for all the shares. That issue has not been addressed and the Delaware position is not clear."

Essentially the same issue was presented in *Universal Foods* to a Wisconsin federal district court applying Wisconsin law. That court said that Wisconsin, in the absence of precedent, would apply Delaware law. Therefore, the court was interpreting Delaware law when it said, in effect, "If the board of directors, acting reasonably and in good faith, determines that a cash bid for all the shares is inadequate and does not serve the shareholders' interest, even if that determination is made on the basis of the directors' own business judgment without an inadequacy opinion from an investment banker, then the directors can just say no." Put a little differently, *Universal Foods* said, "The directors can just say yes with respect to their view of the long-term value of the company." The Seventh Circuit Court of Ap-

MARTY, THE BOTTOM LINE OF YOUR POSITION IS EQUIVALENT TO SAYING THERE CAN BE NO HOSTILE TENDER OFFERS. BECAUSE IF YOU ALLOW A "JUST SAY NO" DEFENSE IN A HOSTILE TENDER OFFER, THAT MEANS THAT IN ORDER FOR THE BID TO SUCCEED, THE BOARD MUST FIRST SAY 'YES" TO THE OFFER.
-JOE GRUNDFEST-

peals, moreover, has recently affirmed the district court's decision in *Universal Foods* solely on the basis that the Wisconsin takeover statute was constitutional.

So what we have is a mixed bag of decisions in Delaware. It is not at all clear what the Delaware Supreme Court would say about this issue, nor is it clear what Chancellor Allen, who has written most of these opinions in Delaware, really thinks with respect to this issue. Moreover, it does not seem likely that these issues will be resolved by the Delaware Supreme Court in the near future.

I personally believe that the law should be that if a board of directors, acting reasonably and in good faith, determines that the long-term values of a company are attractive-even though it is facing an all-cash offer for all shares and even if it is clear that if that offer is rejected the company's stock will not immediately sell in the market for the amount that has been bid for the company–in such cases the firm does have the right to "just say no" and use the pill to prevent the tender offer from being consummated without proposing any alternative transaction. Such a law would not mean, of course, that shareholders would be deprived of their right to express their views. They would still have the opportunity to remove the board of directors or protest the board's decision, either through the proxy mechanism or a consent solicitation, if that's available.

GRUNDFEST: But, Marty, to slice through some of the legal mumbo jumbo, the bottom line of your position is equivalent to saying there can be no hostile tender offers. Because if you allow a "just say no" defense in a hostile tender offer, that means that in order for the bid to succeed, the board must first say "yes" to the offer. But if the board must say yes in order for the bid to succeed, the bid is no longer hostile and a hostile tender offer can never succeed. Therefore the logical consequence of the "just say no" defense is that hostile tender offers are prohibited.

LIPTON: No.

GRUNDFEST: Of course it is. So why don't you just prohibit hostile tender offers instead, because that's exactly the same result as you would achieve under the "just say no" defense.

LIPTON: I think our experience over the past few years is to the contrary. Most bidders have assumed in their planning that they would be met with a "just say no" response. Almost all bids today are accompanied by either one or both of two additional strategies: one, a legal attack on the pill; and two, and most significantly, either a consent solicitation or a proxy solicitation to force the board to accept the transaction.

As I said earlier, our experience is that boards are very responsive to the expressed desires of their shareholders. In many of these cases, the board, totally apart from any consideration as to whether the pill will survive litigation, has determined that they have an obligation to the shareholders to create additional value either by finding an alternative transaction or engaging in a restructuring. So I do not think acceptance of the "just say no" defense is going to spell the end of hostile takeovers.

GRUNDFEST: But, by definition, a hostile tender offer can never succeed.

LIPTON: I do not quarrel with that.

GRUNDFEST: So what you're saying is, "Let's adopt a regime in which a hostile tender offer can never succeed."

LIPTON: Well, yes. But, if you want to look at it that way, a hostile merger also cannot succeed. A merger requires the approval of the boards of directors of both companies. In addition, there is nothing carved in stone that says there should be hostile takeovers of companies.

OLIVER: Marty, isn't there a right to sell your stock as a stockholder for the best price?

LIPTON: I am not interfering with that at all.

OLIVER: You're absolutely interfering with that right.

LIPTON: Gus, under any of these scenarios, if you want to buy my stock, you are welcome to buy it. And if you want to pay more than its selling for in the stock market today, I'm delighted to sell it to you.

OLIVER You mean it's OK as long as I don't go over 20% ownership. Because as soon as I buy more than 20% of the outstanding shares, then I commit financial suicide by triggering the pill. So once I get there I am constrained, prohibited from buying any more stock.

LIPTON: No you are not constrained in the least. There is nobody preventing you from buying all the stock, Gus. All you have to do is make a cash bid for all of it.

OLIVER: Marty, we made a cash bid in TW Services (the case you referred to earlier) that was fully financed and in which 90% of the stock was tendered. The board of directors of TW, at least for some period of time, "just said no." Do you say that's a responsive board of directors?

LIPTON: No. But now TW Services is out looking for a better deal.

OLIVER: Well, now they are. Finally.

LIPTON: But, Gus, even after they won their case, they are still out looking for a better deal. I think it proves my point.

FLEISCHER: Did you raise your bid during the course of this, Gus?

OLIVER: No. We changed it somewhat. But very early on in the process, and not in any way important to this discussion.

IT IS INCREDIBLY EXPENSIVE AND TIME-CONSUMING TO CONDUCT A PROXY CONTEST, PARTICULARLY IN CONJUNCTION WITH A TENDER OFFER. TO DATE, IN THE CASE OF TW SERVICES,WE HAVE SPENT $20 MILLION AND ALL WE HAVE GOTTEN TO THIS POINT IS THE BOARD OF DIRECTORS TO AGREE TO CONDUCT AN AUCTION FOR THE COMPANY.
—GUS OLIVER—

What I think is the follow-up to Marty's discussion, and what I guess would be his answer to Joe, is that stockholders have the ability to change the board of directors through the normal election process. But I think that's too easy a statement to make. It is incredibly expensive and time-consuming to conduct a proxy contest, particularly in conjunction with a tender offer. To date, in the case of TW Services, we have spent $20 million and all we have gotten to this point is the board of directors to agree to conduct an auction for the company.

Now that effectivelywould preclude a lot of potential bidders from even attempting to pay a premium when in fact they might otherwise be inclined to. And if the board had decided to "just say no" and Chancellor Allen had upheld that decision, it would have taken us two years and two proxy contests before we could have gotten control of the board of directors.

LIPTON: No one quarrels with that, and there is no pretense to the contrary.

OLIVER: That puts my mind at rest, Marty, I was worried for a minute.

LIPTON: Those of us who advocate the "just say no" position clearly believe the underlying philosophy that this activity is not good for the economy, and we want to restrict it substantially. These cases are interesting little exercises in logic. But what we lose sight of in viewing them on an individual basis is that what we are really talking about here is fundamental national economic policy- even though it only gets manifested from time to time in a lawsuit here and there.

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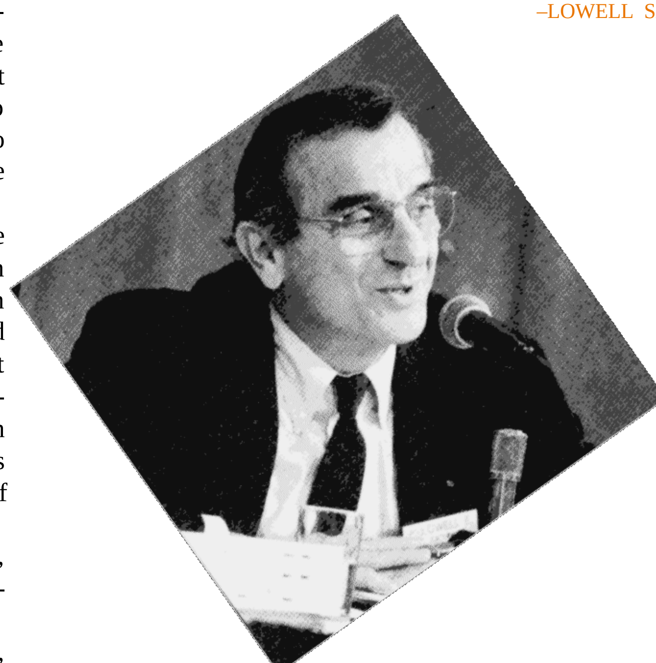
–LOWELL SACHNOFF–



LOWELL SACHNOFF

THE "JUST SAY NO" DEFENSE: COUNTERPOINT

DeANGELO: Let's turn this over to Lowell to present the view on the other side of the "just say no" defense.

SACHNOFF: I would like to start by picking up on Marty's last comment about the macro versus the micro view of takeovers because, as Marty says, that's the larger issue underlying much of this discussion. I should start out by saying that I'm from Chicago and that gives me a bad start with the "just say no" people. I recently had lunch at–I guess I can mention the name in this company without fear of harm to my person-at the University of Chicago with some of the folks in the economics department. When I mentioned that

A COMPANY'S STOCK PRICE MAY BE LESS THAN THE POTENTIAL VALUE OF ITS ASSETS IN DIFFERENT USES, OR UNDER, A MORE: EFFICIENT MANAGEMENT TEAM BECAUSE SMALL TRANSACTIONS DO NOT CONVEY ANY CONTROL. THEY DON'T GIVE THE BUYER THE OPPORTUNITY TO CHANGE HOW THE COMPANY IS RUN.
–JOE GRUNDFEST–

I was going to be on a panel about "just say no" with Marty Lipton, they gave me a pile of data about three feet high. And if I had about three hours I could go over the data with you.

Nevertheless, I am going to bore you with some of that data just to show that poison pills really aren't good for shareholders, and probably aren't good for the economy either. But, before I go into this data, I want to share with you the last comment I got from an unnamed economist at Chicago. He said, "Just tell Marty that 'just say no' is much better when applied to drugs and unsafe sex than to takeovers."

Now, if the "just say no" defense means to do away with all hostile takeovers (as Joe Grundfest, a good cross examiner, extracted from Marty a minute ago), then the underlying claim must be that hostile takeovers are bad for the economy and don't produce net gains. And on that point, again, the terribly boring data get in the way. Because the data show immense gains from takeovers-gains that are enjoyed primarily by the shareholders of target companies. Now, if hostile takeovers are bad, one would think that the gains to target shareholders would be counterbalanced by losses to the bidding companies because the more gains that are transferred to the shareholders of these target firms the less there ought to be available for bidders. Gregg Jarrell, formerly chief economist at the SEC, and Annette Poulsen did a study showing that not only isn't that the case, but it's not the case to a high 2 factor. Using some 600 acquisitions, they showed that there are huge gains to shareholders of target companies and losses to the shareholders of the bidders. Now that tells us something about the macro view of takeovers.

LIPTON: No, it tells us something wonderful about statistics. You can pour half a glass of water out and it is still a full glass.

FLEISCHER: Let us talk about the market. The stock market is not a market for control; it basically reflects only transactions of a small size. Therefore, as soon as you have a transaction involving the transfer of control, you are going to have gains because the buyer will pay a premium over market, These statistics are almost self-evident. To say, on the basis of these statistics, that takeovers produce gains to shareholders is absolutely beside the basic point as to whether takeovers are good or bad for the economy.

SACHNOFF: But, Art, if takeovers were really either bad or neutral, there would be a zero-sum game here. The gains would go to the target shareholders but they would be coming at the expense of the acquiring firms' shareholders.

FLEISCHER: That doesn't follow unless the stock market is a market for control. The stock market is not a market for control and does not measure the efficiency of the market for control.

GRUNDFEST: But, Art, you've pointed out one perfectly legitimate reason why the prices you see posted in the New York Stock Exchange may undervalue a company. A company's stock price maybe less than the potential value of its assets in different uses, or under a more efficient management team, because small transactions do not convey any control. They don't give the buyer the opportunity to change how the company is run.

Now, if the stock market is "undervaluing" a company in this sense, and if you can move the same no company to a higher valuation through a control transaction, doesn't that have to be better for the economy?

FLEISCHER: I don't think the market undervalues securities. If it is an efficient market, it prices securities at their current value to shareholders. But this price has nothing to do with the value of that company in a control transaction.

SACHNOFF: But that statement only goes to prove my point. Which is that the market doesn't undervalue securities at all. An efficient market values companies precisely at their value at that point in time, *under the current management*.

To illustrate my point (and allow me just this one lapse into the anecdotal), let me describe this little pin I'm wearing on my lapel. It's a Pillsbury doughboy. But this doughboy doesn't look like any doughboy you've ever seen on television. He has boxing gloves on and a very mean look in his eye. And this doughboy was passed around to all the Pillsbury employees and stockholders–in fact practically everybody in Minneapolis -when the Grand Met bid came along.

Now, we represented the largest single shareholder in the Pillsbury situation. Pillsbury's stock was trading at $39 when the Grand Met tender offer came in at $60, all cash, unconditional, for all the shares. And when management erected this barricade of defenses against the offer, our client couldn't figure out how $39 was likely to be greater than $60. It didn't make any sense to him. He said, "Gee, I ought to be able to get the sixty bucks." And I said, "Well, tender offers aren't democratic."

FLEISCHER: Was he happy with the $64 he ended up with?

SACHNOFF: Well, any mutual fund or investor with a diversified portfolio would have been happy with even less than $60 across the board. And this is the macro point that I want to get to now.

When we lawyers labor in the trenches in these deals, we look only at the obligations we have to our clients. And I've got a confession to make: When we represent targets, we install

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–LOWELL SACHNOFF–

poison pills, too–although I will say that our pills are by design not as toxic, they don't have the very low flip-in percentages and they dissolve at lower levels of shareholder approval than most pills now used. We have never put in a poison pill that doesn't self-destruct when 80% of the shareholders tender their shares. Because when you get up into those numbers, it's hard to argue you really have the stockholder interest at heart.

FLEISCHER: May I have a list of your clients, Lowell?

SACHNOFF: Well, they're all public. But my point here is that these folks really wanted to sell their shares. And when you talk to fund managers who take a more macro view, another truth emerges. As managers of portfolios of 500 or 1000 stocks, they are concerned that as takeover prices continually are pushed up into higher and higher ranges–and as all the gains are being transferred to the shareholders of target companies–you may have more situations like the Fruehauf situation which emerged just last week. In that case, in order to ward off Asher Edelman, the company used a whole range of defenses that culminated in a management-led LBO. And the price got so high that two and a half years later, like the general commenting about the town in Vietnam that had to be destroyed to save it, the company seems to have been destroyed. Its debt load has led to its being broken up into little pieces with gigantic transaction costs.

Now, there's no question that the Fruehauf shareholders got a good deal from this LBO, the shareholders who were bought out. But, Mr. Rowan, who was the CEO at the time, recently said (and I quote), "Personally, I think we should have let Edelman take it." The investors who bought the Fruehauf junk bonds and the management people who saw their stub equity go down the drain now realize that, in the emotional heat of this takeover, they bid far too much for the company. (And who knows what will happen with RJR-Nabisco?) They leveraged the company to the point where it couldn't stand the slightest shock in the marketplace. And when that shock came they couldn't cover the debt service and the company had to be broken up.

My point here is that, taking the macroeconomic view, a portfolio manager will say, "I'd rather have the $60 than the $64 over all my portfolio if the bidding process means that all the gains are going to be transferred to target firm shareholders and, therefore, bidders will go away. Because some bidders are going to drop out of this process.

BOIES: I'm not sure I understand what you're saying. Are you saying shareholders don't like the pill because the pill will result in too high a price for their shares?

SACHNOFF: No, what I'm saying is that over a portfolio of a thousand stocks, a rational portfolio manager is concerned about Fruehauf type of situations- because over the entire portfolio it means that bidders may be scared away. They may not make bids because the gains are being squeezed out in the bidding process.

Now it's difficult to document this argument with statistics. But this is the position of most economists looking at the economy as a whole. And the thoughtful fund managers I talk to say the same thing. In the particular takeover contest, they want the highest price for that stock. But, when they look at situations like Fruehauf where there are gigantic societal losses (not just in transaction costs, but in human costs for all the people who were laid off, for the products that had to be discontinued), they say that's bad for our economy because takeovers–and the monitoring effect of the threat of takeovers–make for more efficiency and a better allocation of resources. We have to be able to compete in the world marketplace. That's a point that none of has addressed yet, but it is crucial here. We have to be more efficient and be able to make better television sets, not just better hamburgers, than the Japanese.

FLEISCHER: This is interesting. Yesterday Marty was blaming takeovers for almost every ill in society. And today we are blaming the pill for every ill. The fact is, however, that all the pill really does is to extend the time period during which the target management can focus on alternatives. If we had a bidding period of 60 or 90 days instead of 30 days, we would end up with the same result.

In other words, what produces high prices for target shareholders is basically competition. Competition may come from the target company in the form of a restructuring proposal, or it may come from the raider, or from some other third party. The contern that bidding companies will "overpay" is not a concern that should be attributed to the poison pill. It is a concern that should be attributed to the fact that people are prepared to pay more for companies now than they ever have been.

GRUNDFEST: Art, let me tell you a story and let's see if Marty is willing to change his mind about something. About two and a half years ago, we had a roundtable at the Securities and Exchange Commission. And I think it was Bob Rubin of Goldman Sachs who said, "Look, why don't we cut out all these defense strategies and adopt a very civilized way of doing things."

FLEISCHER: We are not in favor of that either.

GRUNDFEST: Of course not. You live off the transaction crumbs. The transaction costs, the golden crumbs.

FLEISCHER: Not crumbs, not crumbs. Nuggets, nuggets.

GRUNDFEST: Forgive me, Marty. Please forgive me.

OVER A PORTFOLIO OF A THOUSAND STOCKS, A RATIONAL PORTFOLIO MANAGER IS CONCERNED THAT HIGH TAKEOVER PREMIUMS MAY SCARE BIDDERS AWAY. THEY MAY NOT MAKE BIDS BECAUSE THE GAINS ARE BEING SQUEEZED OUT IN THE BIDDING PROCESS.
–LOWELL SACHNOFF–

SACHNOFF: No one will debate Marty on that.

HARRIS: Do you realize Marty has a four-year-old daughter that hasn't gone to college yet?

GRUNDFEST: He's buying her the college.

But, to get back to my point, the proposition that Bob put forward was this. Let's get rid of all this *fol-de-rol* and instead adopt a rule that says the following: If somebody wants to do a hostile bid, they put their bid on the table. If other people want to make bids, they put their bids on the table too. There's a sixty-day period and then the stockholders get to vote on the highest bid. Management can propose an alternate strategy, a restructuring or whatever, but they can't block anybody else's bid. Why don't we run our takeover system that way?

That proposal went three quarters of the way around this big round table until it hit Marty. And Marty, very candidly I think, said, "I would be against that because management will always lose and I don't think that's the right outcome in the process."

LIPTON: I still feel exactly the same way.

GRUNDFEST: So here we have a proposition that I think is extraordinarily fair, ultimately fair. Somebody comes forward and wants to do a takeover, and puts the business proposition on the table. You keep the slate clean for 60 days, 90 days, whatever the appropriate period of time is. You say, "If anybody else can do better than that price, step forward and put your money on the table."

FLEISCHER: How easy do you want to make it to take over American companies?

SACHNOFF: We don't want to make it so difficult that we chill the market for corporate control and scare off responsible bidders. Remember, these transactions move assets to higher-valued uses and more efficient users; and that's good for the economy. So it makes good sense to reduce the transaction costs involved.

FLEISCHER: I am an agnostic on these matters of public policy. But, again, the question is: How easy do you want to make it for the major companies in this country to be sold and liquidated? That is really the fundamental policy issue. Is it enough for somebody to come in and say, "I want to buy the XYZ company and therefore XYZ must submit my offer to its shareholders?" In almost every case the company will be sold to the third party.

GRUNDFEST: I drew you out on this issue because the point that really is being made is not simply about the "fairness" of the process. I just put forward something I think people would generally agree is a fair process. What you reallywant to accomplish is to stop the bidding process from taking place, regardless of whether you would consider it fair or not.

FLEISCHER: No, not in my case. For some people it is certainly a question of a basic philosophical objection to takeovers. But, regardless of whether you support takeovers or oppose them, there is also a question of the extent to which you should facilitate them and make them easy to achieve. In my view, there is no question that institutions would be prepared to sell out at a 30%, 25%, or even a 20% premium over current value. In fact at almost any premium over market you're going to get institutional support. I question whether that is in the long-term interest of the shareholders and the economy.

LIPTON: How do you manage a company if you do not know from day to day whether your company will be put up for auction or whether the company is going to disappear?

SACHNOFF: Marty, what do you do about badly managed firms?

GRUNDFEST: Let the shareholders vote.

FLEISCHER: Some people contend that the best defense against takeover is keeping the share price high; but you have already conceded that there is no way the marketplace will ever reflect the market value for control. You recall, in the 1970s that the market was trading at seven times earnings. In today's markets the multiples are 14 or 15 times.

GRUNDFEST: Today the market isn't even trading at seven times legal fees, with the rates you guys charge.

You have misrepresented my position. I did not say that you cannot manage a company so as to eliminate the spread between its current market value and its sale or break-up value. I just said that many companies are not managed so as to eliminate that spread. But I think it can be done. If a company is well run, and its assets are being put to their most valuable current use, then the spread between current value and the "control" value will be very small. There will be little opportunity for a raider to add value in such cases,

SACHNOFF: So, Art, where do you draw the line then? I know you believe in your heart of hearts that the control market monitors public companies and helps close the gap between optimal firm value and the value of the firm as it is currently being run. A low stock price relative to a sale or break-up value just shows that the market thinks management may be doing a poor job. So, where do you draw the line on replacing inefficient management?

FLEISCHER: My experience has been that strategic buyers typically pick out well-managed companies to acquire. If you are doing a product extension acquisition, you want to pick out the leader in the field. You will have to pay a big premium for the leader. So I don't care how well a company has done; its value will still be below the amount an outside bidder is willing to pay.

THE SEC DATA SHOWS JUST THE OPPOSITE. IT SHOWS THAT BAD BIDDERS MAKE GOOD TARGET. IF YOU PAY TOO MUCH FOR AN ACQUISITION, YOU OWN STOCK PRICE WILL GO DOWN, AND YOU ARE LIKELY TO BE THE NEXT ACQUISITION TARGET.
–LOWELL SACHNOFF–

SACHNOFF: But, Art, the SEC data shows just the opposite. It shows that bad bidders make good targets. If you pay too much for an acquisition, your own stock price will go down, and you are likely to be the next acquisition target.

HARRIS: Let me just tell you something about the real world. Strategic buyers cannot compete in today's world. We just ran an auction on a very fine consumer company. Seventy people expressed interest, got the book, and looked at it. The final 10 bidders were all financial buyers, not strategic buyers.

FLEISCHER: I think that's an important point for people to understand. There are enormous pools of money in the hands of buyout groups, not industrial companies; they are the only ones who can compete in any of these auctions.

GRUNDFEST: Wait, wait. Take a look at some of the studies done of what you've been calling "product extension" mergers-which really is a polite way of saying the word "conglomerate." The evidence suggests that conglomerate acquisitions, on average and over time, are dogs. They don't work. They lose money for everybody that's involved.

And that's a result supported not only by research that looks at stock price studies, but also by guys who roll up their sleeves and look at what happens on the factory floor. Mike Porter had a terrific piece in the *Harvard Business Review* about two years ago in which he demonstrated that the vast majority of conglomerate-type acquisitions done by the largest and most prestigous corporations in the United States have been failures. And a lot of what we're seeing in the marketplace today is basically de-conglomeration, an unwinding of the conglomerate movement,

HARRIS: Wait a minute, Joe. Are they failures because they haven't worked operationally, or are they failures because Wall Street will not put a proper price on the shares of the stock of the company?

GRUNDFEST: They haven't worked operationally and therefore Wall Street values them accurately at a relatively low price.

HARRIS: I don't agree with you. I don't agree with you.

OLIVER: I think we're just about to break for the morning, but I'd like to ask a question of the audience since this is obviously an issue on which none of us is going to change our minds in the next hour or so. If you take the term "restructuring" and apply it to takeover activity in the last 10 or 15 years, how many of you in the audience believe that restructuring has been "net-net" good for the country as a matter of public policy? Please raise your hands. . . It looks like an overwhelming majority. . . And how many believe that it's been bad? . . . Not many.

Well, I can see the faculty has been doing a great job here at the University of Michigan. I just wanted to set the stage for the next 45 minutes of discussion.

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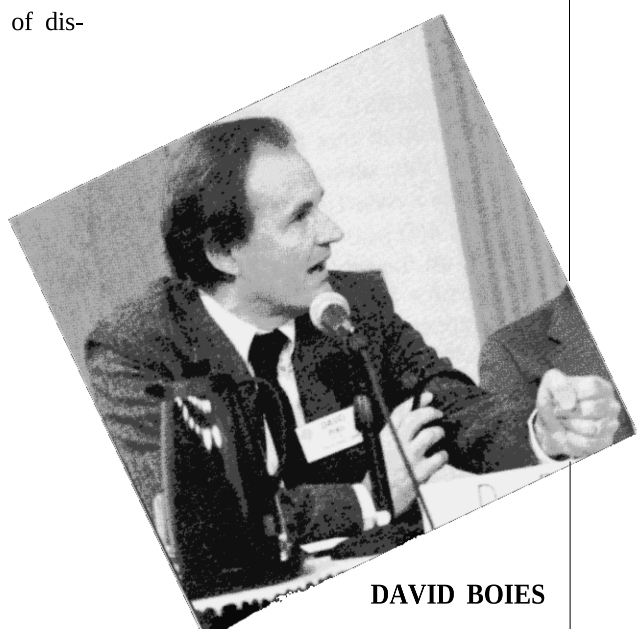

DAVID BOIES

■ I THINK THE COURTS ARE BY FAR A SECOND BEST CHOICE FOR MAKING WHAT ARE ESSENTIALLY LEGISLATIVE DECISIONS–IN THE SENSE OF HOW DO WE WANT TO ORGANIZE OUR ECONOMY? WHAT ARE OUR ECONOMIC GOAL? WHAT ARE THE BEST WAYS TO ACHIEVE THESE GOALS? I THINK THAT THESE ARE LEGISLATIVE MATTERS THAT CONGRESS OUGHT TO STEP UP TO. BUT I HAVEN'T SEEN ANY MOVEMENT THERE THAT GIVES ME CONFIDENCE THAT GIVES TO HAPPEN. AS A RESULT' WHAT YOUR'E LIKELY TO SEE IS SOME COURT ACTION. YOU'RE GOING TO SEE STATE LEGISLATURES WHO HAVE MUCH MORE PAROCHIAL INTERESTS, PARTICULARLY IN THIS AREA– RESPONDING MUCH MORE IMMEDIATELY TO THE PERCEIVED INTERESTS OF LOCAL COMPANIES THAN WOULD CONGRESS. AND I THINK THIS IS VERY UNFORTUNATE.

–DAVID BOIES–

PART III: PROXY CONTESTS AND TENDER BIDS

DeANGELO: We're going to start off on the subject of proxy contests and tender bids with David Boies. David.

BOIES: Let me begin with a couple of observations echoing some things said earlier. Proxy contests are very difficult to win unless you have a record of demonstrably bad management, a credible offer for the company on the table, or perhaps both. Shareholders are generally not prepared to replace one management group with another management group just because the second group says it is going to do a better job for shareholders. So, in order to have any kind of responsible chance in a proxy contest there's got to be some combination of a bad track record on the part of management and a credible, maybe even a cash, offer on the table.

And even then it is very difficult. In defending against a proxy contest, incumbent management is certainly going to disparage the reliability of the offer that's made. Proxy fights are also messy and expensive, in part because they're almost inevitably accompanied by litigation. As a result, the prospect for proxy contests replacing tender offers as the primary means of changing corporate control is at best very limited.

My second observation is that very little thought has gone into the nature of proxy contests. And this requires an answer to the larger question: What should we as a society be trying to accomplish by so-called corporate governance? Bob Monks made a good point when he said, "Let's not talk about shareholder democracy." Yet we always fall into the trap of asking: Is this aspect of a proxy contest democratic? How does this relate to shareholder rights?

A proxy contest is not a political contest. It is run like a political contest. It is won or lost in the same manner as a political contest. But it is not "politics" in the sense that it relates to the governance of society. It is economics. It is an issue of how we want to organize economic activity to achieve society's goals. And the kind of question we ought to be asking ourselves is this: How does this particular approach to proxy contests affect the way we want to organize our economy?

At the end of the morning session, Gus Oliver asked the audience to respond to the question, "Are takeovers good for the economy?' There appeared to be a large consensus in support of takeovers. But now I'd like to follow up on that question with two or three more questions that get a little more specific. I think that most business school audiences would support the proposition that takeovers are good for the economy. But how many in the audience believe takeovers increase the Gross National Product? . . . Not as many. . . And how many of you believe that takeovers increase employment?. . . Fewer still. . . And, finally, how many think that takeovers increase savings and investment and research and development? . . . More. But far fewer than the people that felt takeovers are "good for the economy."

Now, when we ask, "Are takeovers good for the economy?," we also have to ask ourselves what we mean by "good" and what we mean by "the economy." People talk about takeovers as being good for the economy if they can show that it increases shareholder returns. However, increasing shareholder returns is a goal in itself only if we believe that shareholders (and, particularly, shareholders of target companies) are deserving of a redistribution of wealth–a dubious proposition. Increasing shareholder returns through takeovers is good for the economy only if increasing returns in that way will somehow benefit the economy more generally. And I think there has been insufficient attention to the consequences not just to shareholders, but to the economy as a whole of either increasing or restricting takeover activity.

You've heard some people say that poison pills are going to make it difficult for us to compete with Japan, and others say that takeovers are going to make it difficult for us to compete with Japan. But there is little evidence or analysis to support either proposition. We need to determine, as a matter of national policy, the answers to two questions: first, what are our economic goals as a nation? and,

IF PROXY CONTESTS ARE GOING TO PLAY THE ROLE OF BEING A SAFETY VALVE FOR RESTRICTIONS ON TAKEOVER ACTIVITY, THEY ARE GOING TO HAVE TO BE MADE EASIER AND MUCH LESS COSTLY TO ACCOMPLISH.
– DAVID BOIES –

second, how do takeovers either advance or retard the achievement of those goals?

Now, if we conclude that takeovers interfere with long-run planning, long-term investment and research and development, then there's nothing a fortiori wrong with interfering with shareholder rights to accomplish those goals. We do that as a matter of economic policy all the time. We are always making decisions as a society that we will regulate, encourage, or give incentives to business when we think that will have a beneficial effect.

And when you're dealing with matters of economics, the right question is not, Is it shareholder democracy? (because, as Bob Monks says, "We don't have one person-one vote"), but rather, What is going to be the effect on the economy? What are we trying to accomplish by proxy contests? Are we trying to make it easier for shareholders to replace management? And if so, under what circumstances? And how easy do we want to make it?

Now, having said this much, let me return to my first point. If proxy contests are going to play the role of being a safety valve for restrictions on takeover activity, they are going to have to be made easier and much less costly to accomplish. On the other hand, even if you do succeed in transferring the vote from a tender offer to a proxy contest, I'm not sure you've really accomplished that much. Making proxy contests easier to accomplish will have far less effect on how many takeovers are undertaken than, say, abolishing the $15 million Hart-Scott-Rodino level that prevents acquirers from accumulating a bigger stake quickly and without first disclosing their holdings (and thereby increasing their costs of acquisition). If you eliminated that rule, then at least the initial bidder would get some profit from undertaking the investment if another bidder came in and acquired the company.

So, there are a lot of factors that restrict the level of takeover activity other than the difficulties in the proxy process. And until we as a nation decide how much takeover activity is desirable, the provisions of the proxy contest are likely to stay pretty much where they are now. It is very difficult to oust incumbent management through a proxy fight. It is far easier to buy the company than it is to win a proxy contest. And it is particularly difficult to win a proxy contest unless you are prepared to buy the company and then let your offer sit out there for the extended period of time it requires for the proxy contest to run its course. So, again, unless you've had an opportunity to acquire a sufficient stake in the company so that you can profit from another outsider coming in and driving up the price further, people now have very little incentive to initiate proxy contests.

SACHNOFF: David if you could change the rules and make proxy contests easier, what would you do? Because proxy fights seem like a better, simpler, more cost-effective way of achieving more efficient management or better allocation of resources. If you were writing the rules, would you change them in any way?

BOIES: Well, let me say that the biggest disadvantage to the outsider is that the insider has the full panoply of the corporate bureaucracy, if you will, at his disposal. One thing that might be done would be to make some of the resources of the insiders available to the people waging the contest. For example, there are rules giving access to shareholder lists, but you typically can't get a lot of the analytical breakdowns of the shareholders lists that companies maintain, which make the lists much more useful.

OLIVER: One thing that people probably don't fully appreciate-in fact, I think they would find it extraordinary if applied to our normal political process-is that the incumbents get to use the corporate treasury not only to wage the contest in their favor, but also to conduct litigation and otherwise make it very expensive for the insurgents, who are footing the bill entirely themselves. And if the insurgents own stock, then they are indirectly footing part of the costs that are being incurred to fight them. That alone is a tremendous deterrent to a proxy contest.

WILCOX: David, I think you raised a very important question. These questions of proxy contests and takeovers ought to be looked at in a wider framework as to how they advance some societal objective. At the end of the first session, Marty and Art were saying that it might be too easy, given our current jerrybuilt system, to take over any company in America. The question I would have is this: Who ought to make that determination whether it's too easy or not? I think the notion that it would be made by the corporate bar of the City of New York is probably a preposterous one. But, in your view, where ought this dialogue to be carried on?

BOIES: I think that, for a matter of economic policy like this, it ought to be the Congress. Obviously the executive branch has some role. But, in the absence of Congress, the issue will be decided in the courts. I think the courts are by far a second best choice for making what are essentially legislative decisions – in the sense of how do we want to organize our economy? What are our economic goals? What are the best ways to achieve these goals? What kind of trade-offs are we prepared to make? I think that these are legislative matters that Congress ought to step up to. But I haven't seen any movement there that gives me

THE COMPANIES THAT DO INVEST IN LONG-RANGE PLANNING AND R&D, IT TURNS OUT, ARE NOT THE TAKEOVER TARGETS IN OUR COUNTRY. PEOPLE DON'T LIKE TO READ THIS DATA BECAUSE IT DOESN'T SQUARE WITH THEIR INTUITIVE CONCLUSIONS.
–LOWELL SACHNOFF –

confidence that's going to happen. As a result, what you're likely to see is some court action. You're going to see state legislatures–who have much more parochial interests, particularly in this area–responding much more immediately to the perceived interests of local companies than would Congress. And I think this is very unfortunate.

GRUNDFEST: I think there's an even better alternative for resolving these issues and that's one that relies on the mechanisms of self-governance. What we're talking about here are the rules that govern the operation of a corporation. I think the people that are best situated to make these rules are the stockholders and the management of that company. There is no reason, whether grounded in logic or experience, that every company in America needs to be governed by the same rules in the operation of a contest for corporate control. Companies are differently situated and there are good reasons why it should be made easier to take over some companies than others.

OLIVER: In the same vein, take the classic argument that takeovers lead to a reduction in R&D. I'm not sure that's an accurate statement, but let's accept for the moment that cuts in R&D are an outgrowth of takeover activity. In that case, I don't think the solution is to stop takeover activity. Maybe the solution is instead to legislate additional R&D expenditure. If you're talking about trying to focus on public policy, competitiveness with Japan, and other larger concerns, then why don't we focus directly on these issues instead of confusing them with issues of corporate control?

BOIES: I think that's a relevant point. I think that's the kind of point that ought to be addressed by Congress.

OLIVER: I'm sorry, I thought you were heading in the direction that Congress ought to limit or prohibit takeover activity.

BOIES: I don't have a firm personal view as to how good or how bad takeovers are. But I think we've got to focus as a matter of national policy on determining what our economic goals are–and on how takeovers affect those goals, if at all. And I don't think we're doing that. Instead we're getting a patchwork created by people pursuing essentially parochial interests and influencing a variety of courts and chancellors and local legislatures and administrative bodies. We're not having people focus on how these things relate to the public interest. And, unlike Joe, I don't think the solution is strictly a matter of shareholder voting. We don't allow the shareholders of airlines to determine how the airline industry is going to be regulated.

HARRIS: But you know, David, there is something missing from this discussion. I come from Chicago, too, so maybe I'm a little inclined to let the free market work out these issues for itself. What is behind all this takeover activity and the surrounding issues is something that we're not talking about–which is corporate leverage, the availability of debt. As long as people can borrow 90% of the purchase price, and as long as they can deduct the interest, and as long as S&L's put out cheap dollars, the risk-reward ratio is pushing people to use ever more debt.

As a result, I think the best regulator of a lot of this activity is going to be higher interest rates and a recession. Then banks and S&Ls and insurance companies will start to take some losses, and then they will cut back on their lending for takeovers.

BOIES: I agree with that completely.

HARRIS: A few more Fruehauf bankruptcies that took place right in the backyard here will slow down this activity.

BOIES: And if you eliminated the double taxation of dividends, or at least made dividends and interest comparable in some way, I think you'd have a halting effect there, too.

SACHNOFF: Yes, but let me return to my earlier point. The fund managers, the people who run these institutions and have these huge holdings, would truly take a little less for their stock in target companies if they were certain that in doing so they would stimulate more bidding. More bidding for inefficient companies would lead to better allocation of resources and better management.

HARRIS: Lowell, the difference between a loyal institutional shareholder and an unloyal institutional shareholder is an eighth of a point cash.

SACHNOFF: If that were really true, the argument about R&D would show that institutions shy away from companies that put money in R&D. Because, after all, that depresses short-term earnings. But, once again, the free market seems to work pretty well in that area. The companies that do invest in long-range planning and R&D, it turns out, are not the takeover targets in our country. It is the undermanaged companies that are looking to short-term profits and that don't put money in R&D that become targets. And there's a lot of good data from the SEC to support that. People don't like to read this data because it doesn't square with their intuitive conclusions. But the truth is the market works reasonably well in that area.

But I also think that David's point is well taken. Some higher authority, whether it's Congress, or maybe Joe would think it's the SEC, has to look at the macro issues here and determine whether. . .

GRUNDFEST: I don't think it should be the SEC either. Believe me.

SACHNOFF: I think it might have to start with the SEC to stimulate this debate on a national level.

GRUNDFEST: I've got no problem stimulating debates.

SACHNOFF: But where's it going if you don't get a reaction from any of the institutions other than the courts, which look at things only on a case-by-case basis. This process forces us lawyers to do something which we're sometimes uneasy doing–that is, just looking out for the narrow moneyed interests of our clients and the hell with the larger consequences. That's not such a good thing.

GRUNDFEST: Well, as I said before, I think the best system we could move to would be one that relies more on self-governance and that lets each organization craft a set of rules that is best suited to that organization.

Now, as a practical matter, for reasons that Marty's already pointed out, there are a lot of companies that wouldn't like that because they don't like the rules that they would wind up having to live with. People are very goal-oriented in this whole process. If you put a proposal on the table and the proposal is eminently fair, but it doesn't give you the goal that you want, you're going to oppose it. That's why we've got gridlock in Congress. There's a blocking coalition that's able to prevent the passage of any change in the Williams Act under current circumstances because everybody sees their ox being sufficiently gored that they're not going to move forward.

I'm not calling for additional power to be given to the SEC because I understand how administrative agencies operate. I studied them before I came to the SEC and now I've been part of it and I continue to hold the belief. It's a very volatile environment. Who's going to be the SEC five years from now?

SACHNOFF: But what institution is really going to look at these issues and come up with some overall economic perspective that shows us where the public interest lies?

GRUNDFEST: The best institution is the individual corporation, which is composed of the stockholders and boards; and they can self-govern. It's the philosophy of federalism applied in the corporate environment.

FLEISCHER: Joe, there is no evidence that the market for corporate control is not really functioning properly. In my view, the fact of a frustration about regulation, and that Congress has been looking at these issues for the last five years without coming up with new regulations, really reflects the inconclusiveness of the data. Whatever one says about the Chicago school share price data on takeovers, it is inconclusive; nobody feels that there are definitive answers.

When we talk about focusing on what the takeover movement has done, let me remind you that the modern takeover movement started in the mid-1970s. Major U.S. companies were not the subject of takeovers until the early to mid-1980s. On the other hand, the United States lost its dominant position in the automobile industry, in consumer electronics, and in other industries long before the takeover movement. It is clearly not the takeover movement that has caused some of the fundamental problems of American industry. I think we ought to focus on the underlying economic issues, and not blame takeovers for problems with the American economy.

GRUNDFEST: Art is absolutely right on the R&D situation. If you want to understand why Japanese companies invest more for the long term than in the U.S, the dominant cause is the difference in real cost of capital. The real cost of capital in Japan is approximately half of what it is in the U.S. If we cut our capital costs in half, I guarantee you would see a sharp upswing in our R&D spending. People who are trying to use differences in R&D as a reason to stop takeovers are really wrapping themselves in the flag.

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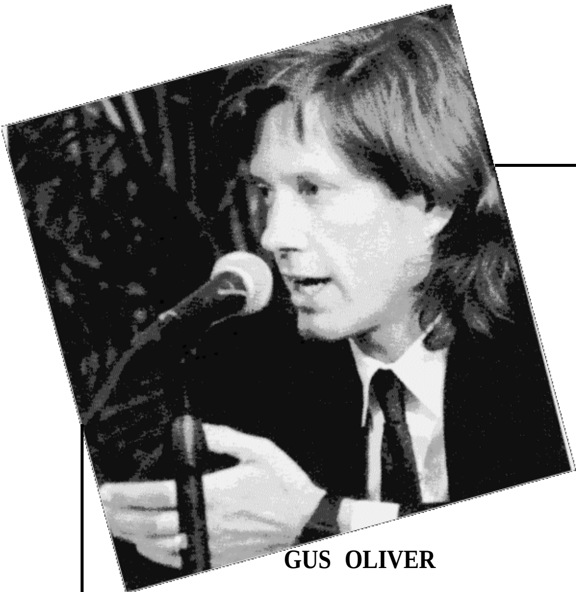
SO WHEN YOU SAY, AS A DIRECTOR OR AN OPERATOR, YOU BELIEVE THAT YOU'VE GOT SOMETHING IN PLACE THAT'S MORE VALUABLE THAN THE MARKETPLACE IS GIVING YOU CREDIT FOR, THEN I'D SAY YOU HAVE AN OBLIGATION TO TRY TO DO SOMETHING ABOUT THAT. AND I THINK TOO FEW MANAGEMENTS AND DIRECTORS DO ANYTHING ABOUT IT.
–GUS OLIVER–



GUS OLIVER

PROXY CONTESTS: COUNTERPOINT

DeANGELO: Let's give Gus a shot at the proxy contest issue.

OLIVER: I want to talk a little about a particular topic that I don't think we've really touched on yet. The central issue we've been talking about here today is the role of the board of directors in trying to manage the public corporation -which, today, is certainly the dominant form of American business.

In the corporate structure, as it was originally set up, the board of directors is elected by stockholders; and the body of law that's been built up over the years suggests that directors have a fiduciary responsibility to stockholders. In recent years, however, there has been a movement towards expanding the concept of fiduciary obligation beyond stockholders. The directors are increasingly seen as having a responsibility not only to the stockholders but also to "other constituencies." In the broadest sense, those constituencies extend to the nation as a whole-and even, in some cases, to the entire world. So, boards are now in some sense being forced to weigh the effect of their decisions on the collective well-being.

You can work back from these larger interests to more narrow ones- to localities where the corporation is particularly active, to employees, to suppliers, to customers, and the list goes on and on. There have been some state statutes which have been promulgated to enact, in effect, a concept of fiduciary responsibility that extends beyond stockholders to these groups. But, this raises questions: To what extent should the board's responsibility to other constituencies outweigh its responsibility to stockholders? How do directors come to grips with the fact that there are these other constituencies out there?

I do think, as a general proposition, that other constituencies are important. And I say that both as an activist shareholder and as a believer that shareholders, as the owners of the corporation in a capitalist society, ought ultimately to be the ones who make the determination as to the direction of the corporation. However, there are a lot of other important concerns in running a corporation besides shareholders. There are employees. Clearly, in order to build a corporate enterprise with people running various elements of it, you need to foster a system in which their contribution is encouraged and some opportunity is provided for them to expand and grow within the corporate enterprise. You need to establish stability with suppliers. Depending on the kind of company you are, you certainly need to establish some kind of a vision or appeal to customers. These requirements shouldn't be pushed aside at the whim of somebody from the outside.

However, having raised this question about the treatment of other constituencies, I will now try to answer it from the perspective of a potential acquirer of a corporation- and also from the perspective of a stockholder who would like to sell stock to the potential acquirer of a corporation. I think that people who buy companies have those other constituencies in mind as well. In fact, they must have them in mind if they want the company to succeed after the takeover.

But I also think that, all too often, the argument that there are other constituencies is used as an excuse for boards not to be responsive to their stockholders. If you asked the average director whether employees, customers, suppliers, or the local mayor ought to have a voice in board decisions about the future of the company, their answer would be, "Absolutely not." Directors do not want other people telling them what to do. But, when a group of stockholders comes in from the outside and says, 'You, Mr. or Mrs. Director, ought to change your corporate policy," then all these other constituencies suddenly become very important. The protection of their interests becomes the principal excuse for the board's refusing to take the action recommended by the stockholder group.

FLEISCHER: In my experience, most boards have a clear concern about employees. I am not talking just about senior management; I am talking about employees. Directors are concerned with what is going to happen to the communities in which the company does business. However, I think that, as a practical matter, the most important consideration in the directors' minds relates to shareholder concerns. In my experience, although boards are very concerned about non-stockholder constituencies, they certainly do not use these concerns as a shield to hide behind.

OLIVER: Well, Arthur, if that's the case, then why isn't it an appropriate response to an all-cash bid by a responsi-

YOU WILL GET QUICKER NEGOTIATION AND A HIGHER PROBABILITY OF AGREEMENT BETWEEN THE BIDDER AND THE TARGET IN THOSE TRANSACTIONS IN WHICH THE OTHER CONSTITUENTS HAVE THE LEAST AT RISK—PRIMARILY THE EMPLOYEES.

–MARTY LIPTON–

ble bidder to negotiate with that bidder? Why not have a discussion, a negotiation?

FLEISCHER: To focus on the strategy and not the policy, the best strategy for negotiating is often by not negotiating at all. That is the way you are going to whet the acquirer's appetite and get him to pay the highest price.

OLIVER: Art, I guess I just don't agree with that. I think that Marty, for all his opposition to acquisitions, represented Kraft in a situation I think was handled quite admirably. . . remarkably enough.

FLEISCHER: I agree with that. I thought it was handled splendidly on all sides.

LIPTON: In Kraft, we did just what Arthur advised, we did not negotiate. First they had to pile a lot of money on the table before we would even agree to talk to them.

OLIVER: Well, I don't know what was going on behind the scenes. But, as an unschooled observer, I saw an initial bid; and then I saw two weeks go by in which presumably there were discussions taking place; and then I saw a final bid at a very high price.

FLEISCHER: No, that is not what happened, and I think that what Marty just said reflects what happened. In other words, Kraft communicated an outlandish number that they knew Phillip Morris would not respond to. Basically they were seeking to put pressure on Phillip Morris to increase its bid before Kraft would sit down and have a discussion. But there were no other side discussions going on.

OLIVER: Be that as it may, the process took about two weeks as I recall.

FLEISCHER: There were a lot of reasons why it happened quickly.

LIPTON: You were going on vacation, Arthur.

OLIVER: Well, okay. I won't attempt to delve. But I think there are too many situations in which the process drags on to the detriment of stockholders and these other constituencies as well; and it's not clear to me that a higher price does, in fact, result from that activity. I think that there are plenty of examples in which very high prices are negotiated right at the outset or in a very brief period of time.

FLEISCHER: Well I agree with that, Gus. But one of the points the courts have made -and I think there is a lot of sense to this-is that a board can apply its business judgment to the process of negotiation. Thus, the board can detide in each individual instance whether they want to negotiate, whether they want to sell the company, and, if they do, what kind of process they want to go through. It may be in some cases you move in immediately and negotiate and in other cases you may hold tight. You could be right or wrong, but that is what business judgment is all about and you should have the freedom to make those kinds of choices,

LIPTON: In my experience, the deals that move the quickest and result in negotiations between the original bidder and the target are those in which it is quite clear that the target's other constituencies are not in danger.

OLIVER: I think that's questionable, Marty.

LIPTON: You will get quicker negotiation and a higher probability of agreement between the bidder and the target in those transactions in which the other constituents have the least at risk-primarily the employees.

OLIVER: We'll see what happens, Marty, but I find it hard to believe that when Philip Morris acquires Kraft, there aren't going to be some Kraft employees who lose their jobs.

GRUNDFEST: But, even if that's the case, Marty, is that good social policy?

MONKS: Joe? Concerned about "social policy"?

GRUNDFEST: I was trying to get him to answer the question instead of just barking at me. I figured I'd talk language he understands,

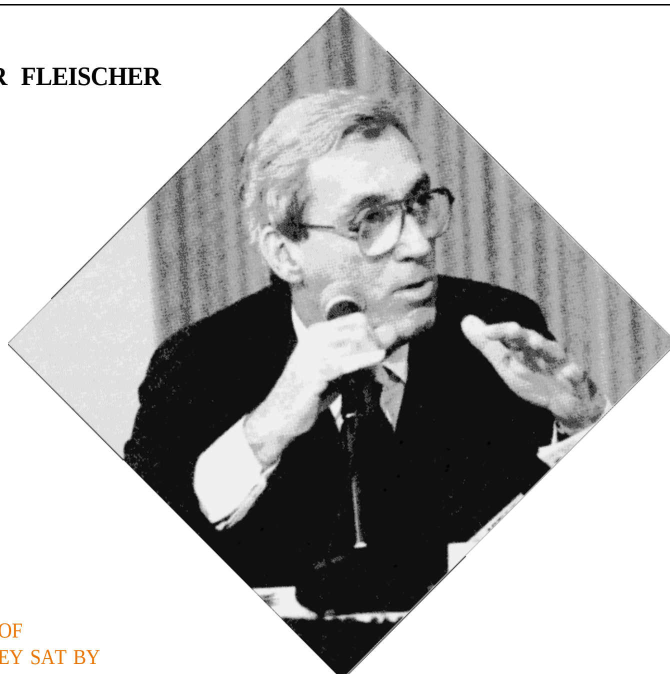
LIPTON: I did not say it was good social policy. Joe, all I am saying is that in response to the question of the other constituencies, we have an academic theory about the interests and incentives of boards of directors, and we talk about what happens in each individual situation. The anecdotal information that we have just doesn't square with the academic theory. In real life, boards do not act irresponsibly either towards shareholders or to the other constituencies.

SACHNOFF: Marty, do you think that the business judgment rule has been distorted beyond all recognition from its origins in the way it's been applied to takeover cases?

LIPTON: Yes. And I think *Unocal* never should have been decided the way it was decided.

SACHNOFF: The business judgment rule developed as a means of protecting directors against bad business decisions. Because courts don't know a lot about business. They know a lot about things like fairness and unfairness and conflicts of interest and the like. But when it comes to making widgets or gadgets, or whether you should invest in diesel engines or gas engines, if corporations and managers make a mistake, then they ought to be protected by the business judgment rule-because that's the business of the firm. But I question whether the business judgment rule has a proper application when the principal issue is whether a shareholder is allowed to accept a bid of $60 for his stock when the pre-bid price was $39. What does that really have to do with the business of the corporation? That was not the way the business judgment rule and the fiduciary obligations of directors were intended to develop. It just doesn't seem like business to me when a shareholder is told, "You can't sell the thing you own."

ARTHUR FLEISCHER



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I HAVE TOLD BOARDS OF DIRECTORS THAT IF THEY SAT BY AND LET A THIRD PARTY ACQUIRE CONTROL IN THE MARKETPLACE THAT'S ALMOST A PER SE ABDICATION OF THEIR RESPONSIBILITY AS DIRECTORS IN SO DOING THEY HAVE FAILED TO MAKE THE ACQUISITION PREMIUM AVAILABLE TO ALL THE SHAREHOLDERS.
–ART FLEISCHER–

PART IV: THE ROLE OF SPECIAL COMMITTEES

DeANGELO: I think that may a useful note on which to ask a different question–whether special committees of independent directors might be one sensible response to the problem of management's conflict of interest in responding to takeover bids. So let us turn now to Art Fleischer.

FLEISCHER: In certain critical circumstances, special committees of outside directors are now essentially taking control of American corporations. Most notably, if the management of a company makes a leveraged buy-out proposal, a group of directors, typically directors unaffiliated with management, will band together with the express purpose of evaluating management's proposal to acquire the company. At the end of this process, the special committee makes a recommendation to the full board of directors.

If you think about it conceptually, the special committees are the ultimate expression of the power of the outside directors. In effect, the outside directors are given responsibility for determining the future of the company. Under ordinary circumstances, management makes the business decisions and the board's responsibility is simply to supervise management. But, in cases involving special committees, the board is separated from the management; it no longer can rely on management. The committee chooses its own advisers, both legal and financial. Recognizing that management now has a conflict of interest in buying the company from its stockholders, the outside committee assumes complete responsibility to the shareholders and to the other constituencies.

The purpose of forming a special committee is to create, as far as is practicable, both the appearance and the substance of an arms-length negotiation with the management group. This process has basically been created by the Delaware common law, which says that, in this context, the law demands "entire fairness." And "entire fairness" means fairness

both as to the price being offered and the procedure for negotiating the sale of the company. As I mentioned, the independent committee selects their own advisers and lawyers. Moreover, when the shareholders vote on the management proposal, the directors may negotiate that a majority of the minority shareholders-unaffiliated with the buyer–must approve the offer. For example, if the management owns 20%, the outside board can require that at least half of the other 80% of the stockholders approve the transaction.

I would suggest, however, that this model of corporate governance is only appropriate in the event of a direct conflict with the management. It is obviously used in situations such as determining management compensation, where the board sits by committee. The format is clearly appropriate in a management buyout proposal. I do not believe that it is appropriate for the directors to isolate themselves in the normal takeover transaction.

A special committee is often composed of all of the non-management members of the board, but it doesn't have to be. It can be a subset of those non-management members. It certainly should not have anyone who has a financial interest in the transaction, whether as an investment banker or a commercial banker. As I stated earlier, it is important that the committee select its own advisers, including its own counsel and its own investment bankers. And that means not simply taking the recommendation of the management. The management can recommend advisers, but the committee must go through the process of interviewing and making their own selection of whom they think should be representing the company.

If the management makes a buy-out proposal and a committee is established, the committee has essentially three choices, the same choices that the board would have. First, it can reject the proposal and recommend that the company continue on its course as a public company. Second, the committee can recommend a sale to the management group or to others. Third, the committee can recommend that the company be restructured. Under the business judgment rule, the committee has the flexibility to make any of these choices.

The critical premise behind this procedure is that the directors are well-informed-because the basis of the business judgment rule is informed judgment. The management is not actively assisting the board; they will report to the committee as the committee chooses. However, it is the outside advisers who have to make sure that the board is getting the appropriate information. That means, for example, obtaining all the data that has been furnished by the LBO group to the banks. Moreover, the management must give access to any other group that is interested in making a bid, so that there is no favoritism shown to the management group. The committee must also obtain assurances and advice from the financial adviser, which involves a two-fold responsibility. First, is the price fair? And second, is the transaction feasible? What does "fair" mean? "Fair" means that the banker employs all the standard analyses of value including LBO value, third party sale value, and restructuring value. The banker goes through these analyses with the board and advises the board whether the price is in the range of fairness. "Feasible" means the transaction can be done. Leveraged buyout transactions are almost invariably conditioned on financing. Therefore, the board does not want to enter into a transaction unless it is confident the transaction can be financed.

GRUNDFEST: Art, let me take up what may be a fine point. Some advisers and committees have drawn distinctions between the "fairness" of a bid and the "adequacy" of a bid. In your mind, is that a legitimate distinction?

FLEISCHER: Very legitimate.

OLIVER: Just a second, Art. I want to make sure all you prospective investment banking candidates in the audience are listening very carefully to this line of reasoning. This is important.

GRUNDFEST: Yes, we're about to get deep into the fine print here.

FLEISCHER: That is right. When a third party makes a bid for your company, the question is, "Is the price adequate?" This simply means–is that the best price you can get, or can you do better? For example, if Joe came in and wanted to buy my house for X amount of dollars, I would not sell him my house unless that was the highest price available. Fairness is a term that means the range of values within which a company could be sold in a third party transaction or in an LBO. So I think a price can be "fair" but not "adequate."

GRUNDFEST: Will independent committees approve transactions with management where the price is fair.

FLEISCHER: Part of the process has to be that the special committee negotiates the price. The committee in this context has to be active, not passive. That means the directors have to use valuation techniques to assure themselves that the price is within the range of what should be obtained.

Can you enter into an agreement without having auctioned the company off or having gone to third parties? The answer to that, in my view, is yes.

GRUNDFEST: But what I hear you saying is that in a deal with a company's management, you've got no problem approving a price you see as "fair." But if that price was offered by a third party, you would oppose it as "inadequate."

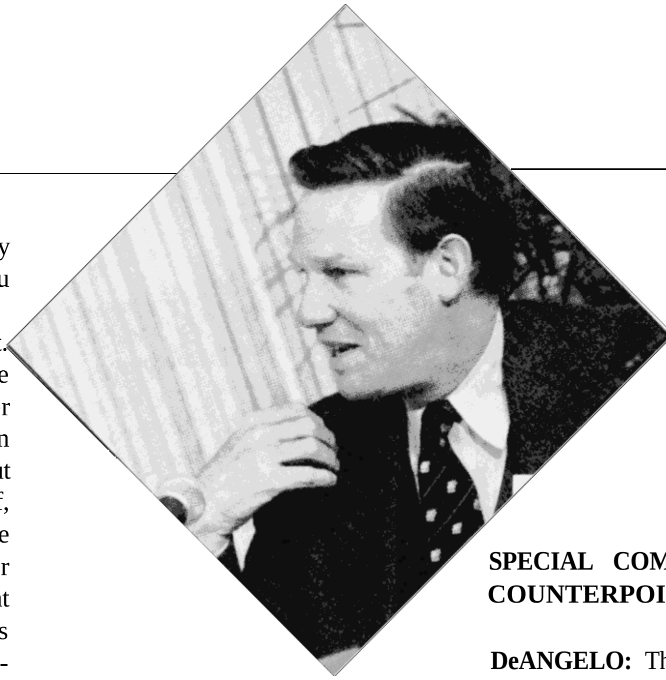
FLEISCHER: I didn't say that.

GRUNDFEST: I know you didn't say that. You don't want to say that. You danced around it.

FLEISCHER: I pirouetted around it. What we are focusing on here is the fundamental question as to whether the board, before entering into an agreement with a management buyout group, has to auction the company off, or choose any other technique designed to ensure that shareholder value is maximized. I would say that, at the present time, the state of the law is that you do not have to conduct an active auction for the company; but, at the same time, you must be receptive to the possibility of other bids.

What does that mean? If you enter into a merger agreement with a third party, that agreement, in and of itself, is not necessarily a deterrent to a third party coming in. Typically, third parties can obtain access to company data and the opportunity to negotiate with the committee. In sum, the independent committee is not going to endorse a management buyout unless (1) it is assured that it is feasible, (2) it believes that the price is fair, and (3) it is receptive, at a minimum, to other parties coming in and getting information and being able to negotiate. Indeed, if the committee receives a higher offer, typically it can terminate the agreement with the management.

The state of the law is, to be sure, in constant flux. Chancellor Allen, who is the leading exponent in discussion on poison pills, is also the major commentator on this question of when and whether a company has to be put up for auction. I do not think Delaware has yet arrived at the point where it imposes a mandatory duty on the committee to actively seek out third-party buyers.



ROBERT MONKS

ANY REPUTABLE PERSON LOOKING AT THE INVESTMENT RETURNS FROM THE EQUITY PORTION OF ERISA PLANS SINCE 1974 WILL CONCLUDE THAT THE ACTIVE MANAGEMENT OF EQUITY SECURITIES HAS ADDED NO VALUE WHATSOEVER. THAT IS, IF ALL OF THE ERISA PLANS HAD PUT THEIR MONEY INTO AN INDEX FUND, FROM THE BENEFIARY'S POINT OF VIEW, IT WOULD HAVE MADE ABSOLUTELY NO DIFFERENCE INDEED, THEY'D BE MARGINALLY BETTER OFF THAN THEY ARE NOW.

–BOB MONKS–

SPECIAL COMMITTEES: COUNTERPOINT

DeANGELO: Thank you, Arthur. Now we will turn it over to Bob Monks.

MONKS: Well, if you will recall, a few hours ago I asked you to be witnesses that institutional shareholders would be the designated enemy. And, as I predicted, they have indeed come in last. From whose perspective should takeover questions be addressed? We have seen focus on almost every viewpoint but that of the owners. What can justify restraint on his capacity to sell to a willing buyer at a mutually agreeable price?

So, let me take this opportunity to talk about institutional shareholders and who they are. There are some major misconceptions here. And after dispelling them, I will describe a genuine problem that I feel underlies all the discussion we've had and then I will close by proposing a possible solution to that problem.

Institutional shareholders, as you've been told, own some 50% of the total outstanding stock. The trouble is that, when you use the word "institutional shareholder," it seems to have a unity, a suggestion of the monolithic about it that belies the utter differences among the various people. The University of Michigan is an institutional shareholder, Fidelity Mutual Fund is, the Episcopal Church is, the California Public Employee Retirement System is, and so is the retirement system for General Motors.

THE FACT IS, IT DOESN'T MAKE SENSE FOR A SHAREHOLDER TO SPEND HIS TIME AND ENERGY TRYING TO BE INFORMED AND INVOLVED BECAUSE IF HE DOES THAT HE, OR HIS BENEFICIARIES, BEAR ALL THE EXPENSE AND THE ONLY RETURN HE GETS IS A PRO RATA SHARE OF THE REWARD.
–BOB MONKS–

Each of these institutions is governed by different laws. They have different fiduciaries. They have different beneficiaries. They have different investment objectives. They have different risk appetites. They have different competencies.

The institutional shareholders about whom I want to talk specifically are the pension funds. I want to talk about the pension funds because, first of all, there's a single governing law, which is ERISA. Everything in Washington has an acronym and ERISA is really the acronym for "Every Rotten Idea Since Adam." The ERISA law has the virtue, if you will, of having been a pre-emptive piece of federal legislation. So every employee benefit plan over all the 50 states is governed by ERISA, which is administered, as far as the fiduciary responsibilities are concerned, by the Department of Labor.

Pension plans own about 20% of all the equity capital of all the companies in America. They are a particularly useful place to focus because the beneficiaries of pension plans are relatively homogeneous. Who is a beneficiary of a mutual fund? They're everybody. But the beneficiary of a pension plan is somebody who, on average, is going to be waiting 18 years until they retire. They want to retire with real income. They want to retire in a country that's clean. They want to retire in a country that's law-abiding. They want to retire presumably in a country that's administered by Americans. It should thus be possible, in contemplating the scope of the fiduciary obligation of someone acting as owner of companies for pensioners, to formulate an investment policy that addresses these fairly homogeneous concerns and goals.

Now, the difficulty has been that there is no way in which owners can act collectively. The problem is that each investor-no matter whether you're the Public Employee Retirement system of California or simply an unaffiliated individual–constitutes such a miniscule portion of the outstanding stock of a company that economists have described the typical shareholder as being "rationally ignorant." (Economists, incidentally, for inflicting such atrocities upon the English language, have much to answer for when they go the Pearly Gates.) But the fact is, it doesn't make sense for a shareholder to spend his time and energy trying to be informed and involved. Because if he does that he, or his beneficiaries, bear all the expense and the only return he gets is a pro rata share of the reward. Or suppose he's really right, and he adds a lot of value. He doesn't get paid any more than somebody who does nothing. But suppose he sticks his neck out and does something other people don't do and he's wrong. He gets surcharged for everything.

Now, you might argue that there's something wrong with a system that has half of the GNP in the hands of risk-averse fiduciaries. And I won't quarrel with that. I do think there is a genuine problem here.

Let me show you the trap that confronts people who manage pension funds. The trap is this: If a fiduciary owns stock worth $40 and if anybody (not just nice people like Gus) comes along and offers $50, what is the risk-averse fiduciary going to do? Well, he goes back to his analyst and says, "What is the stock worth?" The analyst says, "It's a $3 100 stock." "Terrific. When's that going to take place?" "Five years from now," the analyst says, "assuming a compound rate of growth of X percent. It's a very acceptable, indeed it's a wonderful holding." Then the risk-averse fiduciary says, "Well, is it legal not to tender?" "Oh, yes," the analyst says, "Everybody's always said that there's no legal obligation. You can take the long-term view."

After this conversation, the fiduciary sits down and thinks, "Who's paying me? And what's going to happen? On the up side, if I'm right and the stock goes up, then that's fine. But suppose, in the next five years, we have war? Suppose the dollar gets devalued? Suppose this company goes to hell for reasons I don't know anything about? As a fiduciary, I am really the guarantor that, whatever happens, that stock is going to go from 40 to at least 50. So holding is one option. But the other option is to sell for 50 and look pretty good.

Now, what is a fiduciary going to do under those conditions? I don't care if he is the archangel Gabriel, he is going to tender his stock because he has no incentive to do otherwise. And I think that's the core of the problem. We have a situation where the preponderant owners are caught in a paradigmatic contruct in which they're virtually obligated by practical considerations to tender their stock. So, in effect, a determination has been made that American companies are really on the auction block because the majority shareholders are sitting there as people who, as a practical matter, are compelled to tender.

Now, I have a rather heretical suggestion. And this heretical suggestion I tender to you, in a spirit of mutual discussion, as the second worst alternative (the worst alternative being the present situation). What I propose to you is this: Any reputable person looking at the investment returns from the equity portion of ERISA plans since 1974 will conclude that the active management of equity securities has added no value whatsoever. That is, if all of the ERISA plans had put their money into an index fund, from the beneficiary's point of view, it would have made absolutely no difference. Indeed, they'd be marginally better off than they are now.

Well, if the object of a pension policy and of ERISA is to create value for beneficiaries, and if an active investment policy has created no perceptible value over time–and given that the huge volatility caused by buying and trading has also created a lot of problems in the functioning of exchanges–I would suggest to you that if pension funds were only allowed to invest in marketable equities through the medium of an index, we would have gone a long way toward solving the underlying problems I described.

People will be horrified by this proposal. A lot of friends of mine make an enormous amount of money as active managers of securities. Now, I will say I wouldn't have a mandate that says pension plans *must* follow this policy. But I would simply say it's a safe harbor. I would say that, if you invest the equity portion in an index that, from a fiduciary point of view, this investment would constitute "substantive prudence." In effect, this would mean that anybody could hire a manager and take the chance that the manager can do what he is being paid to do-namely, outperform the index. But it would be a little sporting in terms of creating more risk in failing to do so.

What I think this proposal might accomplish would be to take the largest block of highly volatile institutional stock and make it a permanent holding. People have talked, books have been written, and much agreement has been had in this country to the effect that what we need are permanent shareholders. My friends, we have permanent shareholders. They are the pension funds. It is possible to do this with no new legislation. Now, if the pension funds became permanent holders, they then could become good shareholders. It then would be rational for them to be active rather than passive. Because if they can't make money buying, selling, and trading securities, the only way they can make money is by involving themselves as intelligent owners of the companies in which they're invested. And that is the legitimate theory of capitalism which, unfortunately, has been in disarray for the last 50 years.

GRUNDFEST: You've solved buying and you've solved selling. But you left out two words: tendering and voting.

MONKS: Oh, but in terms of voting they would become very active. They would become "rationally" involved.

GRUNDFEST: In other words, when somebody comes along and makes a tender offer, they then have to become active. They have to decide whether to tender or not.

MONKS: I don't think so because if you think about the obligation of an index manager, an index manager has to ape the index. He doesn't make an independent decision about tendering.

OLIVER: I think there's actually another practical problem. One reason the institutional vote was so low in the Gillette proxy contest that we were involved with is that a lot of stock was held in index funds. And one problem with the concept of an index is that a manager or a machine picks the stocks, the money is invested in those stocks, and then everybody goes home. Nobody pays any attention to it at all. And there's no incentive, whatsoever, to pay any attention to it. If you were a fiduciary for the overall fund and you had even a single employee you were paying to respond to tender offers, I'd say that you're likely to be accused of overstaffing.

That's obviously an extreme statement, but when we were trying to get the votes from Gillette there was a lot of stock out there that we were told was held–and I think it actually was–in index funds. That stock was never voted and they couldn't care less. We couldn't reach anybody, couldn't talk to anybody. They're not owners, they've abdicated.

MONKS: Well, as far as that relates to my suggestion, the system that I propose is already in effect. The federal government passed in 1986 the Federal Employee Retirement Security Act and they created a defined benefit plan for three million federal employees with exactly this provision,

WILCOX: Bob, if these shareholders have not done fundamental analysis of the company for investment purposes, how can you expect them to have done any kind of fundamental analysis for voting? How can they be an informed shareholder?

MONKS: What I expect is that there will arise special-purpose institutions in America that will be able, on a collective basis, to advise people how to vote.

GRUNDFEST: Bob, what are you doing for a living these days?

MONKS: I thought you'd never ask.

SACHNOFF: Bob, aren't you leaving out the last step in this analysis-because it really leads relentlessly to the conclusion that the directors of these corporations should be elected and chosen by your institutional investors?

MONKS: Well, I'm saying that the institutional investors certainly will have more influence over corporations...

SACHNOFF: But how else will they have any say, except through voting?

MONKS: You're right. Only by electing directors.

SACHNOFF: Consider Ross Perot, who a couple of years ago managed to extract a $350 million premium for his stock in General Motors by having the audacity to suggest to the management of General Motors that the entire GM board should be composed of those persons who represent the 10 largest shareholders of General Motors. That kind of heresy cost him his job, but it also made him very happy all the way to the bank. It seems to me, Bob, that that's the inescapable conclusion that has to be drawn from your suggestion. And it may make good sense because if they're the owners and if they've been unable to have an active voice in management in the past, what they should do, really, is get on boards and help make this policy.

WILCOX: Are these people really the owners, though? They are really only middlemen who are investing other people's money. And I think you have to recognize the fact that they're also held to a very narrow financial standard. Does that make them good shareholders, good representatives of a diverse interest? It seems to me that we really get ourselves into a situation then where we have what Marty has referred to as "finance corporatism." Where corporations are run purely for market return. Is that what we really want? Is that the right way to run our business enterprises?

GRUNDFEST: Forgive me, John, maybe I'm wrong here, but I thought the purpose of a business was to make a profit.

WILCOX: Over the short term or the long term?

MONKS: The essence of my suggestion is that a healthy economy depends ultimately on a constructive, cooperative relationship between management and ownership. And by having a definable management-ownership group who are long term by definition, I think we will have made a good start.

DeANGELO: I'd like to interrupt here. Dan Carroll would like to make one brief comment on special committees and then let's open this up to questions from the audience. Dan.

CARROLL: Thank you. I'm not sure whether special committees are the highest or lowest form of director life. Having served on one for 18 months, and having been on 11 other boards, I hope we don't have another special committee. But I would like to lay out some rules that I think affect corporate governance in the case of special committees.

First, there has to be a realization that a special committee is in direct conflict with management the minute it's appointed. You are no longer a friend, colleague, cooperator; rather you're an adversary and you have to break all ties. Second, you cannot allow management to select the committee. Management, in the case of GAF, originally selected the committee and the committee, fortunately, changed the membership. You cannot allow management to offer up suggestions as to legal counsel. You cannot allow management to select the investment banker. You may want to select two investment bankers because, in the real world of fairness opinions, they wobble all over the place. We've had investment bankers change their "unfair" to "fair" for fifty cents. That is not a jest. I've seen fairness opinions in innumerable instances where the banker was incapable of defending it. So that you may want another opinion. You also must insist that the advisers, both legal and financial, be prepared to seek outside research help in order to answer fundamental questions, and not simply be content with their in-house contributions.

Finally, if you're going to be on a special committee, if you're going to be an independent director in an MBO, recognize from the beginning that it's a very unpleasant experience. Do not take on the role thinking that it will be cordial, because you're trying to get the most from a management that wants to buy for the least.

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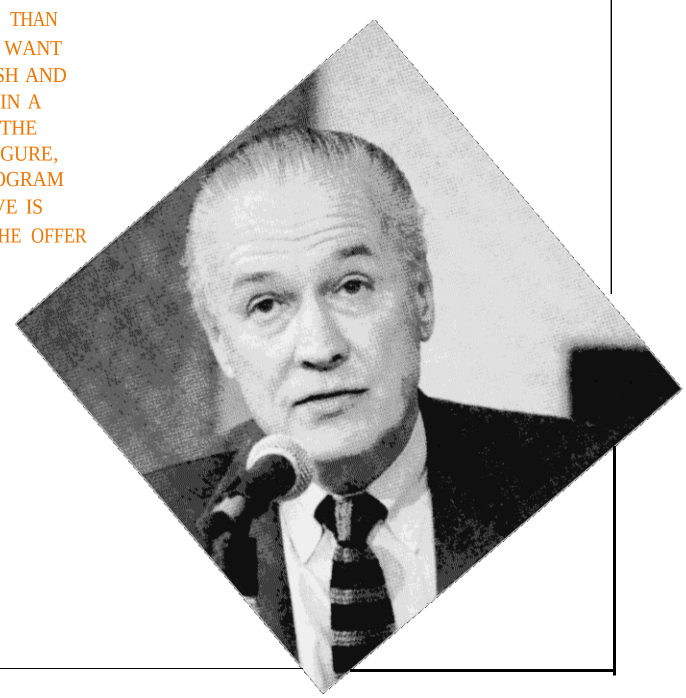
IT'S NEVER A BLACK AND WHITE ISSUE AS TO WHETHER THE CORPORATE R&D AND STRATEGY ARE SO CLEARLY BETTER THAN THE OFFER. AND IF YOU WANT REALLY TO FEEL ANGUISH AND DOUBT, PUT YOURSELF IN A BOARD MEETING WHEN THE BOARD IS TRYING TO FIGURE, OUT WHETHER THE PROGRAM OF THE CHIEF EXECUTIVE IS REALLY BETTER THAN THE OFFER ON THE TABLE.

–DAN CARROLL–



A QUESTION IN CLOSING

DeANGELO: Can we take a question from the audience?

AUDIENCE: As a board member, what can you do when you're confronted with a takeover bid and you know full well that the offer on the table does not reflect the long-term value of the company–because the strategies are in place to bring that company along very successfully. You may want to say no to the offer; but, because of directors' liability, you must vote in favor of accepting the offer or restructuring your company in some way. You may be getting paid $30,000 a year to be a director; but, if the stock should go down after a refusal, your personal assets above and beyond what may be protected by insurance are at risk. What can a director do to save himself in this kind of situation?

OLIVER: I think there may a premise underlying the question that needs to be examined. As Joe said earlier, we are in somewhat of a free market, and the marketplace values securities every day. The prices of securities reflect the profitability of companies as they are currently being run. They represent the market's best guess about the long-term expected value of the firm, but discounted back to its present value. There are certainly companies whose securities are valued higher than any buyer would be willing to pay. And they're valued at that level because people who are buying and selling these securities every day believe in the future of the company.

So when you say, as a director or an operator, you believe that you've got something in place that's more valuable than the marketplace is giving you credit for, then I'd say you have an obligation as an operator or director to try to do something about that. And I think too few managements and directors do anything about it.

FLEISCHER: That is a little too simple. It is October 19th, and the market has lost a third of its value overnight. Raider X comes in two weeks later, and makes a bid at a 20% premium over market when people are in a state of shock.

What do the directors do? From the point of view of the individual director, there is a brooding presence of liability. As a lawyer, it is easy for me to say that, if the director genuinely believes the company has long-term values that aren't manifest in the market, the director is not going to be personally liable if he urges shareholders not to tender and takes steps reasonably related to that goal. It is one thing for me to say it (and I firmly do believe it); it is another thing for the recipient of that advice, who has a lingering question in his mind, to act on that advice. This presence of liability puts enormous pressure on these directors; I think that we should recognize it.

CARROLL: I also think that it's never a black and white issue as to whether the corporate R&D and strategy are so clearly better than the offer. And if you want really to feel anguish and doubt, put yourself in a board meeting when the board is trying to figure out whether the program of the chief executive is really better than the offer on the table.

GRUNDFEST: That really is an excellent point because the story sounds very good, and I bet you it's true in some situations. The problem, however, is that the story has been told and has turned out to be false so many times that the market is now skeptical. Carter Hawley Hale is an example that comes to mind. They defended against their first takeover by saying, "We've invested so much, we're about to turn the corner, we're about to turn this into a great company." Well, the prospects never materialized and they were again the subject of a takeover 3 or 4 years later. And you know what their defense was the second time: "Well, we've invested so much, we're about to turn the corner, we're about to become a great company."

FLEISCHER: What was the price in the second bid, Joe? Was it higher than the price of the first one? My recollection is that the second offer was twice as much.

GRUNDFEST: Yes, and during that period of time the entire market went up at least twice as much. So the shareholders did not even manage to hold their ground.

FLEISCHER: That's irrelevant.

GRUNDFEST: It's interesting, Art, the way you point to the market when it goes down, but you want to ignore it when it goes up.

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