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LEVERAGED BUYOUTS AND CORPORATE DEBT

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BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

JANUARY 25, 1989

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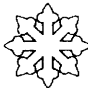

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LEVERAGED BUYOUTS AND CORPORATE DEBT

WEDNESDAY, JANUARY 25, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC

The committee met, pursuant to recess, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Lloyd Bentsen, chairman, presiding.

Present: Senators Bentsen, Matsunaga, Moynihan, Baucus, Pryor, Daschle, Roth, Chafee, Armstrong, and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-1, December 12, 1988]

SENATOR BENTSEN ANNOUNCES FINANCE COMMITTEE HEARINGS ON LEVERAGED BUYOUTS AND CORPORATE DEBT

WASHINGTON, DC—Senator Lloyd Bentsen (D. Texas), Chairman, announced Wednesday that the Committee on Finance will hold hearings on the recent trend in corporate restructurings, mounting debt in the corporate sector, and the relationship of these trends to the tax law.

The hearings are scheduled for *Tuesday, January 24, Wednesday, January 25, and Thursday, January 26, 1989 at 10:00 a.m.* in room SD-215 of the Dirksen Senate Office Building.

Bentsen said, "The recent trend of corporate leveraged buy-outs and other corporate restructurings is troubling and deserves a closer look. In particular, the massive corporate conversion of equity to debt causes me concern about the ability of our country's corporations to weather an economic downturn. I am also concerned about the possible adverse effects of this mounting debt on Federal tax revenues, at a time when reducing the budget deficit is a critical priority.

"One cause for this trend may be our tax system's bias in favor of debt financing, as opposed to equity financing. I intend to examine this problem and explore the possibilities for reform. Additionally, I would like to determine weather any other aspects of the tax system may artificially encourage these sorts of transactions. These issues are complex and I look forward to a fruitful series of hearings on the subject."

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. It is 10 o'clock. This hearing will come to order.

My primary concern in calling for these hearings is the possibility that this surge of leveraged buyouts has created a mountain of corporate debt that could make our next recession deeper and longer than it needs to be.

I would also agree with something that Secretary Brady said yesterday; it seems a shame that we are using so much of our time and talent and money on this sort of financial engineering, while our competitors in other countries spend their time laying the foundation for the future. We have a problem. And that became

clear in yesterday's hearings. But what we do about the problem became less clear.

I am looking for a way to balance the attractiveness of debt and equity. I want a cure that isn't worse than the disease, and we haven't yet found it. Any legislation that we come up with will include both carrots and sticks. But given the size of the Federal deficit, we can't afford many carrots, and as nervous as the financial markets seem to be, any stick larger than a toothpick seems to cause pandemonium.

As I noted yesterday, the difficulty in achieving greater balance between debt and equity is compounded by the difficulty in defining the two. In 1969, the Congress asked Treasury to come up with a better definition, with more specificity, in differentiating debt from equity. And 14 years later, the Treasury gave up.

I might also say, as I have said many times, that mergers and acquisitions are not bad in themselves, and that some corporate management has to be shaken up.

I recall I used a leveraged buyout to make one of my first acquisition, when I was in the private sector. I am well aware that the businesses and industries of tomorrow, which will provide our jobs of the future, will never get off the ground without generally having some leveraged debt. Small firms need to borrow money, usually, to bootstrap their way up. But the $25 billion leveraged buyout of RJR Nabisco could hardly be called a bootstrap operation.

When an American businessman weighs the advantages and the disadvantages of debt and equity financing, the thumb of the U.S. Tax Code is on that scale. A businessman might prefer to raise money, capital, by issuing stock rather than by issuing debt. He doesn't have to struggle to make the interest payments and the principal payments that he would have with bonds or mortgages if his projections don't pan out. For example, the economy may take an unexpected dip, something totally beyond his control. But the hand of the Tax Code tilts his decision heavily toward debt.

I have heard people say, "I want the free market system to prevail in this." That is good rhetoric. and I believe that in substance; but that free market system operates, once again, within the parameters of what we have done with the Tax Code. And our Tax Code seems to favor debt over equity. That simple fact is a part of the root cause of the LBO activity.

These hearings are a learning process. We are learning about the problem and about the prospects for resolving that problem, and trying to make that playing field more level.

Today we are very fortunate in having Chairman David Ruder of the Securities and Exchange Commission with us. I think he is uniquely qualified to comment on corporate transactions, and I am sure looking forward to his insights.

After Mr. Ruder, we will be hearing from the people in the trenches, two businessmen who have direct experience with LBO transactions: Mr. Kidder and Mr. Tom Lee. Then, following them, we will have two distinguished economists: Dr. Larry Summers and Dr. Alan Auerbach, both sophisticated observers of trends in corporate finance. And they will be joined on the same panel by two tax law experts: Professors Bill Andrews and Michael Graetz, who have

been thinking about some of the legislative approaches to debt and equity financing.

I will defer to my distinguished colleague for any comment he might want to make.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I simply want to thank you for taking the initiative on a subject which is of more than passing interest in New York City, I might say, and for the care with which you have done this.

As I am sure you recall, and I am sure Mr. Ruder does, when the Commission headed by now Secretary of the Treasury Brady looked into the question of what happened on Black Monday in 1987, it concluded that of the two specific events triggering the crash, one was an amendment adopted in the Committee on Ways and Means with respect to leveraged buyouts, which had been debated about 7 minutes, or something, around 11:30 at night.

So the care with which you are going forward is obviously appropriate.

I would also mention a question I put to Mr. Brady just yesterday, since I know you had to be at Mr. Mosbachers confirmation hearings to introduce him. I asked Mr. Brady about section 385 of the Internal Revenue Code, which we enacted in 1969 to give semi-legislative power to the Treasury to find a line between debt and equity, and which they worked at until 1980 when they gave up on the matter. But the fact is that section 385 still exists in the Code. It is there, if it seems wise or possible to exercise it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Chairman, we are delighted to have you here. If you would proceed.

STATEMENT OF HON. DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Thank you.

I appreciate the opportunity to address the important issues for the Nation's securities markets presented by the leveraged buyout phenomenon.

The Securities and Exchange Commission has prepared a statement and adopted it unanimously, and I ask that that statement be included in the record.

The CHAIRMAN. That will be done.

Mr. RUDER. The term "leveraged buyout" is a term which has many definitions, but it includes many transactions: "going-private" transactions, hostile tender offers, mergers, and recapitalizations, and I think it is important to note that we are dealing with a phenomenon greater than something called "management buyouts" when we are talking about debt levels and other matters.

A significant point in analyzing leveraged buyouts is that they have created significant wealth gains for shareholders in the United States during the 1980's. There are varying estimates regarding these wealth gains for shareholders of the acquired compa-

nies. Those gains usually range in the area of 30- to 40-percent premiums over current market values.

In going private transactions, our economists state that those gains have been about $38 billion in the last 10 years. Commissioner Grundfest of our Commission estimates that recapitalization shareholder gains are $162 billion during that period, and there is a Harvard study by Professor Jensen which estimates that shareholder wealth gains in all corporate control transactions during this period have been something in the range of $300 billion.

Now, it is important to recognize that, to the extent that these premiums have been reinvested in our securities markets, they have increased the amount of available financial capital and have facilitated capital raising for other issuers of securities.

Notwithstanding these beneficial effects of leveraged buyouts, these transactions have raised numerous public policy questions. These questions are well known: Are the shareholder gains made possible by the anticipated improved operating efficiencies to be implemented following the buyouts, or do they simply represent the anticipated reduced tax liability of companies following the buyouts? Do the shareholder gains in leveraged buyouts represent the creation of wealth, or do they simply redistribute wealth from other corporate stakeholders, including bond holders?

Concern has been raised about the effects of LBO's on research and development and about the exposure of federally insured deposit institutions on LBO debts.

All of these questions deserve the benefit of public discussion, but for the Securities and Exchange Commission, from our particular point of view, we are required to be concerned principally with issues concerning the adequacy of disclosures in the LBO transactions.

A principal concern of the Commission relates to the treatment of shareholders in the acquired company in management-led and other leveraged buyouts. In the management area, the Commission has focused since at least 1975 on the special issues presented by potential conflicts of interest in management buyouts and the informational advantages which management may have.

We have adopted an extensive disclosure rule, Commission Rule 13e-3, which serves to provide shareholders of target companies with information helpful in assessing the fairness of the management leveraged buyout. This information assists in making informed investment decisions; and, since the adoption of that rule, state law developments have also served to provide shareholders with greater substantive and procedural protections concerning conflicts of interest.

I may emphasize here that the role of the Securities and Exchange Commission concentrates upon disclosure issues and does not deal with substantive matters of fairness or fiduciary relationships in the corporate structure. These matters traditionally have been the subject of State law developments, which we believe have been favorable in protecting shareholders in the recent past.

The Commission's investor protection concerns go beyond the interest of shareholders in the subject company. Recent developments have also revealed that subject company bondholders may be at risk. The staff is currently examining disclosure requirements in

our rules to ascertain whether bondholders are receiving adequate and timely disclosure concerning the possibility of a leveraged transaction.

Other areas that will be the subject of attention are the adequacy of disclosures to investors who purchase the LBO high-yield debt and to investors in financial institutions that hold high concentrations of such LBO debt.

In addition to analyzing the disclosure issues, and partly at the request of Members of Congress, the Commission is currently also reviewing available economic data for the purpose of addressing a variety of questions regarding the effects of LBO transactions which may or may not fall precisely in the disclosure area. We are gathering data from various firms which have engaged in LBO transactions, and we hope to be able to provide some helpful conclusions on LBO questions in the near future.

I have in the past 2 weeks interviewed the heads of four firms which are engaged in this process, including Mr. Lee, who will be appearing before you, and I find their statements to be extremely interesting and urge your committee to take into account the information which these gentlemen will provide.

My written testimony describes the various disclosure issues that the Commission's staff is presently studying. Upon completion of this study, the Commission will then determine whether rulemaking or legislative proposals or other action is necessary.

Thank you.

[Chairman Ruder's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

Mr. Chairman, I heard my colleague from New York commenting on what was done over in the Ways and Means Committee, and how some commentators and some on Wall Street said that a part of the massive sell-off resulted from the actions of the Ways and Means Committee.

I have found, in my experience, Wall Street likes to blame a lot of people, and not necessarily themselves, in those kinds of instances.

Do you have any indication that it was the comments in the Ways and Means Committee that caused the sell-off of the stock market?

Mr. RUDER. Our economics office attempted to match stock movements with developments in the October 1987 market break period. Economic studies, as you may know, are concerned with something they call "noise." If there is too much noise—that is, extraneous factors which interfere with the analysis—then they can't reach the kind of conclusions they might otherwise reach.

The Ways and Means Committee's announcements happened to occur during periods in which the noise was not so loud, and our economic staff has concluded that the Ways and Means Committee's introduction of the takeover tax legislation did have some effect upon the market, particularly during the week preceding October 19th.

The CHAIRMAN. Would you suggest, then, that if we do anything in this committee, we do it at a time when the noise level is high? [Laughter.]

Mr. RUDER. No, sir. I suggest that you should be particularly aware that your committee's activities may influence a stock market which is still skittish and nervous.

The CHAIRMAN. Well, I would say, because of the budget deficit and the problems we face there, that whatever we do will not, in my estimate, be particularly dramatic, that we will work to moderate the concern and to level the playing field. And I would assume things we would do would generally be prospective.

Let me ask you about a profile of the type of people or institutions, if you have any, that are buying the high-yield bonds, popularly known as "junk bonds." Do you have a profile of that? The kinds of institutions that are making those kinds of purchases?

Mr. RUDER. I have made inquiries to those that I think have the information about this and am told that the buyers of these bonds are primarily sophisticated financial institutions, including insurance companies, investment companies, college endowments, and other institutions which are going to make a thorough analysis of the risk characteristics of these high-yield bonds before making the purchases.

The CHAIRMAN. Does that also include those sophisticated S&L's? [Laughter.]

Mr. RUDER. The S&L purchases were higher at one point than they are now.

The CHAIRMAN. Sure, because those have been closed.

Mr. RUDER. I think that is right.

The CHAIRMAN. Yes.

Because one of the things that we saw in the S&L's, particularly where you had bad management and they were in trouble, they went to high-yield things with a much greater degree of risk, tried to stay alive, tried to show some kinds of earnings, and sometimes complicated their problem.

Mr. RUDER. Well, sir, we have no indication that the high-yield bond market has been subject to a large number of defaults.

The CHAIRMAN. We have also had a relatively benign economy in this period.

Mr. RUDER. Yes, sir; but with respect to the S&L problems, at least my information is that investments in high-yield bonds has not been the cause of their problems.

The CHAIRMAN. Oh, I think that is true. I think it is marginally a contributor to it.

Tell me, I have been reading some things about the prudent man rule in ERISA and pension funds having to take the high bid. I was intimately concerned, very much a participant in the drafting of that legislation some 14 or 15 years ago. We worked on it in this committee, as the Labor Committee did, too. I don't recall anything where we required people to take the high bid. Do you? In the interpretation of the prudent man rule?

Mr. RUDER. I think there is no black and white requirement.

The CHAIRMAN. That is right. But their concern is protecting themselves insofar as, if they don't take the high bid, how do they explain it—is that it?

Mr. RUDER. Well, sir, it is very hard for any shareholder to resist a 30- or 40-percent premium over market.

The CHAIRMAN. Yes.

Mr. RUDER. And that is the phenomenon that has occurred during the takeover and leveraged buyout phenomenon. I certainly can't fault a pension fund manager who says that it is better for his fund to take the 30- or 40-percent premium——

The CHAIRMAN. That is the point, I think, that you can't fault him, and therefore he takes a position that will most protect him, where he thinks it is right, even though ultimately a higher bid might come along.

Mr. RUDER. Oh, the pension fund managers are very interested in getting the highest of the bids in the takeover situation and in tender-offer situations. As you know, the opportunity to withdraw from a tender offer exists until the very last moment.

The CHAIRMAN. Yes.

Mr. RUDER. These pension fund managers are able to shop, in some sense, for the right bid.

The CHAIRMAN. Now, where you have a leveraged buyout—let us be sure we are running the clock here—where you have a leveraged buyout, and management is involved in that, they may intimately know the company. And they are put in a rather difficult position as to whether they are representing themselves or they are representing the stockholders.

We have had some abuses in that, it appears. Do you feel, in light of some of the rulings of the Court and how they put the Board on notice, that that is self-correcting? That puts the Board very much on notice that it has to leave that bid open long enough to get some serious competitive bids, doesn't it?

Mr. RUDER. Our written testimony discusses the developments in Delaware law, particularly, those that require that once the company is "put in play," as they say, that there be an auction process supervised by the independent directors. In that case, it is very likely that the auction process will provide information to all of the bidders and allow the best bid to emerge.

I have problems with those situations in which the management seeks to purchase the company without getting into the auction process. There, I think we may have very strong conflict of interest problems which must be addressed by the State courts.

The CHAIRMAN. I think I very much share your concern with that one.

Let me ask you about one more case, then. Someone makes a substantial investments in bonds of a corporation, like RJR Nabisco, and they bought them at this price; then, the company gets into this leveraged buyout, and new securities are issued. That has a negative effect on the previous bondholder. Do you think that is self-correcting, that future bonds will give some protection for that type of action in the future?

Mr. RUDER. Yes, it is possible that this will occur. That is, it is possible to draft covenants in the contracts of purchase by the bondholders which will protect against this. We have not yet seen at the Commission a great deal of evidence that this kind of covenant is typically put into bond contracts at this point. There are some examples of this type of protective covenant, but not the great flurry of them that one might have expected.

The CHAIRMAN. Is there anything the Commission can do or should do in that regard? Have you made any determination on that?

Mr. RUDER. Well, we are looking at disclosures to bondholders. We think it is very important. I personally believe it is very important that, at the time these bonds are sold, management is up front with their plans for restructuring the company. And if they are promising to sell investment-grade debt but at the same time have made plans to go private, they are selling investment-grade debt in situations in which their disclosures may not be accurate. In that sense, we are very concerned.

In another sense, however, you must understand that the purchasers of investment-grade debt are primarily very sophisticated financial institutions which we think ought to be able to take care of themselves.

The CHAIRMAN. We will follow the early-bird rule here, and I am sure my time has expired, in spite of the generosity of the timekeeper, and the arrivals are Senators Moynihan, Daschle, Baucus, Chafee, Armstrong, and Pryor.

Senator Moynihan?

The CHAIRMAN. Thank you, Mr. Chairman.

Mr. Ruder, you began by referring to the number of persons who, in the course of leveraged buyouts, had experienced a "wealth gain." Is that like a weight gain? Or did you mean to say they made money?

Mr. RUDER. They made money.

Senator MOYNIHAN. All right. Now we have that clear.

Mr. RUDER. That phrase was given to me by my friendly economic staff.

Senator MOYNIHAN. I think that is recognized. [Laughter.]

Sir, I would like to just pursue the Chairman's inquiry here, and I think I am right here, that the SEC was created very much under the influence of and in the aftermath of Berle and Means' great study of the modern corporation, which I think appeared in 1940. This study argued that there had been profound change in American capitalism, and that modern corporate structure had divorced ownership from management, and it was in that context that the SEC came into being.

Congress should be concerned about the process whereby managers decide to take over and buy a company. For all the disclosures and all of the rules you might put into effect, congressional scrutiny continues to be needed. As Adolph Burley would have said, "Yes, there you are, that is what we were writing about 50 years ago."

This is a very open-ended question, but I would hope that the SEC would recognize in its own origins the importance of this concern, and do more than just say, "Well, the courts will look after it. We don't doubt, or—" have you any thoughts and plans?

Mr. RUDER. Well, I have about a half an hour of comment on that question.

Senator MOYNIHAN. Sure. That does not surprise me, because I do know you do care about it.

Mr. RUDER. I will give you a few specific comments: One is that our Rule 13e-3, which I talked about in my opening statement, is a

rule designed to require management to make disclosures concerning fairness of the transactions when they are involved.

We are finding, in this takeover environment, that some of these LBO transactions are structured so that management is not promised during the current transaction that it will be a participant in the resulting entity. And the fact that management is not promised future participation takes the transaction outside of the scope of Rule 13e-3. So we are looking very closely at whether we should extend the fairness disclosure requirements of Rule 13e-3 to all negotiated transactions. Specifically, we are very concerned about the fact that management may have a kind of implied promise in a negotiated transaction which does not necessarily bring the transaction within the scope of current Rule 13e-3.

Senator MOYNIHAN. Sir, could you just help us, because this is so important? An "implied promise" to——

Mr. RUDER. By the takeover or financial people; that is, they may come to management and say, "We will not promise you an equity participation in the surviving company, but we want you to know that in the 25 deals we have done before, management has always——

Senator MOYNIHAN. It has always worked out.

Mr. RUDER. Somehow it always works out.

Senator MOYNIHAN. Yes.

Mr. RUDER. But technically, our rules don't reach that; so we are considering expanding Rule 13e-3 to cover all negotiated transactions. That is point one.

The second point that I would like to make is that one of the results of the restructuring in buyout transactions is that some of the divisions of these broken-up corporations are now acquired by the real managers. And when you hear the testimony of Mr. Lee and others of those who are engaged in these transactions, you will find them telling you that when the managers become owners again, that the companies are better run and better managed. And I think that is a phenomenon that needs to be looked at very carefully by your committee.

Senator MOYNIHAN. I much agree.

If you would find the chance to elaborate—you said you would need a half an hour on this—and could send us a few more thoughts, I know we would appreciate it.

Mr. RUDER. I would be glad to do so, Senator.

Senator MOYNIHAN. Because I am glad to hear what you said, and I would very much encourage you in that direction.

Thank you. Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman.

Mr. Chairman, yesterday it was late in the day, and Secretary Brady had to go, and we really didn't get an opportunity to talk to him to the extent that I would have liked to about what this LBO trend would do in times of a recession. I was surprised, in what little time I had to question him, that the Treasury Department thus far has really not evaluated the impact of this rash of LBO activity on the economy during a recession, or even on a company

during a recession. At least, that was my understanding from the comments that I received in response to my questions.

I would hope, whether it is through Treasury or whether it is through this committee, that we analyze this—whether it is good or bad. In times of a recession, what is the impact of all of this LBO activity, and what impact would it have on our economy?

I don't wish to take it up this morning with Mr. Ruder, but it is something that I feel we need to address a lot more significantly than we did yesterday.

Mr. Ruder, you talked a lot about disclosure in your opening remarks, and looking through your written statement there is a good deal that addresses disclosure; but perhaps, this morning, you could talk about how you evaluate the disclosure in terms of its acceptability. What are the criteria, the standards that you use to determine whether, after disclosure has been provided, any enforcement is necessary?

Mr. RUDER. We have two kinds of disclosure standards. One is the standard which is applicable at the time of sale of securities which are registered. The other is what we might describe as an anti-fraud standard. The disclosures at times of the registration of securities are somewhat broader than those required in connection with the anti-fraud standards, and I believe, by and large, that our disclosures are adequate at the time of registration of securities.

As I indicated, we are concerned in the bond area that we look at our disclosure requirements to see whether there is sufficient disclosure by the company of what it plans to do in the future. That is an area we are looking at.

We are also, as I have indicated, quite concerned with the disclosures concerning fairness in negotiated transactions. And with regard to fairness opinions themselves, we will be looking very carefully at whether the independence of the evaluators of the transactions are sufficiently disclosed, and whether the factors taken into account by the independent evaluators are sufficiently disclosed. I think that the participants in a transaction—that is, the shareholders—need to know what the other participants are relying upon in reaching their conclusions, so that they can evaluate the transactions.

Senator DASCHLE. How often in the last 12 to 18 months have you felt the need to file an enforcement action?

Mr. RUDER. I was confirming that we have not felt the need to bring enforcement actions in this area in any great number. We have brought an occasional enforcement action. I think the reason for that has something to do with the auction process. When a company is put into play and there are competing bidders, you are going to find that those bidders are given a great deal of information by the company, so that there is some confidence that the price reaches a level that is within the range of fairness to shareholders. And here, one is making some subjective judgments. But I think the market works quite well in that area, and therefore we don't find a need to bring disclosure enforcement actions.

Senator DASCHLE. So I take it from what you are saying that you think the existing law obviates the need for any new legislation in this regard.

Mr. RUDER. I don't believe that legislation in the disclosure area is necessary. We do have substantial rulemaking powers and will exercise those in order to achieve what we think is necessary for improvement in that area.

Senator DASCHLE. Do you make judgments about the financial structure as you consider all of this?

Mr. RUDER. We do not make judgments about financial structure, except to the extent that we insist that there be disclosures regarding the financial structure in the future—that is, when a transaction is under scrutiny by shareholders, we will insist that there be disclosure by the participants in the transaction as to what the financial structure will be in the future and what the financial rewards will be. But we do not make any judgments as to the appropriate debt equity ratios or other questions of that type.

Senator DASCHLE. That is interesting.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Baucus?

Senator BAUCUS. Thank you both, Mr. Chairman.

Mr. Chairman, my point really goes to what role the SEC can perform in trying to help make America more competitive.

As you know, many commentators state that perhaps America has too many lawyers, too many accountants, too many financial officers, not enough engineers, not enough people devoted to making better products; that is, we spend too much time in corporate America rearranging the balance sheets, there are too many rewards in America for those who graduate from the nation's top business schools to try to find more profitable ways to rearrange the balance sheets, and therefore some of the top business talent in America goes to those areas rather than trying to invent another product, better marketing, or other ways just to increase productivity in America.

Frankly, those are all statements which I tend to agree with. I think that we are too shortsighted in America. We just spend too much time worrying about immediate financial gain rather than longer term economic growth.

I was once an attorney at the SEC. I worked on the registration statements that various companies wanted to send to the public. And in the year and a half that I was working in corporation finance, it struck me that whenever we asked a corporation to disclose new information in either a registration offering or in a proxy statement that the company would readily do so. They wanted to get the offering out. In those years, there were lots of offerings, equity offerings; in these years there aren't a lot of equity offerings.

But it also struck me that we would ask the company to write on the registration that, because of some major new venture, "This is a speculative new offering." Be very careful, and beware, potential purchaser, before you buy this security." Frankly, I think that made it more attractive. I mean, people thought, "Gee, I could make a lot of money on this one." And so, I don't know if it made a lot of difference when we tried to encourage that kind of information.

Here is my point: Do you think that it would make sense for the SEC to, in its disclosure requirements, require a company to indicate the degree to which it is spending more money in R&D, in developing new products? Or hiring more engineers? Or in new inventions, the number of new patents that it has pending with the Patent Office?

I am just trying to find ways to include in the disclosure requirements, ways to help encourage, "force" if you will, companies and prospective purchasers of securities to think more about the longer term competitive nature of the company. That would be a major change, and it might take legislation to do so, but I would like you to comment on that, please.

Mr. RUDER. We have a project under way at the Commission involving what we call "MD&A"—Management Discussion and Analysis—and the issues involved concern what kinds of disclosure should be required from management regarding future prospects of the company, and whether or not management should be required to tell what their future plans are.

It is a very controversial area, because management doesn't want to give all that kind of information to its competitors, and yet the shareholders, or the prospective purchasers or sellers of corporate stock surely want that information. So I can't be very explicit in response to your question, except to say we are looking at it, and I share your concern over long-term prospects for management and long-term R&D.

I have been urging the investment community to stop looking at quarterly earnings and try to look at a 3-year earnings projection or a 5-years earnings performance for companies. I have not yet seen very much positive response to that. But in my view, it is partly the investment community which is at fault, if there is a fault, in management's concentration on near-term rather than long-term earnings.

Senator BAUCUS. I think that is right, and that is why I suggest you don't only listen to the investment community which may not be very favorably disposed toward that, but also, take a very positive, affirmative role in the management of the SEC to require these kinds of disclosures, to help push the country to think in the longer term.

Mr. RUDER. I think there is an underlying point, which I certainly want to emphasize, from our Commission perspective.

When the Federal securities laws were passed in 1933 and 1934, the Commission was not given a merit regulation role; we were given a disclosure role.

Senator BAUCUS. That is right.

Mr. RUDER. This is a congressional mandate and a congressional policy which does tend to indicate that the market should be trusted, to a large degree, in terms of determining economic structures in the United States. I think that our attitudes have been faithful to that requirement, and I know that our Commissioners as a group are faithful to that.

Senator BAUCUS. If I might, Mr. Chairman, just one brief statement.

The CHAIRMAN. Yes.

Senator BAUCUS. My point is to encourage the market to have better information.

Mr. RUDER. Yes, I understand. We do have extensive disclosure requirements; but there is a tension because management does not want to give up its secrets.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Ruder, in answer to Senator Daschle's questions, I understand that you do believe that there is a sufficient delay—I am talking in connection with a management leveraged buyout—there is a sufficient delay from the time that management makes its offer before there is any conclusion; there is an adequate opportunity for others to come forward and match that, if they so choose, or to learn the facts of the company and thus to come up with a counter offer.

Mr. RUDER. By and large that is the case, particularly with the widely held public companies.

Senator CHAFEE. So you wouldn't suggest any extension of that period? And I must confess I don't know how long the period is.

Mr. RUDER. We have not thought that we need to extend the period. Each one of these transactions will ultimately end in a corporate transaction, either a tender offer or a merger transaction, or something that either requires a shareholder vote or a tender of shares. And in each of those cases there are some delaying aspects which come out of our laws.

Senator CHAFEE. Come out of your jurisdiction?

Mr. RUDER. Yes.

Senator CHAFEE. Let me ask you another, perhaps broader, question. I have had some discussion with experts in these LBO's, those in favor of them. The point they make—and I think there is a lot of validity to this point—is that there is a lot of incompetent management in American corporations. This incompetence stems from board of directors who are cozy entities, having come aboard through deep friendship with the management of the corporation, and the members of these boards have very little financial stake in the corporation. All of us have seen proxy statements where we are astonished at the low holdings of members of the boards, and the directors just aren't on their job. They don't ask the tough questions at meetings and don't really represent the stockholders, instead they represent management. Now, sure, when there comes a potential buyout, there are actions they must take because of potential lawsuits.

But what do you think about that argument? And furthermore, what do you think of a requirement that if you serve on a board of directors you have got to have a stake in the corporation of x-percent?

Mr. RUDER. I must say, and particularly in response to this question, I am speaking for myself and not for other members of the Commission.

Senator CHAFEE. That is right, but you are here as a person deeply involved in corporate America.

Mr. RUDER. Throughout my career before I came here, I have been very concerned with the operation of corporate boards. There

has been a great improvement in the way in which corporate boards in the United States have operated in the past, and I believe one should recognize that improvement. Nevertheless, I do believe you will find some corporations—and I am not saying all corporations, but there are some corporations in which the board is somewhat too much in the control of management. I think the question is how do deal with that problem, if one believes it is an evil.

My own view here is that it is better to let current corporate practices evolve, as they have been, rather than to try to interfere in the corporate organizational structure. I do not believe that forcing corporate board members to have a stake in the corporations whose boards they are serving will significantly change the way in which they act.

Senator CHAFEE. Well, I don't agree with that. It seems to me they pocket these large directors' fees—$25,000, or whatever it might be—and have little stake in the corporation. I don't see how we can sit around and worry about leveraged buyouts if in fact we do have this cozy relationship that exists.

I am not sure on what basis you are saying boards are better than they used to be, and I would like you to just amplify that a little bit.

Mr. RUDER. I will. We have, in part because of the Securities and Exchange Commission initiatives, insisted that all New York Stock Exchange companies have audit committees which are composed of independent directors. These independent directors in their audit committee process look very carefully at the way internal corporate controls are handled; they look very carefully at whether or not they are receiving information, as board members, of the kind they would want; and whether the disclosures to the public are satisfactory. And I think that represents a very important progress in corporate America.

The area in which I would personally hope there would be greater progress would be that the independent directors would begin to ask more searching questions, would begin to prod management more carefully.

Senator CHAFEE. Well, I agree with that. But also I would say that there is nothing that gets your attention more than if you have got a stake in an operation, and you see your hard-earned investment doing well or not doing well based on what management is doing.

So I would like to see board members have to plow their directors' fees back into purchase of the stock up to some percentage or some amount.

Mr. RUDER. You should be aware that one of the patterns that is emerging in the corporate world is to provide stock option compensation for directors. That process will provide greater ownership.

Senator CHAFEE. Well, that is not the same. You can't lose in that deal. That is not the same at all, a stock option proposal.

Thank you.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you very much, Mr. Chairman.

I tend to share the view that Senator Chafee has expressed. I think boards that have heavy management ownership are much more efficiently run companies.

My own experience is in smaller business. The only boards that I have had any experience sitting on were where the owners of the company are on the board of directors, and they are much more sensitive to the cost-control measures in the company. So I think there is an important point there.

Mr. RUDER. I agree with that, sir, where there is heavy ownership.

Senator SYMMS. I don't think I would recommend having the government impose such rules, but it seems to me that would be a good way for the corporations themselves to do it, if they just had their own internal rules that directors had to buy stock in the company, even the high-level managers of big corporations.

We had a corporation, one of our large corporations in my State, which has suffered some financial difficulties and now has new management, and it was quite shocking, when we started looking at the disclosure statements of the corporation, how little stock some of the top people in the company owned. It was no wonder that it had gotten into some difficult problems. The new managers have invested a lot of their own capital into the stock of this company, and I think that is turning it around. So I think there is a case there.

But I generally want to compliment you on the thrust of your testimony, that LBO's, generally speaking, are beneficial; that the efficiencies that come to our economy make us more competitive; that the profits that are made are plowed back into the economy; in general that there are benefits. And I appreciate your statement to that effect.

I wanted to probe just a little bit, though, about if, from your seat, if we wanted to do something to improve what some people perceive to be a problem with LBO's and takeovers in general, wouldn't it be better to approach it from the standpoint of reducing the confiscatory, anti-capitalistic, double taxation of dividends? To start working on that end of it rather than to work on it from the other end?

Mr. RUDER. Well, I share the concerns.

Senator SYMMS. You see I'm back, Mr. Chairman. [Laughter.]

The CHAIRMAN. Welcome back, Senator Symms. [Laughter.]

Mr. RUDER. I am not going to use your words——

Senator SYMMS. Well, that is what it is.

Mr. RUDER [continuing]. But I would share the thought that the double taxation of dividends has created some hazards for our companies in terms of their ability to compete with companies overseas.

Senator SYMMS. Right.

Mr. RUDER. And I would favor the elimination of the taxation on dividends; recognizing, however, that that carries just enormous problems for the national debt.

I would have one other comment which I think ought to be recognized here. In terms of management discipline, we have found, in connection with tender-offer legislation, that the corporate manage-

ments have been attempting to impede tender offers, and they take the position that somehow the tender offers are bad.

My own view—and I think that of some of our Commissioners at least, if not all, agree—is that the tender offer/LBO process provides a very good disciplinary tool for management. And if the LBO phenomenon tends to break up companies and to create companies with a high concentration of ownership in management, that may be consistent with the view that you are expressing. Then we may have a change in our corporate structure in America in which there is a greater ownership of our companies by the management, in somewhat of a reversal of the Burley and Means phenomenon, which was identified in the 1930's.

Senator SYMMS. Thank you very much.

I think—and I will close on this—I noticed in T. Boone Pickens' book that he wrote that on Mesa Petroleum's board he required that all members had to have 50 percent of their net worth in Mesa Petroleum or they couldn't be on the board. I think that would be one thing that could cause a company to be difficult for anyone to take over.

Mr. RUDER. It sounds like you would only be a two-board directorate.

Senator SYMMS. Right. Obviously that wouldn't be a rule that could work for every board, because of the various financial wherewithal of different people, but I thought it was a strong statement about owner involvement in running a company. That was a private solution to it, not a government solution.

Thank you very much, and thank you, Mr. Chairman.

The CHAIRMAN. Yep, Mr. and Mrs. Pickens. [Laughter.]

Well, Mr. Chairman, thank you very much. We appreciate your testimony.

Mr. RUDER. Thank you.

The next panel will be Mr. Robert Kidder, the president and chief executive officer of Duracell, Bethel, CT; and Mr. Thomas Lee, president of the Thomas Lee Co.

If you will please hold down conversations.

Let me state that these two gentlemen will be, as I understand it, generally supportive of the LBO effort in the country. And in seeking to have a balanced point of view, tomorrow we will have a panel of two businessmen who are critical of the LBO effort in the country.

I would ask that each of you limit your testimony to 5 minutes. We will take your testimony in its entirety for the record, but we do want to have an opportunity to question you, and with the limitation of time, I would ask that limitation to be met.

Mr. Lee, if you would proceed.

STATEMENT OF THOMAS H. LEE, PRESIDENT, THOMAS H. LEE CO., AND CHAIRMAN AND INDIVIDUAL GENERAL PARTNER, ML-LEE ACQUISITION FUND, L.P., BOSTON, MA

Mr. LEE. Thank you very much, Mr. Chairman and distinguished members for allowing me to come before you today to discuss leveraged buyouts.

I am Thomas Lee, head of the Thomas Lee Co. of Boston, MA. It is an investment firm which I formed in 1974. We have participated in over 75 leveraged buyout transactions since 1974, all on a friendly basis. We use our own funds and that of the ML-Lee Fund, which is a public limited partnership with 40,000 limited partners, which we manage.

The hallmark of our firm is investments in growing companies with the managements of those companies.

The CHAIRMAN. Let me understand that, again. Did you say 40,000 limited partners?

Mr. LEE. We marketed the fund through Merrill Lynch in 1987, a public limited partnership, and the ML-Lee fund was the first public subordinate of that fund.

The CHAIRMAN. And how many limited partners?

Mr. LEE. Forty thousand.

The CHAIRMAN. All right. Thank you.

Mr. LEE. Our companies today, by the way, have sales of $7 billion and employees of about 70,000 employees nationwide. These are all growing companies, and we invest with the managements.

In the SEC study, which you will find on tabs 2 and 3 of the testimony which I have given you, we have studied not only companies we took private but many of the other transactions which we were involved in in the 1980 through 1987 time period.

You will find that sales rose much faster than the gross national product. You will also find that the employment pre-buyout of these companies was 45,000, and it rose at the end of the study to a level of 59,000 employees. The capital expenditure level, pre-buyout, was running at the rate of $70 million per year. At the end of the study you will find that the capital expenditure levels had risen to $130 million per year.

You will see some interesting success stories in the study: Hills Department Stores, Sterling, J. Baker, and so forth. These are American companies which, after the buyout, were able to increase market share and beat foreign competition. We think these are productive for the economy.

It is ironic today that a lot of attention has been focused on the RJR transaction. Also, not that one but there have been some hostile deals which we read about. But the vast majority of leveraged buyouts are private companies, and they concern either divisions of large corporations who don't want them anymore or they concern themselves with family companies where a change has to be made.

If you restrict the leveraged buyout market, which is an important capital market for these transactions, frankly, all American companies will have to be sold only to large corporations or to foreign buyers.

In a counter-intuitive sense, it is the corporate buyer who often gives us an employment loss, not the leveraged buyout buyer, because that corporate buyer has to close plants and reduce corporate overheads in the name of efficiency.

We feel that the large conglomerate theory of the 1960's may be passe today. The theory that a few business managers sitting in a distant area could manage 50 subsidiaries better than those managements themselves we think doesn't hold water now, and lots of companies have downsized themselves, have focused themselves

from an efficiency point of view into chewable bites. And through the leveraged buyout medium, you are seeing smaller, efficient business units with manager-entrepreneurs. Frankly, when we make an investment, management is always with us. They are incentivized by the stock, and sometimes they own as much as half the stock in the company.

Now, as to recession, we are very, very concerned every time we make an investment as to whether we are putting too much debt on the company's books.

First of all, we are only buying a good company; we never would try to do a leveraged buyout of a bad company. So then, in a good company we have got maybe a 20 to 30 year good history of making money. We test the past years. We take a look and see what happened during, say, 1974, during 1981, and we want to make sure that this company can weather the storm.

Banks are loaning only about half the money, and if we are paying seven times cash flow, banks may be only lending say three and a half times cash flow. Believe me, the banks are very hard to deal with now for us. Also, we don't see a lot of wild action. We don't see lending that is not responsible.

We hope you will take a careful look at these data, hope you will take a careful look at all the other data, and realize the positive impact that buyouts have had.

Thank you very much.

The CHAIRMAN. Thank you.

[Mr. Lee's prepared statement appears in the appendix.]

The CHAIRMAN. Mr. Kidder, if you would proceed, please.

STATEMENT OF C. ROBERT KIDDER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DURACELL, INC., BETHEL, CT

Mr. KIDDER. Mr. Chairman, Senators, my name is Bob Kidder. First of all, to Senator Baucus, I am an engineer graduate from the Midwest. I am president and chief executive officer of Duracell Holdings Corp.——

Senator BAUCUS. How much more money are you now making, though?

Mr. KIDDER [continuing]. Which is based in Bethel, CT. I have been president of Duracell since 1984 and chief executive officer since the consummation of our LBO in June of 1988. Hopefully you know Duracell best not by our LBO but rather by our copper and black batteries. We are the leader in the global marketplace for premium batteries.

However, obviously, the reason I am here today is because Duracell is a good example of a leveraged buyout, and I believe our experience can provide some useful and informative perspectives on LBO's in general.

In these opening remarks what I would like to do is three things: first, to describe our transformation to a private company; second, to highlight the impact of the LBO on our competitiveness, which is obviously of central concern; and then, finally, to address some frequently raised LBO concerns.

Importantly, from 1979 to 1988 Duracell was a wholly owned subsidiary of publicly held companies. Indeed, over the last 10 years

we have changed ownerships five times, with four different owners. With each new owner came new reports, new questions, and of course new concerns on behalf of our employees. Duracell was an example of what Tom Lee has said, the conglomerates assembling disparate companies in the 1960's. We were owned by people who did not share our focus, and we did not fit.

For example, from 1986 to 1988 we were a part of Kraft, Inc. based in Chicago. We were only about 10 percent of Kraft's business. During those 2 years, Kraft tried valiantly to get us in line with food reporting. They tried endlessly to understand our business—the competitors, the technology, the marketplace—and ultimately decided that Duracell Batteries and Velveeta Cheese were unreconcilable and accordingly decided to sell us in December of 1987.

After an auction selling process in which six LBO or financial firms and two corporations, were involved at least in the last stage, Kohlberg Kravis Roberts & Co. bid $1.8 billion and won ownership of Duracell. The KKR bid, although just slightly ahead of two others, I am told, was significantly higher than the value that Kraft expected. Their management was ecstatic. Clearly, I as a senior manager—and our other senior managers were also ecstatic. What I would now like to do is outline some of the reasons why.

At the point that independence was achieved, Duracell became a new company. It was new in several respects: First of all, because it was a freestanding, privately held independent company. It was new because its shareholders included Duracell management, three members of which now sit on its board. It was new because managing for cash flow became a central focus of the company. It was new because our employees felt the rebirth of spirit, being free from corporate bureaucratic intrusions. And finally, it was new because we felt empowered to build a battery company in the image of a battery company, enabling us to compete more effectively in the world marketplace.

Today, Duracell employees are focused solely on the needs of the battery business; decisionmaking is more efficient; key decisions are taken by people who are intimately familiar with the battery business. The realities of managing for cash flow rather than quarterly earnings has accelerated the pace of productivity gains within Duracell. Clearly, there is greater focus on effecting changes which will help us achieve our mission of being the leading worldwide battery company.

I would like to particularly emphasize that since the LBO,investments in the activities which enhance our competitiveness have been increased substantially. Research and development spending is 25 percent greater than the last full year as a part of Kraft. Marketing spending is at record levels, well above the levels during the Kraft days. And, not one single capital project that is important to building our business has been denied. In fact, a large, strategically important program to add capacity for the next long-lasting Duracell lithium battery is being implemented today.

Somehow, in the flurry of news reporting on the subject of LBO's, the view that management must destroy the business to realize attractive financial returns seems to dominate. From the perspective of Duracell shareholders, both KKR and ourselves, this

view is seriously flawed. We are committed to fighting aggressively for share in the short term, and building a strong strategic foundation in the long term. Without that competitive strength, there is no financial payoff for anyone in this deal.

Since one LBO and another differ as greatly as the cheese and the battery business, I think it is important that you not just take an aggregate view of LBO's but rather consider cases such as Duracell's, and I would like to illustrate some of the LBO concerns as they relate to Duracell.

In our case, shareholders benefited. We believe that management as well as KKR will benefit in terms of return on investment, and the Treasury has benefited from increases in capital gains tax.

Despite our relatively high interest payments, even more inhospitable to our plans was the bureaucracy of Kraft. Our ability to make interest payments in economic downturns is much more secure than most outsiders realize, the reason being that, we have a recession-resistant business. We have never had a downturn in all the history of our business or in the history of the industry.

The CHAIRMAN. Mr. Kidder, your time has expired. It is an excellent statement.

Mr. KIDDER. I will quickly summarize.

Accordingly, I would simply summarize, going past some of the concerns which perhaps I can pick up in the questions, and say that since the time of the LBO our company is more vital, we believe we are more competitive, and we are considerably more optimistic than we have ever been in my 10 years with the company.

[Mr. Kidder's prepared statement appears in the appendix.]

The CHAIRMAN. Well, that is a good statement, from both of you, and encouraging statements. But as I understood you, you were stating that your company was really not a cyclical company, is that correct?

Mr. KIDDER. That is correct.

The CHAIRMAN. How would you feel about those numbers being applicable to something that was in a cyclical industry, and you had the ongoing debt to service, rather than being able to have the cushion of equity to fall back on? Do you think that those numbers and that kind of performance would be as applicable? Would you go to a leveraged buyout to that extent if it was a cyclical industry? Has not that been done in some of those instances, other cyclical industries?

Mr. KIDDER. I am not familiar with all the LBO's that have been done. I am familiar with the KKR report, which has been reported in the press recently.

If you look at KKR deals, which are the ones that I am most familiar with, and I am certainly familiar with their criteria, their criteria is indeed to invest in businesses which are recession-resistant, that have a stable growth pattern. I believe if your staffs were to do an analysis of the industries in which LBO's are done, they would probably find a concentration of investment in businesses such as the food business, for example, with RJR.

The CHAIRMAN. Well, I think that is correct, from what I have been able to see in a rather cursory study and review of it. Yes.

Mr. KIDDER. I think as it relates to cyclical businesses that, if someone invested in an LBO in a cyclical business, the pricing and

capital structure would certainly have to reflect the characteristic of the business, and presumably, therefore, it would not be as highly leveraged.

The CHAIRMAN. I would hope they would all exercise the kind of judgment that you are talking about.

Mr. Lee, I enjoyed your statement. Quite a record of success, from what you tell me of the numbers.

Now, let's take the situation of original issue discount financing, and you are talking about zero coupons, and you have accrued interest, interest that is not paid at the moment. And yet, when we allow that to be expensed, taken off your taxes, it seems to me the government is almost in an equity position there, because it all has to work out in order for those bonds to be paid. Do you think we should allow a deduction for interest that is not paid under those kinds of circumstances?

Mr. LEE. Sir, we see zero coupons being used sometimes. We feel, because the lender is not receiving current cash, that they should only be done with the best of companies—that is to say, a zero coupon bond should only be issued where that company is very strong and only very senior in the balance sheet. So that, in our firm, while I am not sure that we have ever—I guess at one time we bought Playtex, this year, and we issued some senior subordinated zero coupons, zero coupon bonds, right next to the bank financing. Playtex is a company with highly repetitive purchases by the consumer. We feel it is recession-resistant. In this case, the bond buyers certainly feel that they are going to get the money back.

We do not favor the use of zero coupons in very junior subordinated debt, and that might really be a case where you might see it, more like common stock.

The CHAIRMAN. Unfortunately, I am going to have to leave the hearings a little early because of a commitment with the President at noon. I like to work his name into those comments. [Laughter.]

I defer now to Senator Moynihan for any comments.

Senator MOYNIHAN. Mr. Chairman, I have no questions but would like to thank our witnesses for some very interesting and informative statements.

The CHAIRMAN. Senator Daschle?

Senator DASCHLE. Mr. Lee, I would like to follow up on the same question that the Chairman asked of Mr. Kidder, with regard to which leveraged companies ought to be considered with some concern in times of recession.

You said that you only have a practice of investing in companies that appear to be recession proof, good companies. Obviously, that doesn't happen in all cases. How would you decide just how much leverage is appropriate in companies that are cyclical, and how do you separate the "good" from the "bad," as you have described these terms in your earlier comments?

Mr. LEE. Sir, we see approximately 1,000 deals per year—that is to say that about 1,000 transactions come over the transom. We are looking closely at about 100 of them. Last year we purchased 13 companies. We have bought recession-proof companies.

Now, if we are looking at a Coca Cola bottler, for instance, where we feel that those customers will continue to buy the Pepsi or the

Coke every single day, we might be willing to pay nine times the cash flow; we can finance at that level and finance safely.

We bought a company in the copper wire business this year, and we were only willing to pay five and a half times cash flow. So, the price of a cyclical business really reflects the risk of the transaction.

Senator DASCHLE. Is that a universal fact of making deals such as this? I mean, the impression I have is that there are a lot of companies that are highly leveraged that are very sensitive to recessions right now, that somebody—not in your company, but somewhere out there—made decisions with regard to those companies, regardless of the criteria that you appear to describe as somewhat conservative.

Mr. LEE. Well, of course, we did buy the company which I mentioned at five and a half times cash flow. We were the high bidder. So it wasn't a huge auction, but there were a number of people who looked at it. I don't know whether the companies that you are mentioning went through a leveraged buyout or not.

I have invested through recessions, and I have been in a company closely related to the housing business, and in 1981 and 1982 we had to lean that company down. I refer to Hendrix Wire and Cable in the study which I have given you in my statement. And that was difficult.

Senator DASCHLE. In the case of the five and a half—you said five and a half?

Mr. LEE. Five and a half times cash flow, right.

Senator DASCHLE. In the case of the five and a half times, if you saw interest rates go up by 50 percent, what would the leverage be then?

Mr. LEE. Well, we made mistakes in the Seventies of letting all of our debts float. I would say today almost all of our debt is capped or fixed.

Senator DASCHLE. So you are saying the leverage wouldn't change at all?

Mr. LEE. No. Now, obviously if we lost money, the net worth would go down, so that would increase leverage. But we have made the mistake of investing—and as I mentioned with this Hendrix Wire and Cable, we had floating rate debt right in 1981. I am happy to say that Hendrix came through, and today's sales are four times its grade, and employment is 150 percent higher. So, it was a success story. But it can be tough.

Senator DASCHLE. Do you think in most cases that companies in circumstances like that could survive?

Mr. LEE. Well, first of all, we bought Hendrix from an older gentleman—Mr. Hendrix was 74. At that point in his life he didn't want to put money into new plant and equipment. We put the money in, so that as soon as the marketplace turned, which was some 15 or 18 months later, we were able to gain market share. We did things in a modern way that it is possible that an older owner might not. I am not sure, of course. I don't want to just tell a story. But we have a contingency plan every time we go into a situation.

Senator DASCHLE. Are you confident that your approach to all of this is the common practice? Or are you unusual in that regard?

Mr. LEE. I don't think so. We use our own money, so our money is down at the bottom of the pile, and we certainly don't want to lose it. But whether a leverage buyout firm is using a fund or whether it is their own money down in the common stock, I think people feel a sense of responsibility, and the analyses done are very careful.

Chairman Greenspan did some jawboning after the announcement of RJR. If the banks weren't tight before, right now they are scrutinizing all transactions; and, as I say, any froth that you thought might have been out there is really tamped way down today.

Senator DASCHLE. Thank you very much.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Lee, what do you think about my idea that securities laws and the disclosure requirements should include more indications of a company's potential competitive position?

Mr. LEE. I think that is great.

Senator BAUCUS. What kinds of disclosures would you recommend?

Mr. LEE. Well, we deal in the private sector. We have taken a few companies to the public market ourselves. I really can't give you a good answer as to what else should be there; but of course there is that fine line which Chairman Ruder mentioned, in that a company, with marketing what they might think of secrets or a proprietary edge, certain cost data we feel should not be disclosed. We are not anxious for the competition to understand some of the specifics of some of our product line costs.

Senator BAUCUS. But do you share my concern that in some degree too much managerial effort is devoted to "financial engineering," to use Secretary Brady's words from yesterday, and too little time devoted to longer-term product development and growth and planning?

Mr. LEE. Yes. We see ourselves, anyway, as people who buy companies and who want to own those companies for a significant period of time.

Senator BAUCUS. What else can we do to help you move the line a little more away from "financial engineering" and more toward better products?

Mr. LEE. I think many companies get stuck today looking at earnings per share on a quarterly basis. They manage for the short term, and they don't look at the long.

Senator BAUCUS. Well, that is what many companies do, but why don't you answer my question? My question is what can we in the Congress do to help move that line, appropriately?

Mr. LEE. From the sense of a company which has been taken private?

Senator BAUCUS. Just generally. Well, more specifically, in LBO activity and takeover activity. I am focusing now more on disclosure requirements. I mean, if you agree with my proposition that the line should be shifted, I am asking your help, because you are very close to all of this, in making some recommendations to us as to how the Congress might appropriately shift that line, what it might do to encourage that shift.

Mr. LEE. Well, certainly I think that the Far Eastern experience has shown that companies can operate with debt and can gain market share. If we could cooperate with the government, if we could have a sense that we and you work as a team, if we could have an economic policy on a national level. Are we going into should the country be going toward telecommunications? Should we be building up the semiconductor industry? Where should the private sector be going? I think that if we had a national policy, all of us would benefit.

Senator BAUCUS. I am surprised to hear you say that, because it is my impression that most people in the private sector, certainly in Wall Street and in the financial sector, are very much opposed to something like that, believing that, "My gosh, let the market decide!" You know, "The market is the best indicator, far and best the decisionmaker in all of these things. There should be virtually no government planning," if you will, to help decide whether we should go more into semiconductors or what not. I am very surprised to hear you say that.

Mr. LEE. Well, I think that this country is really part of a larger economy today. It is my own belief that one reason why we have had seven years of growth or eight years of growth here is because the United States has been drawn forward by the wider economy that we are all a part of today.

I think if we are going to compete effectively against companies in countries where government and business work well as a team, it is an approach that we should look at.

Senator BAUCUS. Do you agree with that, Mr. Kidder?

Mr. KIDDER. What I agree with is that if we can provide incentives for managers to be shareholders, that that will be the first investment we should make to encourage people to focus on the long haul.

Senator BAUCUS. Should we undertake any other efforts which will help encourage us to be more productive in the longer haul, or only incentives to make managers owners? Are there any other efforts we should make?

Mr. KIDDER. We have enormous incentives today. As Mr. Lee said, we compete in a worldwide marketplace today. Clearly, in the battery business we do. Japanese competitors, large American competitors, new entrants—Kodak, very aggressive competitors, European competitors. That is all the encouragement we need to keep a lean ship, also to be investing for the long haul.

Senator BAUCUS. My time has expired. I just encourage all of us to try to think of ways to help think more about productivity and if that is going to make the bigger difference.

Thank you.

The CHAIRMAN. Thank you.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Kidder, in response to Senator Baucus's question, and Mr. Lee, likewise, doesn't part or all of this—the ability for you to invest and think of the long term—come from the fact that you are private? I mean, that in itself is a plus out of all this, isn't it? Your ability to move quicker, you are not dependent upon quarterly statements to satisfy eager stockholders, you can conduct your

business with more of a long-term view. Am I correct in believing that?

Mr. KIDDER. Yes, sir, I believe so. I believe there are a number of factors that are causing us to take the long view. One of them is the fact that we are indeed private, we are not reporting on a quarterly basis. Another is that we have a major shareholder—in our case, KKR, as well as Duracell management—who understands that the financial payoff comes as a result of long-term competitiveness.

We also have a very different decisionmaking process. It is hard to describe unless you have been there—perhaps some of you have. I spend less time flying to Chicago and more time worrying about the battery business. I spend less time answering naive questions about our business. I spend less time filling out reports that have no bearing on where we are going with the business. I spend my time and we spend our resources on those things which will build a terrific battery company. We don't take risky forays into diversification because the corporation needs quarterly growth, or annual growth for that matter; we focus on the area where we have great strength.

All of those things, a focus, is what is important to our productivity as well as to our competitiveness, therefore.

Senator CHAFEE. A lot of this is dependent, it seems to me, on the amount of ownership and the view of the majority shareholder towards profitability—I read your statement, and KKR is in for 90 percent and management is in for 10. So KKR, in your statement, is very patient. If they weren't, this would be quite a different picture, though, wouldn't it?

Mr. KIDDER. It might also be added that management is patient. I should say, although we only have 10 percent, that part that I am an owner in, it is a much larger percentage of my net worth than the $350 million of KKR investment is of their net worth.

Senator CHAFEE. You are in deeper than Mr. Kravis is?

Mr. KIDDER. Yes, I am in much deeper than Mr. Kravis. And therefore, I have a very strong interest in the success of the venture.

Senator CHAFEE. Okay.

Mr. KIDDER. Their patience is based on their understanding that the returns come as a result of building a strong enterprise. They also, importantly, have structured a capital base for Duracell that is a very large amount of equity, $350 million, which percentage-wise is a large amount in an LBO, roughly 20 percent of our capital. Of the remainder of the debt, only one-third is floating, and half of that is outside the United States, which suggests that you have got some interest rate hedging going on in terms of the effect of any interest rate changes. And as I mentioned earlier, they are fully aware of the characteristics of our business, which, although not recession-proof, certainly is recession-resistant.

So they made the investment with the understanding that we would indeed be investing in new products, that we would continue to invest in advertising. Indeed, I should say that at the outset, we said to all of the would-be leveraged buyout companies that we discussed this deal with that we would only invest our money under the condition that we would be able to invest, that we did not want

to preside over the milking of a great franchise, the milking of a great company.

Senator CHAFEE. Thank you, Mr. Chairman. Thank you gentlemen.

The CHAIRMAN. Thank you.

Senator Matsunaga?

Senator MATSUNAGA. No questions.

The CHAIRMAN. I was intrigued by your answer on the question by Senator Baucus, insofar as the encouragement of the private sector by government. I have some deep concern about having a so-called "national industrial policy," picking winners and losers. It seems to me the private sector has to continue to do that, but I can see a situation where the private sector says, "Without some help, we can't do it, because we are competing against a consortium of companies, be it in Europe or be it in Japan, plus the backing of the government there. Therefore, if you will put some of the seed money in for research, and perhaps give us some relaxation on the antitrust provisions where we have true international competition to hold the prices down, then we can put together a consortium, we are willing to take it on." But the private sector is taking the main part of the risk, and it is a judgment they finally arrive at. With that, I can see it working.

Gentlemen, thank you very much for your testimony.

Senator BAUCUS. Mr. Chairman, may I just ask one very brief question?

The CHAIRMAN. Yes.

Senator BAUCUS. In answer to Senator Chafee's question, Mr. Kidder, you pointed out the value of being private; that is, you don't have to worry so much about the 10(k)'s, et cetera. The logical extension of that is that we should abolish the SEC. I mean, should all companies be privately held so that all managers need worry less about 10(k)'s, and so forth? I mean, where do we go?

Mr. KIDDER. There are some LBO firms that believe of we are in a wave of privatization that will go that direction. Ultimately, we seek the right capital and will at some point, evolve to the point where we have more equity in our structure. The debt well is obviously not infinite; the capital structure has to be right. At such time as additional growth requires enormous infusions of capital———

Senator BAUCUS. Might Kidder go public? Excuse me—might Duracell go public?

Mr. KIDDER. Right. Right now we are limited to 35 investors, so we have very limited ownership, and therefore a limited amount of capital. KKR is not in this to be in the battery business over the long haul; Bob Kidder is. And so I would suspect at some point that there will be an infusion of equity into Duracell, not the least of which will be built up as a result of very positive cash flows.

The CHAIRMAN. Do you have some comment you want to make?

Mr. LEE. Just a quick mention, Senator Baucus. We have taken six companies back to the public market. We have used the equity that we raised to pay off the high-rate bank debt, and those companies have indeed performed well.

The CHAIRMAN. Thank you, gentlemen.

I would like to combine the next two panels, because I believe we have two points of view here, and it will give us a chance to "play one off the other," you might say. So there will be Dr. Summers, department of economics, Harvard University; Dr. Auerbach, chairman and professor, department of economics, University of Pennsylvania; Dr. William Andrews, Eli Goldston professor of law at Harvard University Law School; and Dr. Michael Graetz from Yale University Law School.

Gentlemen, we are very pleased to have you.

Dr. Summers, are you prepared to lead off? If you will hold your testimony to 5 minutes—each of you—that will give us time for questioning. And I will apologize to you if I have to leave. I do have to leave at 20 minutes of 12. I have been invited to a free lunch; but, on second thought, it may not turn out to be a free lunch.

STATEMENT OF DR. LAWRENCE H. SUMMERS, NATHANIEL ROPES PROFESSOR OF POLITICAL ECONOMY, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. SUMMERS. Thank you very much, Senator Bentsen. I appreciate the opportunity to testify before this distinguished committee on the important topic of corporate debt and its interaction with the tax system.

I have submitted a longer statement for the rec. rd, but let me just summarize its four main conclusions.

First, I conclude that widely voiced fears of corporate restructurings and leveraged buyouts pose grave dangers to the economy are probably somewhat exaggerated. These financial innovations in many cases do reduce cost of capital, and in particular improve managerial incentives. Particularly the smaller and less publicized transactions in which owner-founders retire and sell their companies or corporations divest valuable divisions that don't fit with their overall strategy probably serve a constructive purpose.

While there will be bankruptcies in the next recession, inevitably, it seems to me that the financial problems of the over-leveraging of the corporate sector are dwarfed by the financial problems facing the banking system or the savings and loans in the event of another recession.

This does not mean, however, that there is a justification for the large subsidies that we currently give to these transactions through the tax system, only that a punitive effort to tax them out of existence would, I think, be quite unwise.

Second, the tax incentives for these transactions are quite substantial, for two related reasons: First, as is widely recognized, equity income of corporations is taxed twice, once at the corporate level and then again as dividends; second, there are large differences between the rate at which interest is deducted by corporations and the rate at which individuals, the owners of bonds, pay taxes on that interest.

Table 1 in my testimony makes an estimate of the tax rate on the interest income generated by corporate bonds. The conclusion is that that tax rate averages about 7 percent. That means that every one dollar of corporate borrowing results in a 34-cent deduction for the corporation, a 7-cent tax to the holders of the bonds,

and a 27-cent loss to the government. It is easy to see, then, that there will be strong incentives for excessive indebtedness, both in the context of transactions such as leveraged buyouts and in the context of corporate restructurings by incumbent management, as well as transactions that redefine equity as debt, represented by the recent Shearson-American Express deal.

I have seen a number of studies purporting to demonstrate that LBO's in fact help the Treasury. For a number of reasons I can go into, I find that conclusion to be quite implausible and to rest on assumptions that probably do not stand up.

The third conclusion I reached is that a fully satisfactory resolution of these problems is likely to require tax reform of a fairly fundamental sort, tax reform that moves toward expenditure taxation rather than our current system of income taxation, or which eliminates the current distinction between dividends and interest within the context of the current tax system by doing away with existing distinctions between debt and equity.

Others on this panel will speak to possibilities for that kind of fundamental tax reform. I think it is unlikely that the Congress will move in that direction in the short run, and so I think it is helpful to consider the fourth area of my testimony: alternatives which more narrowly get at the problem of excessive leverage.

There is inevitable arbitrariness in trying to distinguish between debt and equity. Inevitably there will be close cases. But when corporations borrow at rates of 10 or more percent above the safe rate of return, when they offer a risk premium greater than common stocks, make no commitment to pay cash for 5 to 10 years, and issue 90 percent of their balance sheet in the form of debt securities, they are, in the words that the investment bankers frequently use, "offering equity in drag." There is little reason why they should be permitted to——

Senator MOYNIHAN. Dr. Summers, would you say that once again? What did you say? [Laughter.]

Dr. SUMMERS. Equity in drag.

Senator MOYNIHAN. That is what I thought you said. [Laughter.]

Dr. SUMMERS. The term is not mine.

Senator MOYNIHAN. Well, you also were careful to make that point. [Laughter.]

Dr. SUMMERS. It is the term that is used by those who are explaining that these debt securities are consistent with financial stability in these transactions.

I believe that it would be desirable to enact limitations on interest deductions based on some combination of the share of earnings paid in interest, whether cash flows are actually paid out, and the yield carried by debt, to use the revenue from such limitations to finance dividend relief on new equity.

Proponents of LBO's argue that they are not driven by tax considerations. In many cases they are right. If so, the benefits of these transactions will continue, even after the Congress mitigates current incentives to push the economy towards debt finance. But some marginal transactions will be eliminated, and those that will remain will command somewhat lower premiums and be somewhat more stable by virtue of greater reliance on equity.

Thank you.

[Dr. Summers' prepared statement appears in the appendix.]

Senator MOYNIHAN. Thank you, Doctor Summers. We will return to you, of course, but we will also move right across our panel.

I believe Dr. Auerbach has a slightly and somewhat different view, and that is what economists are for. [Laughter.]

We welcome you, sir, not just as someone who has studied the subject but who has published on the matter. If you would proceed, we would be very happy to hear.

STATEMENT OF DR. ALAN J. AUERBACH, CHAIRMAN AND PROFESSOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. AUERBACH. Thank you very much, Senator.

Let me summarize the longer statement that I have submitted. And let me also, then, expand briefly on each of the points that I make in my summary.

Senator MOYNIHAN. All statements will be included in the record as if read.

Dr. AUERBACH. And I would be happy to answer questions on my written testimony.

I also have four conclusions, so you see, economists can agree about something.

First, there is no question that corporate debt-equity ratios have risen sharply in recent years. In fact, if one looks at 1988, one would find that the extent to which equity was disappearing from the corporate sector, in terms of share repurchases, after stabilizing for the period a few years before 1988 actually exploded again in 1988. So there is unquestionably reason for the concern that you have about what has been happening to that debt-equity ratios.

I think concern is appropriate. On the other hand, at the moment the levels of debt-equity ratios that we observe in the aggregate in the United States are not unprecedented, even for the United States, and as yet they do not compare to those of our trading partners. Perhaps the starkest comparison can be made with Japan.

Second, the increase in borrowing and merger activity, particularly in the last couple of years, certainly cannot be attributed to changes in tax provisions. Nothing that happened in the 1986 Tax Reform Act can be blamed. If anything, the changes in the incentive to borrow and to engage in takeovers in the last couple of years have worked very much against such activities.

Certain incentives to borrow and acquire may still be provided by the Internal Revenue Code; but those that exist now have existed for many years, long before the merger wave started in the mid-1980's.

Third, the ultimate aim of tax policy should not be to discourage borrowing in general or leveraged buyouts in particular, but simply to ensure that such activities are not driven by tax advantages.

Fourth, given what I see as an increasing difficulty of telling debt from equity—and there are certainly recent types of securities that have demonstrated that—the only practical way to achieve neutrality between debt and equity, even in the short run and not

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just in the long run, is to reduce and eventually remove the distinction between debt and equity imposed by the corporate income tax.

Any plan that does this would have to have as a component tax relief for corporate dividends. But in order to be practical, such a plan must restrict this relief in some way in order to avoid enormous losses of tax revenue.

To elaborate briefly on some of these points, in terms of looking at the tax incentives that have changed in the last couple of years, people have often pointed to the reduction in individual rates, to suggest that now that the top individual tax rate is lower than the corporate tax rate, that means that there is a much greater incentive for corporations to borrow than existed previously.

It is true that for some individual investors the incentive to transmit their money to corporations via debt is greater than it was before; but there are other classes of investors for which the effect has gone in the other direction—for example, tax-exempt investors, pension funds, foundations, universities, and so forth, who are in the zero rate bracket and for whom the major effect of the 1986 act was to reduce the corporate rate and make equity more attractive.

Moreover, the increase in capital gains taxes in 1986 puts a damper on the kinds of transactions that you are most concerned about—namely, leveraged buyouts and straight corporate share repurchases—there the capital gains tax is applying in full force, particularly if there is a large premium involved in the transaction, because that is entirely taxable; there is no additional basis for such increases in value.

I might add, parenthetically, that although we are not here discussing changes in the capital gains tax rate, any thoughts about reducing the rate of tax on capital gains realizations ought to be done in conjunction with a consideration of the types of issues that are being reviewed here. In particular, a reduction in capital gains tax rates, if it were simply a reduction in the tax rates on realizations, would encourage the sorts of transactions that are being discussed here.

The reason why I think that limitations on certain kinds of borrowing or interest deductions are inappropriate is because in many cases there may be great administrative complexity. In other cases, I can't really see the logic in doing so. In particular, I wonder about limiting the rate of interest which one can deduct. There are many reasons why companies would be risky, and only some of them would be appropriate targets.

In introducing a form a equity relief the American Law Institute (ALI) Plan, which Professor Andrews has written, is an attempt to extend equity relief to all corporate dividends, and at the same time limit the extent of the revenue loss to new equity and not existing sources of equity.

That plan is basically an attempt to give dividend relief for all dividends and then take back the relief that is given to existing sources of equity in the form of a disguised tax on the windfalls that such a cut in dividend taxes would produce. That objective is the correct objective to have. It is unfortunate that we can't be explicit about what we are trying to do. Given that the proposal is a very indirect way of doing that, it might achieve the ultimate ob-

jectives that we seek, but at some cost in terms of administrative complexity and potential economic distortions.

[Dr. Auerbach's prepared statement appears in the appendix.]

Senator MOYNIHAN. We thank you, Dr. Auerbach, and we are now going to hear from Dr. Andrews.

May I, just on a point of personal privilege, note that Dr. Andrews is the Eli Goldston Professor of Law at the Harvard Law School. Eli Goldston was a personal friend and a great benefactor of the Joint Center for Urban Studies of MIT and Harvard at the time that James Q. Wilson and then I was director. So, we welcome you especially, sir.

STATEMENT OF DR. WILLIAM D. ANDREWS, ELI GOLDSTON PROFESSOR OF LAW, HARVARD UNIVERSITY LAW SCHOOL, AND REPORTER, SUBCHAPTER C, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, CAMBRIDGE, MA

Dr. ANDREWS. Thank you very much. I have the happy and not universal privilege of having known Mr. Goldston myself and sharing a very warm friendship for him as well as now wearing that label.

I agree with both the prior speakers about the bias created by the present tax law in favor of LBO transactions, and others, and I think it is, in the first instance, in most transactions a product of the interest deduction; although, I would urge that I think a similar and in fact essentially equivalent bias exists with respect to ordinary corporate acquisitions for cash, and, indeed, in favor of transactions by which corporations sometimes buy back their own shares.

And so, the proposals I want to describe here would deal both with leveraged transactions and with unleveraged transactions.

Senator MOYNIHAN. Dr. Andrews, could I just ask, are these proposals those of the American Law Institute?

Dr. ANDREWS. These are proposals that have been developed in a project at the American Law Institute but have not been adopted by the institute; they have been widely discussed over a period of 10 years and published in an earlier version, and a publication of the newest version is scheduled for next month. But they have not been approved by the Institute or formally approved by anybody except me.

Now, to return to what the proposals are: The first would be to confine the deductibility of interest to debt which has been issued to bring property or funds into corporate solutions; which is to say "disallowed" interest deductions on debt entirely for debt which has been issued in exchange for outstanding equity, whether in an LBO or any other transaction that involves the substitution of debt for equity.

And then the second proposal is that, when any corporation makes a non-dividend distribution, a distribution other than an ordinary dividend, and there is not debt in sight on which the interest is to be disallowed, then there should be what the materials now call "a minimum tax on distributions," equivalent essentially, as closely as we can make it, to the tax burden on an ordinary dividend to top-bracket taxpayers.

These proposals I just said were initially developed 10 years ago, and so they are not something which has been developed as a quick fix for the present situation. They are both responses to long-term problems in our present system of taxing corporate income. They happen to be quite responsive to the present situation, but their origin is much more long term.

Indeed, I would describe the first proposal as a resolution, a proposed resolution, of the debt-equity imbroglio. We all know now how hard it is to tell that from equity by the terms of the instrument. This proposal says, "Don't look at the terms of the instrument; look at what it is used for." If you are talking about borrowing, having brought funds into corporate solution, where there will be an increase in corporate gross income as a result of the presence of those additional funds, then an interest deduction should be allowed because it offsets that increase in tax and makes the tax law neutral with respect to the borrowing. If no funds have been brought into corporate solution, on the other hand, and debt is issued in exchange for equity, an interest deduction is nothing but a reallocation of income streams from the government to private investors, and I think that makes no sense at all.

With respect to the minimum tax on distributions, I would also like to assert that it is a new solution, if you will, to an old problem. The old problem is dividend-equivalent distributions. We have had in the law since 1920 a provisions that taxes dividend-equivalent distributions as dividends. That has been developed in the context of private corporations. I think my present view is based upon the observation, and I would like to assert, that for a publicly traded corporation, any distribution to shareholders is dividend-equivalent—dividend equivalent in two senses: first, in the sense that it could have been effected, exactly the same result could have been effected, by paying a dividend to all of the shareholders and then leaving it to them to rearrange ownership of corporate enterprises; and, secondly, equivalent in the sense that it moves funds out of corporate solution with a reduction in future tax liabilities and should subject to the same immediate tax costs; that is to say, a tax equivalent in burden to an ordinary dividend tax.

Thank you.

[Dr. Andrews' prepared statement appears in the appendix.]

Senator MOYNIHAN. Thank you, Dr. Andrews, and we will get back to each of you with questions.

Now, Dr. Graetz, who is from the Yale Law School, which gives you a certain advantage in Washington these days.

STATEMENT OF DR. MICHAEL J. GRAETZ, JUSTUS S. HOTCHKISS PROFESSOR OF LAW, YALE UNIVERSITY LAW SCHOOL, NEW HAVEN, CT

Dr. GRAETZ. I am not sure that is correct, but thank you, anyway.

Let me begin by saying that I think there has been a widespread agreement in the testimony over the last 2 days that the tax problem at issue here involves the disparity between debt and equity, and the tax favoritism for debt vis-a-vis equity, and although there

is a great deal of dispute about the proper solutions, we at least seem to be in agreement about the problem.

Second, I want to echo Secretary Brady's comments of yesterday that the corporations of America seem to have found their own way to integrate the corporate tax by substituting debt for equity. This means, I think, that the transactions which we are discussing today, which include not only leveraged buyouts but also corporate financial restructurings, are a serious threat to the Federal revenues.

This seems to me to be reason for concern by this committee in light of deficit-reduction problems, both for this year and for the next five years in the future. They are also a threat to the efforts of the Congress last year to equalize the tax treatment of companies both across industries and within the same industry, because different companies will pay different taxes depending on how aggressive they are in taking advantage of this problem.

I have in my written statement some rough estimates of the revenues that are at stake, and I think they are worth mentioning here. These are estimates based on facts which are in the Joint Committee Staff pamphlet, but they are not far off the estimates that Professor Summers has presented. I assume a slightly higher rate than he does on interest deductions; nevertheless, my estimates suggest that by substituting a dollar of debt for a dollar of equity, you can move 40 cents that otherwise would go to the Federal Government into private hands.

Mr. Summers suggests that the interest deduction costs 27 cents per dollar to the Federal fist. My number is higher than his, because I also am taking into account the elimination of the double tax on corporate dividends. And I suggest that, even if you make up some of this money from shareholder-level taxes on capital gains in the case of LBO's, you do not make it up in a variety of other corporate restructuring transactions.

The Joint Committee pamphlet suggests that, if the interest deductions of corporations remained at their 1976 level, that1985 corporate taxes would have been $45 billion higher in 1985 than they were. I would be surprised if that $45 billion in lost revenue was made up in that year by shareholder-level taxes.

Second, I think it is no small irony that we are here in the year which marks the twentieth anniversary of two major congressional solutions to this problem—section 385 of the Code, which distinguished between debt and equity, which you mentioned earlier; and also section 279 of the Code, which was designed to limit deductions on interest incurred in connection with corporate acquisitions. Those 20 years proved two things, I think: one is that neither of those solutions is the proper course, and, secondly, that targeted gerrymandering solutions are not likely to outsmart the corporate and investment communities.

In addition, I would say that I think that the least propitious course for the Congress to take lies in proposals aimed at limiting deductions for interest on indebtedness in connection with corporate acquisitions. If the subject is LBO's, the problem is again the "L" word, not the "BO."

In my testimony I comment on Professor Andrews' ALI proposal, and I will not repeat that here, only to say that I continue to be-

lieve that the core of the problem lies in the distinction between debt and equity, and that I would attack that problem more directly.

Let me say that the proposal—the goal that I suggest, rather than a proposal, in my written statement—is that we try and achieve a single tax, at whatever level, on corporate source income. And by that, all I mean is that we impose one tax, at say a 33- or 34-percent rate, on income that is earned by corporations before it is divided up among either the creditors or the shareholders who own the corporation.

In my written statement I detail such a proposal, which suggests that we should move in the direction of a shareholder credit method of imputation on dividends, similar to the method that has been used in Western Europe, and at the same time that we should move in the direction of a bondholder credit type of solution, to the extent that we finance this shareholder credit through reductions in allowances of interest deductions.

Let me make two points about this: One is, it is different from all prior integration proposals, which would have financed dividend relief through increased taxes on retained earnings, either through accelerated depreciation reductions, investment tax credit repeal, or higher corporate rates. Here, we are going to finance relief for distributed earnings from increase of taxes on distributed earnings, so that there is not the corporate problem.

And finally, in conclusion, let me just say that I think if we are going to disallow interest under any of the various—and there are many—proposals before the committee, that rather than substituting one double tax with a simple interest disallowance, which is another double tax, that we should think about giving the bondholder the kind of credit for corporate taxes paid that we are now considering giving to the shareholder both in Secretary Brady's testimony and in my own.

Thank you, Mr. Chairman.

[Dr. Graetz' prepared statement appears in the appendix.]

Senator MOYNIHAN. I want to say, I, for one, found these to be remarkably helpful statements. I know you don't agree, but you are talking about the same thing, and that is extremely helpful to us.

Senator Chafee has been our resident populist and would no doubt want to have some questions.

Senator CHAFEE. Thank you, Mr. Chairman.

As I understand what you were saying, Dr. Graetz—"Grates," is that correct?

Dr. GRAETZ. My uncle pronounced it "Grates," but my father pronounced it "Grats." So I am sticking with my father's view, but even the family couldn't agree on that.

Senator CHAFEE. All right, Dr. "Grats," what you would say is that you would in effect disallow the corporate deduction for interest payments, is that correct? Forget the shareholder or the creditor at the moment; as I understand what you were saying, you would disallow the deduction for interest payments by the corporation. Am I correct in that?

Dr. GRAETZ. Well, Senator Chafee, I think it is important to not disallow the bondholder credit, for the following reason: In the

studies of corporate tax integration, particularly in 1978 when Congressman Ulman made a proposal before the Ways and Means Committee, we learned that a dividend deduction is equivalent to a shareholder-credit method of corporate tax integration. What that means is that a bondholder credit is equivalent to an interest-deduction method of taxing corporate distributions to lenders, with the exception of those people who do not get the credit. And doing this in the form of a bondholder credit allows you——

Senator CHAFEE. Yes, but I am talking about solely looking at it from the corporation's point of view. As I understood it, you would disallow the corporate deduction for the interest payment. Am I correct or wrong in that?

Dr. GRAETZ. No, that is correct.

Senator CHAFEE. That is correct. Then you would send through a credit to the bondholder, or creditor.

Dr. GRAETZ. That is correct.

Senator CHAFEE. Yes. And you would do likewise for the dividend payment.

Dr. GRAETZ. That is correct.

Senator CHAFEE. Now, with some exceptions, that would cost just as much to the Federal Government, as far as the interest goes, wouldn't it?

Dr. GRAETZ. No, Senator. I think that the problem is that you have got three different kinds of tax situations. You have a double tax on some dividends; you have a single tax on some interest; but you also have a zero tax on some interest. It is deductible at the corporate level, and it is either not taxed to the recipient or it is taxed at a very low rate. And I think Professor Summers' numbers suggest that you are not getting a single tax on corporate-source income that is distributed as interest. All I am trying to do is equalize the treatment of debt and equity, and eliminate the biases for retaining or distributing earnings by saying that the government is going to collect a single tax, at whatever rate—I picked a 33-percent rate because you have—at whatever rate on corporate source income without paying any attention to how it is divided up. And you are not now getting that single tax on interest.

Senator CHAFEE. This is heavy weather, I agree.

Dr. GRAETZ. If I have brought it, I apologize.

Senator CHAFEE. I will ask no one in the room, without peeking at his statement, to tell me exactly what is contained in Dr. Andrews' proposal. [Laughter.]

But it seemed to me to involve the purpose of the investment, is that correct?

Dr. ANDREWS. No, that is not correct. That is, in operation, it would not——

Senator MOYNIHAN. Dr. Graetz is saying it is correct. You need to know this.

Dr. ANDREWS. Excuse me?

Senator MOYNIHAN. Dr. Graetz just was saying it is correct, and you were saying it isn't.

Senator CHAFEE. Well, it is his proposal. Let him grade himself.

Dr. ANDREWS. He has misunderstood the proposal for a long time. [Laughter.]

Senator CHAFEE. All right, go ahead.

Dr. ANDREWS. No, it would not turn on any measure of motivation whatsoever. In operation, the proposition would be: if a corporation makes a distribution to shareholders, its own or other corporation shareholders, not as an ordinary dividend, then if it has any debt, an amount of that debt equal to what he's distributed will thereafter not be treated for debt for purposes of the interest deduction.

Senator CHAFEE. I nod my head, not because I understand, but more to indicate, yes, that concludes your time and we will move on to somebody else. [Laughter.]

Well, we will brood over these.

I must say there are two kinds of reaction in Congress to very, very complicated proposals: One is to reject it because we can't understand it; another is to accept it because it is so complicated that obviously there must be a lot of value to it, and no one wants to show his ignorance as the thing sweeps through.

So, I would like to claim a moratorium here for a while, Mr. Chairman, while we investigate these proposals, and I join in thanking this distinguished panel very, very much.

Senator MOYNIHAN. And wouldn't you agree that, while the responses may be complicated, we are being presented with a very elemental question which is easily understood? Debt as against equity, and the differing treatments. And what I hear is an effort to say let's treat them alike, because otherwise you have the Tax Code driving economic decisions in ways that we really don't intend but end up doing.

I have a couple of questions. Since Dr. Graetz and Dr. Andrews have been queried, this is for Drs. Summers and Auerbach. Is there any evidence that would allow you to estimate how much corporate debt would be reduced if your proposals were adopted? Would you have a feeling on that?

Dr. AUERBACH. If which proposal were adopted?

Senator MOYNIHAN. Well, each of you has one.

Senator CHAFEE. That is a challenge.

Senator MOYNIHAN. Start with Dr. Summers.

Dr. SUMMERS. I talked about two options: a fundamental option and what you might call an "incremental option"— defining some kinds of debt as egregiously masquerading equity, and disallowing them. My guess is that that would affect aggregate corporate debt burdens not to a great extent, only probably one or a couple of percent.

On the other hand, that would be enough to be the difference between taking some LBO that is now 90-percent debt financed and making it be 80-percent debt financed, which means that there is twice as large a cushion of equity before it goes into bankruptcy in the next recession. It means there is somewhat less tax juice there.

I think it is important to recall that debt/equity ratios in the United States were substantial—I can't quote the number—before World War I, when there weren't taxes. And so, the idea that all debt is a consequence——

Senator MOYNIHAN. Is a response to taxes.

Dr. SUMMERS [continuing]. Is a response to taxes is, I think, a substantial overstatement. Something that we treated all interest payments the same as all equity payments would be a very sweep-

ing change in the tax structure, and I suspect it would change debt-equity ratios quite significantly, though it certainly wouldn't eliminate debt.

Senator MOYNIHAN. Prior to World War I, prior to the SEC, stocks were pretty risky things, weren't they? I don't know, you would, but the willingness to give money to corporations on the basis of stock must have undergone a considerable increase since the advent of the SEC and quarterly reports, and the departure of Jay Gould to his just reward.

Dr. SUMMERS. There are a lot of things different between now and World War I, and that is one of the important things. If you look at other countries that have dividend-deduction schemes of various kinds, you are not struck that they have lower debt-equity ratios than the United States, and if anything they may have somewhat higher debt-equity ratios. There are other differences having to do with capital gains taxes working differently and banks working differently.

My judgment would be that it would be a mistake to think that the existence of all debt is tax driven; at the same time I think, to the extent you reduce the tax incentives, you would reduce the amount of debt.

Senator MOYNIHAN. Well, we have your estimate of the 27 cents on the dollar as a tax response, and Dr. Graetz' 40.

Dr. Auerbach, the question, again, is how much would corporate debt decline.

Dr. AUERBACH. I think the point Larry made should be emphasized. The determinants of debt-equity ratios are complicated, and to think that changing the tax structure alone, in ways that are being considered here, would have a major impact is probably incorrect.

I don't think the current wave of borrowing, which dates back to about 1983, has much to do with changes in the Tax Code.

Senator MOYNIHAN. You don't think the 1986 Act—?

Dr. AUERBACH. No. I am quite certain, actually, that in the aggregate, although not necessarily with respect to particular investors, that the——

Senator MOYNIHAN. Feel free to repeat yourself. [Laughter.]

Dr. AUERBACH [continuing]. That the 1986 act didn't drive increases in leverage. For one thing, there was no discrete change in behavior in 1986 or 1987, at least with respect to debt-equity ratios.

It has a lot to do with the fact that the economy has been growing quite steadily since the recession of 1981-82, and people may have shorter memories than they ought to about what happens to corporate debt during recessions. That doesn't have much to do with the tax system, nor do the facts that other countries, as well as the United States before World War I, have much higher debt-equity ratios than the U.S. corporate sector.

The point has been made that higher leverage, for example, is threatening financial collapse, is threatening research and development. I find the research and development point particularly strange, given that the comparison is usually made with Japan.

Senator MOYNIHAN. And where the R&D is higher.

Dr. AUERBACH. Where the R&D is supposedly proceeding very nicely with very high debt-equity ratios.

Senator MOYNIHAN. Yes. It is complicated. If it weren't, there wouldn't be departments of economics.

Dr. Andrews, could we ask—again, this is for our very learned staff, who are much more capable in these matters than we are, or I am, certainly—if your proposal requires drawing a line based on what debt is used for. And, if so, isn't it likely that investment bankers will find creative ways to get around such a rule?

Dr. ANDREWS. Well, I honestly believe, sir, that if the proposal on debt were adopted, along with the minimum tax on distributions, which I have also urged, that that would not be a substantial problem, because the only thing that one would have to look for is to see if there have been distributions other than ordinary dividends.

Senator MOYNIHAN. Other than dividends.

Dr. ANDREWS. And if there has been any such distribution, then it will bear either the burden of disallowance of interest on an equivalent amount of debt, or the minimum tax on distributions. And I think if the rates are set at the right general levels, that there is not going to be much play in that at all.

I think it is very easy to imagine that this proposal would depend upon tracing the use of particular proceeds. And if it did, I think it would have a lot of the difficulties that have arisen with respect to the various parts of the interest limitation on increases of home mortgage indebtedness, for example, in which it is very difficult to figure out rationally whether people have spent the borrowing on one thing and their bonus on the other, or vice versa. But this proposal does not have that feature.

Senator MOYNIHAN. Thank you.

We are coming about to the end of our morning, I am sorry to say.

Senator Chafee?

Senator CHAFEE. Just one other point, if I might, Mr. Chairman.

Senator MOYNIHAN. All right.

Senator CHAFEE. I just want to stress for the record a statement that Dr. Summers made on page 15 which I strongly believe in. This is in response to a solution that we are going to hear proposed around this place, and that is, in order to take care of these LBO's, which many find distasteful, that you disallow the deduction for the interest.

Senator MOYNIHAN. Where are you?

Senator CHAFEE. I am on page 15, about 8 lines from the bottom.

Senator MOYNIHAN. All right.

Senator CHAFEE. "There is the additional complication that limitations on interest deductibility might give foreign acquirers an advantage over their American competitors."

Do you agree with that, Dr. Auerbach?

Dr. AUERBACH. Yes, I do, and I am not in favor of limiting interest deductions.

Senator CHAFEE. Well, I don't think any of you have come at it with another approach.

Dr. AUERBACH. That is a significant factor, yes.

Senator CHAFEE. Yes.

Now the other point I feel a little leery about is the suggestion that "the increase in the debt-equity ratios in American corpora-

tions isn't of such great concern, because look at the Japanese." I just think there are all kinds of other factors that are involved that prevent us from just making a straight comparison. "The Japanese have a far higher debt-equity ratio than we do, so what is the matter with our situation?" I find that a dangerous line to go down.

Senator MOYNIHAN. Why do you?

Senator CHAFEE. Why? It is hard to articulate, but I just have a feeling that the cozy relationship between their government and their corporations prohibits their companies from getting into the trouble that our companies might with a similar situation.

Now, how many of you have enough knowledge on these foreign situations—let us take the Japanese, because I am not sure what the European companies are like. First of all, are European country companies similar to Japanese companies, with a very high debt-equity ratio?

Dr. AUERBACH. The Joint Committee reprint that was prepared for these hearings does mention the debt-equity ratios in some European countries, and, although they are not as high in Japan, they are higher than those in the United States.

I certainly apologize if my remarks came out sounding as though, "Well, any debt-equity ratio up to Japan's level is okay, notwithstanding any institutional differences." I guess what I would emphasize is that, if we get rid of the tax incentive to use debt as opposed to equity, then other economic factors may cause debt-equity ratios to fluctuate in this country. And if after doing this kind of tax change we observe higher debt-equity ratios in the United States than we have historically had in recent years, that should not necessarily cause concern.

We don't really know to what extent current borrowing is driven by the tax system; but to whatever extent it is driven by the tax system, that incentive should be made to disappear, and then we can have a little bit more confidence that the decisions that are being made concerning borrowing are based on fundamental economic principles by the companies that do it.

Senator CHAFEE. Why don't we ask Dr. Summers just briefly, because all of us have got to leave.

Senator MOYNIHAN. Sure.

Senator CHAFEE. Go ahead, Doctor.

Dr. SUMMERS. Just very quickly on that: I think there is some merit in the argument that the reason Japan has such high debt-equity ratios is that Japanese banks have some equity in firms, that they have a continuing and ongoing stake in the firms.

To a significant extent, the same kind of thing takes place in LBO transactions, where the use of so-called "strip financing" means that the same people have the equity as have some of the debt, the leveraged buyout firms have strong reputational reasons for being patient, for staying with companies, for not being in a hurry to pull the plug in the way that traditional bondholders and bankers would.

So, to some extent this phenomenon represents evolution towards Japanese-style institutions and therefore can permit higher debt-equity ratios than might have been the case given our previous institutions.

Senator CHAFEE. And finally, Mr. Chairman, let me just say this.

Senator MOYNIHAN. Please.

Senator CHAFEE. I think one thing we have learned in this committee over many years is that trying to use the Tax Code as a method of correcting what we think, or might think, is a problem in our society is a dangerous way to go.

Senator MOYNIHAN. It is the complicated way to go.

Senator CHAFEE. And it results in unanticipated occurrences that none of us foresaw.

Senator MOYNIHAN. I wanted to ask a question, and maybe you could just stay for one moment. In response to your question to Dr. Auerbach, I heard you ask, "Just what is the degree to which corporate borrowing is driven by the Tax Code is something we don't know." Well, I wonder if I could respectfully ask this learned panel, how would you know? If we try to find out the answer to Dr. Auerbach's question so we can make a decision about the Tax Code, we could ultimately conclude, "Well, if it is being driven by the Tax Code, maybe it shouldn't be," as all of you seem to think. But how would you know? How would you get at that? Who is doing the work? Dr. Andrews?

Dr. ANDREWS. I think one way is to talk to people who are doing some of these transactions.

Senator MOYNIHAN. That is right; that is always possible.

Dr. ANDREWS. And just understand that they look at corporate earnings of $100 million, and they immediately recognize that there is that plus the corporate income taxes to be reallocated among investors if they do an LBO. So, if there is $100 million of earnings after taxes, there is $150 million of earnings to be distributed among creditors and shareholders, and if $110 million were distributed to the creditors and were deductible, then the government will only have a third of the remaining 40, and of course the security holders will walk away from the table with a great deal larger a share of the operating income from the corporation than they had before that transaction.

I am not an expert at measuring the macroeconomic magnitude of the thing, but it seems to me perfectly clear that in particular transactions the tax savings to be effected are—I don't know what it means to say "they are driving the transaction," but they are affecting the price; they are determining the price that can be paid for the stock of the company in the LBO.

Senator MOYNIHAN. Well, we have a saying in the social sciences that "data is the plural of anecdote," and I suppose that is one way to go about it. I mean, just ask me, and we could hold hearings on the subject.

One last question before Senator Chafee has to leave and we have to close:

Do we agree that, whatever the case, the shift from equity to debt has cost about $45 billion annually, that we would have about $45 billion more in revenue had we continued with the old patterns? Is that about right?

Dr. GRAETZ. I was the one who used that number, and I think I ought to be clear. The Joint Committee has data that shows what has happened to corporate debt over a period of time, and they

have an estimate which they do not then conclude. I think their numbers would give you this $45-billion number. All I did was a little arithmetic. Their number suggests that if corporate debt had remained at the 1976 level, 1985 corporate tax revenues would have been $45 billion greater than they were at that time.

Now, there is the question of to what extent have the total revenues been affected by other taxes on shareholders or whatever from these transactions. I am not offering a number as to that today, but I think it is extremely dangerous for the Congress to assume that that number is big enough to offset that $45 billion loss in the corporate tax revenue base.

Senator MOYNIHAN. Thank you very much. May I just say that the Joint Committee staff is not prepared as yet to offer an estimate, but no doubt it will.

This committee—we regret that this is our first day in actual working session, and so Senators are in every which direction. But we have learned a very great deal. We are very much in your debt. We mean to look to you for further analysis. I hope you will feel free to call us, let us know what you think we should know.

And with that, the second day of the hearings is closed.

[Whereupon, at 12:30 p.m., the hearing was recessed, to be reconvened at 10:00 a.m. on Thursday, January 26, 1989.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

STATEMENT BY WILLIAM D. ANDREWS

Mr. Chairman and Members of the Committee:

My name is William D. Andrews. I am the Eli Goldston Professor of Law at Harvard University where I have specialized in Federal Income Taxation, and particularly the income tax treatment of corporations and shareholders, for twenty-five years.

I have also served, since 1974, as the General Reporter for Subchapter C in the Federal Income Tax Project of the American Law Institute (ALI). A final report of that Project was published in 1982, containing Proposals of the Institute on a number of matters that have been the subject of legislation since that time; and a Reporter's Study concerning the matters involved in these hearings. The Project was reactivated two years ago, and a new Reporter's Study Draft is scheduled for publication next month.

The current work in the ALI project is very relevant to these hearings. But it is work in process, and the Institute has not adopted any of it. My testimony today is solely my own and not on behalf of the Institute, and my position here, while generally consistent with that in current drafts in the ALI project, does not in any sense represent an ALI position.

A. *Taxes and Leverage*

Present tax law contains a very generous subsidy for LBO's and similar transactions. That subsidy takes the form of a drastic reduction (or elimination) of corporate income taxes following such transactions, chiefly by reason of the corporate

interest deduction. One effect of this subsidy is a substantial loss of corporate income tax revenue, for some years to come, every time one of these transactions is done. Another effect is that more of these transactions are done than would be in an environment of neutral taxation (or no taxes). I do not believe that the tax laws should be used to curb LBO's (or hostile takeovers or other transactions); I think free market results may well provide the best available measure of the social desirability of financial rearrangements. But that judgment only holds if markets are allowed to operate free of artificial distortions like tax subsidies, and it is therefore quite intolerable to have a tax law subsidizing such transactions, and the law in that respect needs to be fixed.

The primary effect of an LBO is to reallocate future corporate operating income among investors - shareholders, bondholders and other creditors. A substantial portion of income is allocated to creditors in the form of interest, leaving less for shareholders - but that smaller portion is divided among many fewer shares, so that earnings per share may actually increase, and in any event they become much more volatile - more subject to change on account of increases or decreases in operating income. This is the standard, well-understood view of the matter. And if it were a complete picture, then lots of reasons could be given why parties should be left free to make such arrangements, and why we should accept whatever level of LBO and acquisition activity might result.

But that is not a complete view, because it fails to take any account of the tax collector's role. Before a typical LBO, a substantial share of corporate operating income is allocated to the tax collector in the form of corporate income taxes. Under present rates, the tax collector's portion is about half as large as that accruing to shareholders (after taxes). (Until 1987, the govenment's portion was nearly equal to that of shareholders after taxes.) After a typical LBO the government's share will have shrunk drastically, often to zero, and often for several years to come. Total investors' shares of operating income will have risen by the same dollar amount, even if the transaction has no effect whatever on operating income.

Suppose, for example, a corporation has only common shares outstanding and no funded debt. Its earnings are 100x, and it has 10x shares outstanding, so earnings per share are 10. Suppose the stock sells at 80, for a price/earnings ratio of 8, and a total market share value of 800x.

Now suppose the corporation borrows 800x at 12.5 percent interest and uses the proceeds to retire 7.1x shares at 112 (a 40 percent premium over the market price of 80). One might think, at first, that if an amount equal to the whole value of the company were paid out to 71 percent of the shareholders there would be nothing left for the remaining 29 percent.

But LBO promoters know better. If a corporation has earnings of 100x, it likely has pre-tax income of around 150x and taxes of 50x. Interest at 12.5 percent on new debt of 800x would be 100x. While that just equals the prior earnings, it is only two-thirds of pre-tax income (150x). After the transaction, one will subtract interest from operating income, leaving 50x for continuing shareholders and taxes. If the government takes a third of that (17x), there will be 33x left for shareholders, which is 11.4 per share, 14 percent more than what they had before.

So the net effect is that 71 percent of the shareholders have been paid off at a very handsome premium, and those continuing have had an immediate increase in earnings per share, just assuming that operating income can be held constant. As to the government, it has had 71 percent of its share of operating income simply cut off; reallocation of that share from the tax collector to private investors accounts for most of the market premium produced in these transactions.

Of course the government, like the selling shareholders, may get something in the way of immediate compensation for liquidation of its income share; its compensation will take the form of income taxes on the gains of taxable shareholders who sell their shares. But that compensation is virtually sure to be far less in amount than the value of the income share terminated by the transaction. A substantial number of selling shareholders are apt to be tax-exempt; for them there is no tax. And among taxable shareholders, many will have substantial bases, from having purchased or inherited their shares; a tax on their *gains* will not adequately compensate for elimination of corporate income taxes on the whole *value* of their shares. If the whole amount paid out to shareholders in these transactions were taxed as a dividend to taxable shareholders, the resulting tax would be reasonably adequate compensation for liquidation of the government's corporate income tax share; existing taxation of investors falls far short of that, and leaves a very substantial net tax subsidy in place.

B. *Unleveraged Equity Acquisitions*

Though it is less obvious, the tax law contains essentially the same subsidy for various other transactions that have occurred with increasing frequency during the present decade. These include corporate acquisitions for cash of the acquiring corporation; simple share repurchases; and cash investments in the already-outstanding shares of other corporations: indeed any distribution of corporate funds for or on account of outstanding equity interests in the distributing corporation or any other corporation, other than an ordinary dividend. The funds used in these transactions have presumably been invested in income producing assets or deposits prior to their use in the transaction, and the effect of the transaction will be to move the investment return on them out from under the burden of the corporate income tax. The effect of distributing such income-producing financial assets is essentially identical to that of distributing debt obligations of the distributor itself: - future corporate taxable income is reduced by the amount of interest on the amount distributed, and the resulting tax savings become available to private investors, thus producing a magical increase in security values, even if the effect on operating income and business performance is nil. The premiums payable to shareholders of acquired corporations are said to be about the same for corporate cash acquisitions as for leveraged buyouts, and can be explained in exactly the same way.

C. *What Should Be Done?*

1. *Disallow Interest on Debt Incurred or Continued to Finanace Equity Acquisitions.*

The tax law creates a subsidy for debt-financed equity acquisitions and redemptions by way of the interest deduction; the most direct and obvious way to eliminate the subsidy would be to disallow the deduction, and this should be done. No deduction should be allowed for interest paid on indebtedness incurred or continued to take the place of outstanding corporate equity, either that of the interest-paying corporation itself or that of other corporations. And the determination whether debt is incurred or continued to take the place of outstanding equity should be made by a straightforward, tough stacking rule:

whenever a corporation with debts outstanding uses funds to acquire or retire outstanding equity (instead of making payment on the debt), the debt should be considered to be continued to take the place of the retired equity, and interest disallowed accordingly.

On the other hand, interest on debt incurred to bring funds or other property into corporate solution should remain deductible. When property is brought into corporate solution, its earnings will be subjected to the new burden of corporate income taxes, and that new burden creates a bias against such contributions. The interest deduction functions nicely to offset that bias in the case of debt-financed corporate property acquisitions. Nothing should be done that would impair this general operation of the interest deduction. (One might well wish, however, to disallow interest above some reasonably generous specified rate, even in this case; but only the excess interest should be disallowed, since it promotes neutrality to allow an interest-type cost-of-capital deduction to offset the tax on the basic return from contributed funds even if the paper issued in return has many of the characteristics of equity.)

2. *A Minimum Tax on Distributions.*

Some of the transactions for which present law provides an inadvertent subsidy do not involve the issue of debt, and some of the corporations involved in such transactions are without substantial debt at all. As to them, disallowing interest is not an effective way to eliminate the subsidy. What is needed is a tax on the transactions themselves, sufficient to create a level playing field.

I would urge the Committee to consider and approve a Minimum Tax on Distributions (MTD) along these lines: The tax should be at a rate equal to the top individual rate or the top corporate rate - at the present time 28 percent would do. It should be collected out of the amount distributed, so that its burden will equal that on a dividend going to a top bracket taxpayer. It should be collected from the distributing corporation. Finally it should be allowed as a credit, in most cases, against investor taxes arising from the distribution transaction, since the purpose is to be sure that taxes on the distribution reach a certain minimum level, not to impose an additional burden when shareholder taxes are already high.

With a tax of this sort in place, a rough balance of

incentives will have been restored in which all distributions bear an immediate tax whose burden is commensurate with the benefit of getting future earnings out from under the burden of corporate double taxation. I use the word *restored* because this seems to me to be an equilibrium that held, in a rough way, for most corporations, so long as the vast majority of distributions took the form of ordinary dividends.

3. *Relations between Proposals.*

First, these proposed provisions are alternatives, in the sense that any transaction subject to one should not be subject to the other. As to which should apply to a particular transaction, taxpayers would likely prefer interest disallowance to the payment of MTD, and this seems perfectly acceptable as long as there is debt to be so treated. So all distributions other than ordinary dividends should be applied first in reduction of qualified debt and then anything more than that subjected to MTD.

What if one of these proposals were to be adopted without the other? If the MTD were adopted, then I believe the interest disallowance proposal is a matter of choice. That is to say, while substitution of debt for equity would indeed reduce future corporate income tax collections, the MTD itself would represent substantial compensation to the government for that loss, and prevent the large windfall gains that accrue to shareholders under the present system.

On the other hand, interest disallowance would not do away with the need for the MTD. Interest disallowance, along the lines suggested here, would take the tax subsidy out of many of the transactions that have been done in this decade, but it would leave the subsidy there for corporations with excess cash available to carry out acquisitions and stock retirements without borrowing. Moreover, it would create some difficulties in implementation, because debt-financed transactions would sometimes be so arranged that it would be difficult to match distributions and borrowings. If a corporation is completely liquidated, it will have no debts thereafter on which to disallow interest deductions; yet its assets may well have been previously sold, directly or indirectly, on a debt financed basis.

In my judgment it would be better to do interest disallowance alone than to do nothing; but it would be much better, in terms of effective administration and evenhandedness,

to limit interest in this manner and also adopt the MTD for distributions where the debt financing, if any, is not obvious.

4. *Dividend Relief.*

Another way to reduce the biases in favor of debt over equity and nondividend distributions over ordinary dividends, would be to treat dividends more like interest. This could be done several ways, and it could readily be done in a manner calculated to offset the revenue and wealth effects of interest disallowance and MTD.

a. *The ALI Reporter's Proposal on Equity Contributions.*

The current ALI working drafts, as well as the 1982 final report, contain a proposal to treat new stock issues akin to debt by establishing a net capital contributions account and allowing a deduction for dividends paid, to the extent of a reasonably generous specified interest rate times the balance in that account. New equity issues are disadvantaged under current law since they bring property earnings under the burden of the corporate income tax without any offset akin to the interest deduction. This proposal would fix that by creating a deduction equal to what would have been allowable as interest if the financing had included debt as well as stock. This proposal would affect only future capital contributions and would have no effect on yields from corporate capital already in place. While I know of no professional revenue estimates on this proposal, my impression is that the revenue impact would be quite limited.

b. *Dividend Relief Integration.*

There are more general schemes of dividend relief designed to remove the burden of double taxation on dividend income, either by granting corporations a deduction for dividends paid or by giving shareholders credit for the corporate taxes already paid on the corporate earnings from which their dividends are paid. Many countries in the world today have some degree of dividend integration of this sort.

Adoption of 100 percent dividend integration would virtually eliminate the tax biases here under discussion. It would also apparently be very expensive in revenue terms, and would confer substantial windfalls on existing corporate equity owners.

But dividend relief integration can be taken in parts, with a deduction or credit for some fraction of dividends paid. Such a step would reduce but not eliminate present tax biases.

c. *Relations to Interest Disallowance and MTD.*

The ALI Reporter's Proposal on Equity Contributions is designed to go with interest disallowance and MTD, and if those proposals are adopted I would urge adoption of the Equity Contributions proposal, too. On the other hand, the ALI work, so far, takes no position on the desirability of general dividend relief integration. It is clear, however, that the proposals described here can be readily combined with whatever amount of general dividend relief integration the Committee, or the Congress, may desire. It would be perfectly sensible to construct a combination of interest disallowance, MTD, and an amount of partial dividend relief integration designed either to hold tax revenues constant, or to have no net effect on stock values, or both.

5. *Other Matters*

a. *Rate Inversion.*

Throughout virtually the whole history of our modern income tax, the corporate income tax rate has been significantly below the individual income tax rate for top bracket investors. As a result, for a growing business, operation in corporate form was a way to reduce immediate taxes. This reduction in immediate tax burden would tend to offset the eventual burden of double taxation. In effect the government made taxpayers a shrewd offer of lower immediate taxes, permitting faster after-tax growth, in exchange for a long-term share in the resulting corporate wealth, a share represented by the claim for two rounds of tax on earnings of mature corporations (i.e., those with earnings exceeding their continuing capital needs).

That relationship was eliminated in 1981 with the reduction of the top individual rate on investment income from 70 to 50 percent, something very close to the top corporate rate. No longer was there any immediate tax advantage from having taxable income accrue to a corporation instead of its shareholders (except for the first $100,000 of income of any particular corporation, which is taxed at less than the regular corporate rate).

The discrepancy in rates was revived in 1986, but turned on its head. Now the corporate rate stands 6 full points *higher*

than the rate applicable to top bracket individuals, so avoiding corporate form not only avoids double taxation it also produces an 18 percent reduction in immediate taxes.

The proposals described above are designed to respond to problems that are inherent in the classic system of double taxation of corporate earnings, so long as some distributions are allowed to go on without the burden of a dividend tax. They are the biases that have governed close corporation practice under the income tax since the beginning, even while corporate and individual tax rates were maintained in a natural relationship to each another.

The 1980 and 1986 changes in rate relationships are not the primary source of the cureent tax bias in favor of LBO's and the like, but they have aggravated that bias considerably, and should be undone. It has not been the policy of the ALI to make recommendations with respect to rates, but in my personal view it is a matter of some urgency to correct the present rate inversion and somehow figure a way to make marginal corporate tax rates again somewhat *lower* than top individual rates on interest income. This correction should be made whether or not any of the other changes recommended here are adopted.

b. *Capital Gains.*

The question of capital gain rates is much less clear, but there are substantial reasons for restoring a regime of reduced taxation on sales of shares not involving any corporate distribution.

Prior to 1986, one could have a nondividend distribution to a fully taxable shareholder and have it taxed at much less than the rate applicable to dividends generally, in part due to the capital gain rate break. But the imposition of ordinary income rates on gains from sales does not eliminate the bias in favor of nondividend distributions, as compared with dividends, because gains are often much less than the whole amount distributed. Moreover, sales of shares to noncorporate purchasers automatically bear the burden of continuing corporate income taxes, unless a restructuring is in view, and the addition of a full ordinary income tax on such gains creates an excessive burden. In short, the burden of ordinary income rates on gains is excessive for transfers among noncorporate shareholders, and still deficient in relation to distribution transactions.

I would therefore favor restoration of a substantial rate preference for sales of corporate shares, but only upon adoption of a Minimum Tax on Distributions, or something similar.

PREPARED STATEMENT OF ALAN J. AUERBACH

Mr. Chairman and Members of the Committee:

The recent explosion in corporate borrowing and leveraged buyout activity raises significant questions about tax policy and financial regulation. This committee is to be commended for addressing these questions so swiftly. I will begin my testimony by stating my conclusions.

1. Corporate debt-equity ratios have risen sharply in recent years. This increase is largely attributable to increases in share repurchases, cash-financed acquisitions and leveraged buyouts. Yet current debt-equity ratios are not unprecedented for the United States, nor do they yet compare to those observed in Japan or in many other industrial countries.

2. The increase in borrowing and merger activity cannot be attributed to changes in tax provisions. While certain incentives to borrow and acquire are provided by the Internal Revenue Code, these have existed for many years and, in some cases, were actually reduced by the Tax Reform Act of 1986.

3. The ultimate aim of tax policy should not be to discourage borrowing in general or leveraged buyouts in particular, but simply to ensure that such activities are not driven by tax advantages.

4. Given the increasing difficulty of telling debt from equity, the only practical way to achieve "neutrality" is to reduce and eventually remove the distinction between debt and equity imposed by the income tax. A component of most plans would be tax relief for corporate dividends, but the relief must be restricted in some way to avoid enormous losses of tax revenue.

Debt-Equity Ratios

There is little question that fundamental changes in corporate financial behavior have occurred in recent years. In every year since 1984, net corporate equity issues have been negative. After appearing to level off at an annual level of about $80 billion through 1987, net repurchases occurred at an annual rate of $109 billion during the first three quarters of 1988, according to statistics compiled by the Federal Reserve Board. The bulk of this decline in equity is attributable to cash-financed acquisitions, although share repurchases have also played an important role.

Over this same period, corporate borrowing has increased. Net annual borrowing by nonfinancial corporations averaged $64 billion during the period 1980-83, $153 billion during the period 1984-87, and $183 billion during the first three quarters of 1988.

Despite this evident shift away from equity and toward debt, the aggregate corporate debt-equity ratio is still not especially high by historical standards or by international comparison. At the end of 1987, the debt-equity ratio of the U.S. nonfinancial corporate sector, measured at market values, was .71. This ratio has hovered between .62 and .76 since 1980, and indeed was higher during the entire period from 1974 to 1979. Measured at book values, the current aggregate debt-equity ratio is higher than during the last decade, but comparable to those of the late 1960s and early 1970s. By comparison, the aggregate debt-equity ratio for Japanese nonfinancial corporations has exceeded 1.0 (more debt than equity) for decades.

These aggregate statistics suggest that current levels of indebtedness of U.S. corporations are not dangerously high. What is cause for concern, though, is the speed with which debt has recently replaced equity and the

prospect that the shift may continue at this pace. At some point, the financial stability of U.S. business could become a serious issue. While I cannot offer a definitive explanation for recent behavior, I do not believe that changes in tax policy are the cause.

Borrowing and the Corporate Tax

Corporations deduct their interest payments in computing their taxable income, but cannot deduct dividends. Because of this, companies are encouraged to finance their investments by borrowing rather than by issuing new equity. This is a defect of the system of taxation under which we treat corporations as separate entities, but it has always been one. Little has happened in the relative treatment of debt and equity that can explain recent changes in financial behavior.

The Tax Reform Act of 1986 reduced the corporate tax rate from 46 percent to 34 percent, cutting by over one-fourth the value of the corporate interest deduction. This can hardly explain an increase in borrowing. One must look at the taxes paid by asset holders to get a complete picture of the total tax burden. Marginal tax rates on interest receipts and dividends also fell under the 1986 Act, especially for high income investors. On the other hand, capital gains tax rates rose. Since a significant part of the return to equity is typically in the form of capital gains, the net impact of these provisions was to lower the individual tax burden on interest income by considerably more than on total returns to equity. This works against the reduction in the corporate tax rate, and the net impact depends on an investor's tax bracket. Among high bracket investors, for whom the reduced tax burden on interest payments is significant, the net result has been to encourage corporate borrowing. For another significant class of investors, tax exempt institutions and pension funds, only the corporate tax changes are

relevant, and these discourage the use of debt. If one weighs the effects on different classes of investors, the 1986 Act appears, on balance, to have discouraged borrowing.

A second factor discouraging the use of debt recently has been the decline in the rate of inflation and nominal interest rates. Since the potential tax advantage of borrowing is attributable to the deductibility of nominal interest payments, this decline in interest rates would have reduced the tax advantage of borrowing even had there been no change in marginal tax rates.

As recent changes in tax rules and inflation have discouraged borrowing in general, they have put an even greater damper on borrowing associated with cash acquisitions and leveraged buyouts. I have already described the changes in the relative tax burdens on returns to equity and debt. But to convert equity to debt, corporations and shareholders must bear additional taxes. The increase in capital gains taxes hits equity repurchase transactions with full force, to the extent that shareholders are taxable. This is especially true in the case of acquisitions, because the premia associated with tender offers are fully taxable at the capital gains tax rate. Moreover, the 1986 repeal of the General Utilities doctrine means that the tax benefits of stepping up asset bases are likely to be more than offset by immediate corporate capital gains tax liabilities. On balance, it is very difficult to argue that debt-financed takeovers have been newly encouraged by the tax system. The evidence is very much to the contrary.

Why the increase in borrowing and debt-financed takeovers? I believe there are several causes. One is the macroeconomic performance of the 1980s. The U.S. economy has been growing steadily since 1982. The fear of financial reverses that normally limits borrowing may well have subsided as memory of

the last recession faded. Another important factor is the changing nature of U.S. financial markets. The increasing availability of large pools of funds to finance potentially risky borrowing on a significant scale has helped. There has been considerable debate over the social value of "junk" bonds and whether markets have adequately measured the risk they carry. But, in general, innovations that reduce the cost of financial intermediation and make funds more available are technological advances just as much as discoveries that reduce the costs of manufacturing processes. Historically, the development of financial intermediaries has played a significant role in the rise of industrial economies. We hardly should lament the continuation of this process or the changes in financial structure that it brings.

Borrowing has also increased, I believe, because of an increase in the competitiveness of the market for corporate control. Whether involved in a takeover or not, managers are being pushed to borrow more to maintain equity values. In this more competitive market for corporate control, fostered by relaxed antitrust enforcement and the increasing availability of funds, corporations have often been driven to borrow as a way to increase the value of their shares and thereby defend against potential acquisition. Directly or indirectly, the takeover process has spurred corporate borrowing and its associated increases in share values.

Not all of this increase in value has been socially beneficial. Increased borrowing can reduce the value of existing corporate debt, in effect transferring resources to shareholders from the owners of outstanding debt. Another source of value that is equally unproductive from the social perspective is the reduction in federal tax burden associated with borrowed funds. Even though the tax incentive to borrow has not increased, the pressure to take advantage of this tax incentive has. While perhaps helping

shareholders, competition that forces corporations to reduce their tax burden is hardly in the public interest. Evidence on leveraged buyouts from the period through 1986 suggests that a substantial part of the takeover premium can be explained by tax factors. However, such evidence also suggests that companies taken private subsequently reduced operating costs, a result some would attribute to the increased pressure of having to meet higher interest payments. The continued growth of LBO activity after 1986 suggests that nontax factors play an important role.

In summary, the tax incentive to borrow has not increased in recent years, though pressure on managers to take full advantage of this incentive may help explain increased corporate borrowing. At the same time, the strong economy, the reduced cost of financial intermediation and increased pressure on managers to operate efficiently may also have played a significant role in encouraging corporate borrowing.

The Social Costs of Borrowing

There is little question that tax-driven borrowing is an appropriate target of tax reform. If borrowing has tax advantages, then those who borrow impose a cost on the rest of society by increasing the amount of tax that must be raised from other sources. Some would argue that corporate borrowing, even if not tax driven, has social costs beyond those recognized by those who borrow, that a "level playing field" is still too generous to borrowing. I do not subscribe to this position, but believe the arguments are worth review.

1. Restrictions on Monetary Policy

If a significant fraction of the corporate sector is deeply in debt, a credit crunch with sharply rising interest rates would drive many firms into bankruptcy. The prospect of such a debacle might impede the ability of the

Federal Reserve to use tight monetary policy to fight inflation. Hence, more borrowing might inevitably lead to more inflation.

This theoretical possibility is not very convincing, particularly given the behavior of monetary policy in recent years. In the early 1980s, the economy experienced the deepest recession since the Great Depression, as a tight monetary policy was successfully used to bring the inflation rate down rapidly. If the Fed is willing to fight inflation with unemployment rates exceeding 10 percent, why should it be cowed by higher rates of default?

2. Lack of Long-Range Planning

Managers of U.S. firms have been criticized for being too concerned with short-run results, and have been compared unfavorably to their foreign counterparts, notably the Japanese, in this respect. The increased pressure to meet interest payments is viewed by some as increasing the pressure to focus exclusively on short-run results.

There are several difficulties with this line of argument. Perhaps most obvious is that, as I have already pointed out, Japanese firms have significantly higher debt-equity ratios than do those in the United States. Moreover, companies taken private typically have been mature companies in stable industries with little research and development or long-term spending. There is no evidence to support the related argument that firms involved in ordinary mergers and acquisitions experience a reduction in expenditures on research and development.

3. Reduced National Saving

There is little doubt or disagreement that the U.S. saving rate is very low, particularly in light of the federal budget deficit. In recent years, private saving has barely exceeded public dissaving. Corporate saving, via

retained earnings, typically has accounted for about half of all private saving in the United States. By substituting debt for equity, corporations are committing themselves to save less. Some fear this will reduce private saving as a whole.

Although this is a worrysome prospect, there is no evidence that increasing distributions of funds from corporations, either through interest payments or increased dividend yields, in itself causes a decline in the level of private saving. The recipients of these funds are not prohibited from reinvesting them. My own recent research on this subject fails to turn up any evidence that changes in corporate financial policy, by themselves, affect the rate of private saving.

The Appropriate Objectives of Tax Policy

The main problem associated with corporate borrowing - if any problem exists - is the tax advantage of borrowing that remains even after the Tax Reform Act of 1986. Once this advantage is eliminated, no further restrictions on borrowing are necessary. Even if the tax advantage is not eliminated, the imposition of borrowing restrictions represents a poor substitute for the direct solution.

1. Borrowing Restrictions

Several restrictions have been proposed to limit corporate borrowing. The simplest would be to reduce the deductibility of interest payments on all corporate debt. This is the most general type of borrowing restriction and for many reasons the most attractive. It is the simplest to enforce, for it is easier (though not necessarily easy) to identify debt than to identify debt incurred for particular reasons. Reducing interest deductibility also attacks the underlying problem, which is the tax advantage of debt over

equity. Finally, it can be implemented to satisfy other objectives as well, such as raising tax revenue and moving toward a system of taxing real income, with only the real component of interest expense (and not the inflation premium as well) deductible. The main drawback of reducing the deductibility of interest is that it exacerbates the distinction between corporate and noncorporate investment; the latter already enjoys a lower overall rate of tax. It would be better to achieve neutral tax treatment of debt and equity by lowering the tax rate on equity income, for this would also reduce the distortion between corporate and noncorporate investment.

Other, narrower restrictions on borrowing are far less attractive, being harder to implement and more difficult to justify. One type of policy that has been considered seriously in the past would limit the deduction of interest on debt incurred to finance takeovers. Like other targeted borrowing restrictions that have been introduced in recent years, such a restriction would introduce great complexity to the tax system. Identifying such debt would be very difficult, for money is fungible. Even if this problem were overcome, I can see no reason to discourage takeovers this way; what problem is such a measure supposed to address?

Another restriction on borrowing would place a cap on interest deductions based on some relatively safe rate of interest, making the excess interest on high-yield, lower grade bonds nondeductible. Once again, I see both administrative and logical problems with such a policy. From the administrative viewpoint, one would have to identify the interest rate on each obligation. How would one treat bonds that had been downgraded after their issue, for example? One might seek to rationalize this policy by pointing to the fact that it removes the tax advantage of borrowing once there is substantial risk of default. However, the extent to which interest deductions

should be denied to produce neutrality between debt and equity depends on the relative tax treatment of debt and equity, not on the riskiness of the debt. An alternative argument is that once debt becomes risky, it is like equity and should be treated like equity. But the sources of risk for equity and low grade debt are quite different.

2. Equity Relief

As I have already suggested, the best approach to the unequal taxation of debt and equity is to reduce the tax burden on corporate equity. A simple and straightforward approach, already practiced in many countries, is some form of "dividend relief," implemented either through a deduction for dividends paid (also called a split-rate system) or through a shareholder credit (also called an imputation system). The problem with such a plan is also simple: it is very expensive. The Treasury's November 1984 tax reform proposals included partial dividend relief in the form of a 50 percent deduction for dividends paid. It was then estimated that this plan would cost the Treasury $30.9 billion in fiscal year 1990. Little has happened since that would alter this estimate substantially. Such partial dividend relief, and certainly more complete relief, is entirely impractical at present. Even a 10 percent dividends paid deduction would cost roughly $6.7 billion during fiscal year 1990, according to the estimates presented in the president's 1985 tax reform proposals.

These proposals are expensive because they would create windfalls. Most dividends paid during the next few years will come from income on assets already in place. Reducing the taxes on all such income is a very inefficient and (to the recipients of such income) overly generous method of correcting the distortion between debt and equity finance. There are many ways to make this policy more efficient, but each has its drawbacks.

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A. Institute the policy, but combine it with a tax on the windfalls generated. The most straightforward approach would combine a dividends paid deduction with an offsetting tax on some measure of current dividend capacity, such as accumulated earnings and profits. For example, a 50 percent dividends paid deduction would be combined with a 17 percent (50 percent of the 34 percent corporate tax rate) tax on accumulated earnings and profits. The windfall tax could be made payable over several years. The logic of this policy is that it would eliminate the net benefit of the deduction for all dividends paid out of past earnings and profits; it would provide a net reduction only for dividends generated by new equity capital. Depending on the timing of the windfall tax, the total package could raise revenue for a number of years. The disadvantage of this policy is not economic but political. The president's 1985 proposals included a similar provision (to reduce the windfalls arising from the corporate rate reduction) that proved to be extremely unpopular, and I am sure this policy would have a similar reception. That is unfortunate, because from an economic perspective it is clearly the best policy.

B. Institute the policy of dividend relief only for new equity issues, and combine this with restrictions on the conversion of existing equity to debt or new equity. This is the proposal circulated by the American Law Institute (ALI). The most recent version (dated November 1988) would provide a dividends paid deduction based on the extent of new equity contributions, and would at the same time impose an alternative minimum tax of 28 percent on nondividend corporate distributions, withheld at the corporate level and credited against shareholder tax liability on the distributions.

The ALI proposal is intended to limit windfalls by excluding existing equity from dividend relief. Under certain assumptions, this approach would

provide the same incentives as the combination of full dividend relief and a windfalls tax. Neither the tax on accumulated earnings and profits nor the ALI proposal would either discourage or encourage conversions of existing equity into debt. This would be true in spite of the new tax on nondividend distributions because this tax (or the ordinary tax on dividends) would apply to any distributions a corporation made in the future. Thus, the tax could be deferred (with interest, since distributions would be greater in the future) but not reduced in value, and so, like the tax on accumulated earnings and profits, could not be avoided.

The ALI plan is a more elaborate way of achieving the tax on windfalls. In effect, the corporation rather than the government decides when the tax is paid; the unpaid balance accumulates interest. The proposal's major "benefit" is that it is less clearly an unavoidable capital levy. While this lack of transparency may make it more acceptable, it also makes it harder to understand and, I would presume, enforce. This is evident from the many drafts through which the proposal has gone. Unlike the more straightforward policy, its effectiveness depends on taxpayers believing that its provisions are permanent. A permanent tax on distributions may not affect the timing of such distributions, but a temporary tax would. Given the frequency with which tax provisions change, any tax on distributions may be perceived as a temporary one. In this case, the ALI plan would strongly discourage share repurchases, leveraged buyouts and other cash acquisitions. It might even discourage dividends, if corporations anticipated that dividend relief would be made available to all dividends in the future.

My conclusion is that the ALI plan's chief distinction is that it is more difficult to comprehend than a windfalls tax. At best, its impact would be identical, but it might very well impose costly distortions as the price for

its complexity.

C. Combine a partial dividends paid deduction with a partial denial of the deduction of interest. Although this approach would raise the overall burden on new corporate investment more than either of the previous approaches (it pays for dividend relief with an increase in the tax burden on debt-financed corporate investment), it would still achieve neutrality between corporate debt and equity without a significant revenue cost. It is a workable approach that does not depend on novel tax instruments or particular expectations about future policy, but it also imposes costs (in discouraging corporate investment) that may outweigh its benefits (removing the distortion of corporate financial decisions).

Conclusions

In a dynamic economy experiencing financial innovations and more competition for corporate control, it is natural to ask to what extent the changes we observe are for the best. It is not clear that the tax advantage to debt is an important cause of recent increases in borrowing, but this distortion has merited correction for many years and might well be addressed now to ensure that it play no part in future behavior. The solution chosen, however, ought to satisfy the ultimate objectives of taxation rather than simply assuage the fears of the moment.

STATEMENT
OF
MICHAEL J. GRAETZ
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before the
SENATE FINANCE COMMITTEE
on the
subject of
LEVERAGED BUY-OUTS
January 25, 1989

Mr. Chairman and Members of the Committee --

It is a great pleasure to appear before you today to discuss the tax aspects of leveraged buyouts and other corporate financial restructurings. I am delighted that this committee has decided to hold these hearings which I believe are extremely important even though there seems to be little evidence that the recent spate of mergers and acquisitions have been predominately motivated by tax reasons. Deregulation of the financial services industries, for example, seems to have played a more significant role and nontax economic considerations may well dominate. Moreover, other social and economic issues, such as dramatically increased corporate risks, may potentially have greater import. The tax aspects of leveraged buyouts ("LBOs") and other corporate financial restructurings, however, play a very significant role in how the transactions are structured and are a worthy subject for this committee's attention for both long and short-term reasons.

Corporate Tax Base Problems

The immediate fiscal problem is the potential erosion of the corporate tax base. This should be especially disturbing to the Congress this year, given the great difficulty ahead in reaching the Gramm-Rudman deficit targets and in light of the decisions by the Congress in 1982 and 1986 both to resurrect a substantial role for the corporate income tax as a source of federal revenues and to produce a more equal distribution of the corporate tax burden both across industries and among companies in the same industry. There should be no doubt that LBOs and related corporate financial restructuring transactions pose a clear and

present danger to the fulfillment of both of these goals.

From both an immediate and a longer-term, or structural, perspective of the corporate income tax, the most serious problem seems to be the long-lamented fact that the tax burden on income earned by a corporation and distributed to shareholders as dividends bears a heavier tax burden than corporate income distributed in other forms or to other suppliers of capital -- most importantly, amounts distributed in other forms or to bondholders as interest. Unlike dividends, interest is deductible at the corporate level and therefore bears no corporate income tax. This disparity creates tax incentives for raising corporate capital through debt rather than equity and for substituting debt for equity. I have not seen the figures for 1988, but during the period 1984-1987 corporate equity apparently decreased by more than $300 billion, while corporate debt increased in excess of $600 billion. These numbers alone obviously portend major revenue effects from substitutions of corporate debt for equity and, potentially, from restructuring the corporate income tax law.

The tax issue is further complicated by the relationship of tax burdens on retained versus distributed earnings and by the tax consequences of various corporate financial transactions to the recipient. With regard to the latter, amounts of corporate income distributed to suppliers of capital as interest and dividends are generally taxed in a similar manner to the recipient -- as ordinary income, subject to rates ranging from a low of zero on pension funds and other tax-exempt organizations to a high of 33 percent for some individuals. In contrast, earnings distributed by corporations to their shareholders in exchange for stock are typically treated as stock purchases and sales and an offset is allowed to the recipient for her basis in the stock with any gain taxed at the shareholder's normal tax rate. Amounts distributed to bondholders as principal repayments are untaxed.

Needless to say, this number of potential variables, coupled with great flexibility in structuring corporate finance, make it extremely difficult either to obtain and maintain a firm grasp of the matters at stake or to devise a solution that cannot readily be undone by tax planners for the corporate and investment communities. These difficulties are further compounded by our general reliance on similar tax rules to govern the taxation of huge multinational corporations and small corporate businesses.

The Fiscal Impact of Substituting Debt for Equity

Such complexities, however, should not be permitted to obscure the potential impact of corporate financial restructurings on the federal revenues. A back-of-the envelope calculation demonstrates the critical points. The corporate income tax today generates nearly $100 billion of revenues and additional revenues are produced by shareholder and creditor level taxes on dividends, interest and stock sales. These also are significant potential sources of revenues for state governments, many of which are confronting fiscal crises of their own.

At the extreme, $100 of corporate income distributed to a shareholder taxed at the top 33 percent marginal rate as dividends can produce as much as $55.78 of federal income taxes ($34 at the corporate level plus $21.78 at the shareholder level (33 percent of the distributed $66 of after-tax income)). If the dividends are distributed to a 28 percent shareholder, the federal government collects $52.48 of taxes ($34 plus $18.48); and if the dividend is distributed to a tax-exempt shareholder, the government collects only the $34 of corporate income taxes. By comparison, $100 of corporate income distributed to bondholders bears no tax at the corporate level and is subject to a maximum of $33 of total federal tax if distributed to the highest marginal bracket individual, $28 if paid to a 28 percent taxpayer and no tax at all if distributed to a tax-exempt creditor. Corporate income that is retained at the corporate

level normally bears a 34 percent corporate income tax.

Depending on the corporation's method of raising capital, therefore, the federal government's taxes on corporate source income can range from zero to nearly 56 percent. If a single level tax were levied either in the form of a corporate income tax or at the top marginal rate applicable to individuals, the federal government's tax would be roughly equal to one-third of the income, while about two-thirds would stay in private hands.

In 1985, the last year for which IRS data is available, corporate taxable income before interest deductions for domestic nonfinancial corporations totalled nearly $440 billion. A single federal tax imposed at a 33 percent rate on such income would produce about $145 billion of revenues, a number that seems to be at least as great as that year's combined corporate and individual level income taxes on all corporate source income (by which I mean simply the net pre-tax income earned by corporations before it is divided among those who have contributed to the corporation the capital with which the income was earned, viz. the creditors and shareholders).

Federal Reserve estimates suggest that about one-half of corporate equity at the end of 1987 was held by individuals while the other half was held by charitable organizations, pension funds, foreign investors or life insurance companies, which are likely to receive favorable federal income tax treatment. By contrast, only about 5 percent of corporate bonds are thought to be owned by individuals. Thus a shift from equity to debt as a source of corporate capital will serve to avoid corporate income taxes and, in addition, will tend to reduce or eliminate individual income tax revenues. If we simply assume an average weighted tax rate for charitable organizations, pension funds, foreign investors, etc. of about 10 percent, corporate source income distributed to bondholders would bear an average overall federal tax of about 11 percent in contrast to an overall weighted average rate in excess of 50 percent on corporate source

income distributed to shareholders as dividends. These, admittedly rough, figures imply that by replacing a dollar of dividends with a dollar of interest, the corporate and investment community can move about 40 cents that otherwise would have gone to the federal fisc to private hands. In some instances, this shift can be achieved only with the cost of some shareholder level tax.

As indicated above, in recent years about $100 billion of equity has been replaced annually by debt. If such corporate financial restructuring patterns continue without tax law changes, the government should expect not only to forego the natural increases in federal revenues that would be brought about by future growth in corporate income but also to experience a shrinkage of revenues from corporate and individual taxes on existing corporate source income. This portends great strain for the federal fisc. Congress cannot await a consensus about perfect solutions before taxing remedial action. If we are indeed embarking on an era of "no new taxes," we simply cannot afford to stand idly by while the corporate and investment communities eviscerate the old ones through leveraged buyouts and other corporate financial restructurings.

Inadequate Solutions

It is no small irony that this year marks the twentieth anniversary of two well-known "solutions" to the kinds of problems we are discussing here today. The first is § 385, added to the Internal Revenue Code in 1969, which, as every schoolchild knows, delegated to the Treasury regulatory authority to resolve the question how to distinguish between debt and equity. The Treasury Department failed to produce as much as a whimper in this regard until it issued proposed regulations in 1980 that ultimately were withdrawn in 1983 when the enterprise attempting to distinguish debt from equity based on their economic substance once again returned to a moribund state.

The 1969 Tax Reform Act also added § 279 to the Code, in an effort to restrict deductibility of interest on acquisition indebtedness, apparently on the view that, like construction period interest, such interest is in the nature of a capital expenditure. Corporate financiers, however, apparently have not found § 279 to be even a tiny barrier to corporate financial restructurings or LBOs.

The two decades of experience with these laws suggest great caution in attempting to enact solutions that require the recharacterization of debt as equity or that attempt to limit a disallowance of interest to indebtedness incurred for a particular purpose, such as a hostile (or even any) takeover. The past two decades also teach that there is little gain and no stability to be had from such marginal tinkering as opposed to beginning to address the underlying fundamental income tax problems. One cannot help but wonder where we would be today if Congress in 1969 or even in 1978 -- when Congressman Ullman, then chair of the House Ways and Means Committee, advanced such a proposal -- had begun to phase in an integrated corporate tax that eliminated, or at least narrowed, the corporate income tax treatment of debt and equity.

In my view, the least propitious course for Congress to take now lies in proposals for legislation aimed at limiting deductions for interest on indebtedness incurred in connection with corporate acquisitions. If LBOs are the subject, the problem is the "L", not the B.O. (As you well know, Mr. Chairman, it has not been an auspicious time for "L" words.) Erosion of the corporate tax base identical to that which occurs with a leveraged buyout may be accomplished, without any takeover at all, by a corporate recapitalization that substitutes debt for equity, for example, by a corporation using borrowed funds to purchase its own stock from its shareholders or by incurring debt to finance a large extraordinary dividend. Indeed, it is so obvious from the perspective of the corporate income tax that

buyouts or takeovers are not the critical problem that one cannot help but suspect that many of these proposals are being advanced either because members of Congress perceive political gains from corporate takeover bashing or are acting in response to corporate managers who would applaud any legislation that would make hostile takeovers more difficult.

Attacking Distributions Rather Than Debt

Somewhat greater promise may lie in proposals of the sort recently put forward by Professor William Andrews of the Harvard Law School, who is also testifying here today, in connection with his study of the corporate income tax for the American Law Institute ("ALI"). This work is quite complicated and neither time not space permit a complete discussion here, but, as I understand it, Professor Andrews regards corporate distributions rather than corporate debt as the culprit. This vision seems to be grounded in concerns that the taxes that are imposed on the distributee of corporate assets are often inadequate to compensate for the revenues lost due to the removal of cash or other assets from corporate solution. This problem has certainly been exacerbated in recent years by the trend to share repurchases and other nondividend distributions. The goal of Professor Andrews' most recent proposal -- a new minimum tax of 28 percent on certain corporate distributions -- seems to be to maintain the revenue potential of the currently existing corporate tax base while simultaneously precluding immediate gains to existing shareholders from increased share prices due to the elimination of future corporate taxes on existing equity.

Indeed, these ideas and proposals have evolved from an ALI project that has explicitly eschewed any consideration of integration of the corporate tax and -- apparently embracing some version of the ancient saw that an old tax is a good tax -- that seem to regard preservation of the existing corporate tax structure as the relevant mission. At times this project seems

to take the view that the existing corporate tax regime is the equivalent of an implicit contract that means that once assets are placed in corporate solution, assets will not be removed without incurring a tax burden that reflects the costs of future corporate taxes.

Coupled with his earlier ALI proposal for allowing limited deductions for dividends on new equity and disallowing a related portion of interest deductions, Andrews' proposals seem to imply that the corporate income tax should be a tax on all income from existing equity, on no income from existing debt and on income above a specified rate of return on both new equity and new debt. It is difficult to know why this is an appropriate vision of a corporate income tax.

To be sure, most of the transactions that are now threatening the corporate income tax base involve both debt and distributions and a law that successfully addresses either aspect of the problem may preserve corporate tax revenues. In addition, there is no consensus favoring comprehensive interest deduction limitations designed to solve the problem of debt-financed distributions, and the ability of corporations to uncouple their borrowing and their distributions makes such solutions elusive. A corporation, for example, might use accumulated cash reserves to buy back its own stock and then at a later date borrow to finance new investments in plant and equipment. If interest deductions on such subsequent borrowing are allowed in full and no tax is imposed due to the distribution, a result identical, from the perspective of the corporate tax, to a debt-financed share repurchase or even a leveraged buyout would be achieved. If this kind of corporate tax reduction is to be prevented, either the debt or the distribution must trigger additional taxes.

I continue to believe, however, that the core of the tax problem lies in the age-old corporate tax distinction between debt and equity, rather than in the removal of assets from

corporate solution. You may test your own intuitions about whether distributions or debt are the principal problem by evaluating two extreme versions of each transaction: (1) a complete liquidation of corporate equity built up through retained earnings and (2) a purchase of a debt-financed corporate asset. The latter case provides the classic illustration of the bias of current law in favor of new debt rather than new equity as a source of corporate capital. To date, I fail to see any reason for a special corporate tax in the former case, and I would be inclined generally to distinguish the case of a genuine corporate contraction from the far more typical case where the equity distributed is either simultaneously or subsequently replaced by debt.

A Single Tax on Corporate Income

I urge this Committee to reject gerrymandered ad hoc solutions designed to preserve the status quo, and, instead, to seize this opportunity to move toward true corporate income tax reform by embarking on a path that ultimately would provide equal corporate income tax treatment for debt and equity -- in other words, to move in the direction of an integrated corporate income tax.

What needs to be done, I think, is to begin now to move toward a single tax on corporate source income -- by which I again simply mean a single tax on the net pre-tax income earned by a corporation before it is divided among the creditors and shareholders who have contributed to the corporation the capital with which the income was earned. As indicated earlier, such a single tax should produce revenues at least equal to the combined corporate and individual income taxes now imposed on all corporate source income, and, in addition, would ensure that the federal government would share in any future growth in such income.

I do not mean to suggest by this observation that this is an appropriate occasion for raising additional revenues from taxes on corporate income, although it does seem the proper moment to

halt the ongoing disappearance of the corporate tax base. There are a variety of revenue neutral ways to begin to move toward the goal of a single tax on corporate income, and I think that it is important that steps be taken clearly in this direction now, indeed far more important than the precise contours of such steps. My preferred solution, however, would be to begin to phase-in a shareholder-credit type integration of corporate dividends, financed through an identical bondholder-credit approach to interest payments. This would be an important first step toward equal treatment for corporate debt and equity.

Such a proposal is grounded in the lessons learned from thinking in some detail about corporate tax integration. In particular, we have learned that a dividend and interest deduction or, as an alternative, a shareholder and bondholder credit are essentially equivalent methods of eliminating the corporate tax burden on distributed earnings with respect to debt or equity contributed or owned by shareholders or bondholders who are allowed the credit.

In brief outline, a tax credit could be provided to shareholders for some portion or all of the corporate tax paid with respect to corporate earnings distributed to shareholders as dividends. Likewise, in lieu of the interest deduction, a similar tax credit could be provided to bondholders for some portion or all of the corporate tax paid with respect to corporate earnings distributed to bondholders as interest.* The shareholder or bondholder would include both the amount of the tax and the cash dividend or interest in income and receive a tax credit for the amount of the tax.

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*For a detailed discussion of the equivalence of a shareholder (or bondholder) level credit system and a deduction for dividends (or interest), see my 1978 testimony in the Hearings on the Presidents' 1978 Tax Reduction and Reform Proposals before the Committee on Ways and Means, U.S. House of Representatives, 95th Cong., 2d Sess., pt 9 at 6156-6165. See also Testimony of Donald C. Lubick, Acting Assistant Secretary of the Treasury for Tax Policy, id. at 6244-6257; Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 Harvard Law Review 717, 775-777 (1981).

In advancing such a proposal, I am not suggesting that it is problem free, but many of the problems and their solutions have been identified by the work on corporate tax integration that has occurred both here and abroad during the past decade. For example, limitations to insure that credits are allowed only for corporate taxes actually paid would be necessary but are manageable. In order not to unduly burden financial institutions, the bondholder credit approach would probably have to be limited to interest expenses in excess of interest income, and careful thought must be given to the impact of such a scheme for takeovers of U.S. corporations by foreign corporations who may deduct their interest in full under their country's tax rules.

To be sure, if the credit were not refundable, much of the burden of shifting from an interest deduction to a bondholder credit system would be borne by foreign creditors and tax-exempt bondholders, while the benefits of the shareholder credit would tend to accrue to individual shareholders who now bear the burden of the double corporate tax. However, many of the benefits of elimination of the corporate tax from substitution of debt for equity in leveraged buyouts and other corporate recapitalization transactions are now accruing to those same nontaxable persons and entities. The result of such a proposal, as mentioned earlier, would be to take a major step in the direction of a single tax on corporate income without regard to who contributed to the corporation the capital with which the income was earned and regardless of whether the capital contributed was debt or equity.

Previous proposals for corporate tax integration, whether through dividend deductions or shareholder credits, have received a lukewarm reception from the corporate community. But much of the corporate community's previous opposition to corporate tax integration may have been due to the fact that on every prior occasion where such integration has been before the Congress it

would have been financed through tax increases on retained earnings, in particular through reduction or repeal of investment tax credits or of accelerated depreciation or through higher corporate tax rates. Needless to say, corporate managers prefer not to have the tax on income distributed to shareholders as dividends reduced at the cost of higher taxes on income they retain in corporate solution. Today, however, we are talking about financing a tax reduction for shareholders by increasing taxes on another form of distributed earnings, namely amounts paid to bondholders as interest. The reception in the corporate community might well be more positive, although it may be naive to expect the corporate and investment communities to welcome any effective barrier to their ability to shed the corporate income tax through restructuring their financial systems or by leveraged buyouts.

In any event, this idea merits your serious attention because it implies a corporate income tax that would not distinguish between debt and equity and that, by providing such equal treatment, would eliminate the potential provided by current law to eliminate the corporate tax burden by substituting debt for equity. It has the additional advantage of abandoning the fruitless quest of the past two decades for a workable distinction between debt and equity. At the same time, it avoids any effort to permit or disallow interest deductions based on the purpose of incurring a debt; such an enterprise is inevitably complex and ultimately will prove unsuccessful. If some basic structural change along these lines suggested here is not begun now, I fear that we simply can look forward to future years and perhaps decades of half-solutions or nonsolutions.

More Modest Approaches

Finally, if a bondholder and shareholder credit system along the lines I have outlined here is regarded as too substantial a change and a more limited response to the current erosion of the corporate tax base due to LBO's is approved -- for example, by

limiting corporate interest deductions to cash payments of interest** or otherwise or taxing corporate distributions -- I would nevertheless urge the committee to take at least a small first step on the path to corporate income tax integration by beginning to phase in a shareholder credit system or a deduction for dividends. By coupling any new limitations on interest deductions with tax relief for earnings distributed as dividends, the gap between debt and equity finance would be narrowed and the negative impact on share prices of the sort attributed to the 1987 House interest limitation proposals might be diminished or avoided.

I have become convinced, however, that an truly effective solution to the problems we are discussing here today will only occur if corporate earnings on both debt and equity are subjected to identical tax treatment.

**This is but one of many ideas for limiting interest deductions. This particular proposal would deal with the leveraging problem caused by original issue discount, including zero coupon bonds or "pay-in kind" debt (interest financed by more debt), by allowing a deduction only for interest paid in cash but nevertheless taxing holders of such debt on an accrual basis. The thought here apparently is that by allowing a current deduction for original issue discount -- even where the deduction is properly valued -- the government is sharing in the risks that the loans will never be repaid and, by so doing, it is contributing to and indeed encouraging high risk leveraged buy-outs. Other alternatives for limiting interest deductions have also been suggested; examples include attempting to improve the scope and functioning of § 279, disallowing deductions for interest once some specific debt-equity ratio is exceeded, disallowing deductions on debt that replaces existing equity, and limiting deductions of interest in excess of a specified rate (presumably to reflect "equity-like" risks or the inflationary, i.e. principal, portion of interest).

TESTIMONY OF C. ROBERT KIDDER

President and Chief Executive Officer of

Duracell Holdings Corporation

Good morning, Senators. My name is C. Robert Kidder. I am President and Chief Executive Officer of Duracell Holdings Corporation. I am pleased to appear before the Senate Finance Committee today to outline my views on leveraged buy-outs.

My views are of a person who has ten years' experience with Duracell, who has been President of Duracell Inc. for nearly five years, and who has seen the transformation of Duracell from a corporate subsidiary to an independent company through the LBO process. I am hopeful that my experiences in this regard will help you and your Committee see the LBO as non-threatening, potentially beneficial and a pro-American idea.

Duracell Holdings Corporation (Duracell) is a privately held, independent company recently formed through the leveraged buy-out (LBO) process. Some of the myths and mystique surrounding the acronym "LBO" can be explored by reviewing the transformation of Duracell from a subsidiary of a public company to an "LBO" company. This statement does this by providing a history of Duracell's transformation, and by looking at the impact of its new ownership/capital structure on its competitiveness. The statement also provides an "inside Duracell" perspective on some of the frequently raised concerns about LBO's.

The main message is that, in the case of Duracell, the LBO has strengthened and will continue to strengthen the company's competitive vitality.

DURACELL: AN HISTORICAL PERSPECTIVE

Duracell is a multinational consumer battery company headquartered in

the U.S.A. in Bethel, Connecticut. Fifty percent of its sales revenues are derived from operations outside the U.S.A. The Duracell brand is well known by consumers worldwide for one characteristic: premium performance. And, perhaps because of that, Duracell is the largest consumer battery company in the world ($1.3 billion in worldwide sales revenues).

Despite its growth and battery industry leadership, Duracell has experienced four (4) ownership changes in the past ten years. In 1978 Duracell, then a division of P. R. Mallory & Co. Inc., was acquired by Dart Industries. Dart Industries then merged with Kraft in 1980 to form Dart & Kraft, Inc., and Duracell became a division of Dart & Kraft with resultant new reporting, new questions, etc. Dart & Kraft demerged in 1986, and Duracell was left behind as a subsidiary of Kraft, Inc., with resultant new reporting, new questions, etc. Then, in December 1987, Kraft announced its intention to sell Duracell because of a strategic misfit with Kraft's mission to become a food industry leader.

To sell Duracell, Kraft engaged investment bankers to manage a two-stage public auction of the company. The seriously interested parties (i.e., reaching the second stage of the auction) included six (6) LBO/financial buyers and two (2) major corporations. Kohlberg Kravis Roberts & Co. (KKR), one of the LBO/financial buyers, submitted a bid of $1.8 billion which was accepted by Kraft's Board of Directors. The range of bids - for at least three of the bidders - was narrow, differing by less than 10 percent.

KKR, with the support of Duracell management, formed a new private company in June, 1988. The shareholders of the new Duracell Holdings Corporation (DHC) included KKR (90%) and Duracell management (10%). KKR put up $350 million in cash of equity funds to purchase its shares. Management contributed $6 million in cash to buy its shares

and were issued stock options in relation to the shares purchased which would involve an additional equity payment of $30 million. The remainder of the financing - including revolving credit agreements, term bank debt, and subordinated debentures - was in place by the end of September, 1988.

At year end 1988, Duracell's capital structure included $376 million of equity, $767 million of bank debt and $762 million of subordinated debentures (so-called junk bonds). Of the debt, only $617 million has floating interest rates and, of this amount, $280 million (45%) is foreign currency denominated to provide a currency hedge.

For the six months since the formation of the company, Duracell's performance has exceeded plan on a net cash flow basis by over $70 million. And, this favorable financial result has been achieved without any sacrifice to employment or to our strategic strengths. At the same time, there have been no cuts in R&D spending. Indeed, R&D spending has increased substantially since the LBO. Finally, unit volumes grew 18 percent during the same period and worldwide shares increased. Appropriately, the historical look is concluded by noting that, had Duracell not become an independent company through the LBO, it would now be under new corporate ownership (Phillip Morris) answering new questions, filling out new reports, and still wondering about its future.

LBO IMPACT ON DURACELL

Because of the LBO, the competitive vitality of Duracell has and will continue to increase. The following six reasons account for this increased competitiveness:

- Focus on Batteries
- Efficient Decision-Making
- Focused Resource Allocation
- Increased R&D and Marketing

- Financial Payoff
- Entrepreneurial Empowerment

Focus on Batteries

Duracell is a consumer battery company. This business has its own set of characteristics which set it apart from other businesses such as food. Its management is experienced in the battery business and understands these characteristics. The ability to focus exclusively on the needs of the battery business without responding to the questions, reports and incentives, driven by a food business or a direct selling (i.e., Tupperware) business is critical. Of course, the distractions of being a small part of a large conglomerate go well beyond reports and questions. For example, comforting employees that business life is meaningful in a food company - of which Duracell is a small "misfitting" part - is a major distraction in itself. Clear focus in any business - including this one - is a key ingredient of competitive success.

Efficient Decision-Making

Quick reacting, non-bureaucratic decision-making is at the heart of competitive vitality. As a misfit division in a large bureaucratic corporation, Duracell's vigor was increasingly jeopardized by a slow, naive (on batteries) decision-making process. The corporate (e.g., Kraft) decision process necessarily involved individuals whose risk tolerance was low given their naivete regarding a business with different technology, competitors, and key success factors. This aversion to perceived risk led to major efforts to win approval for even small projects and conservative decisions that delayed or suspended research and product development. For example, because of technology concerns and short term profit pressures, development of a new rechargeable technology was stopped and

experienced scientists were lost. Today, a more efficient decision-making process is quickly building a faster pace and new competitive vigor.

Accelerated Productivity Gains

In retrospect, the effect of corporate focus on "reported earnings" slowed decision-making, and isolation from the realities of cash flow resulted in excessive management patience with under-performing businesses and corporate inefficiencies. The realities of cash flow management - having to pay the bills from our own treasury - assigns a greater focus to resolving problems that drain cash resources and erode competitiveness. In the case of Duracell, many productivity improvement programs were initiated prior to the LBO. However, just as many improvements often were stifled by the review and approval system of a major conglomerate. Since the LBO, actions have been accelerated on several productivity improvement programs which have strengthened our strategic foundation - as well as cash flow. Two examples will illustrate the point. On December 29, 1988, Duracell sold a military lithium sulfur dioxide battery business because the technology involved is inappropriate for consumers (thus, does not fit with the Duracell mission) and because the business was not profitable. And, Duracell Europe ceased manufacturing outmoded, environmentally difficult mercury button cells whose demand is rapidly declining. Both of these actions permit Duracell greater resources and a stronger focus on the main consumer battery technologies - alkaline, lithium, and zinc air - and thus greater competitive strength.

Focused Resource Allocation

Duracell does not need, nor can it afford, risky forays into diversification outside the battery business - its area of expertise and strength. As a division of a cash-rich parent

seeking growth, such forays are oftentimes encouraged. As an independent company dependent on prudent cash management, allocating resources to the strategically important battery business is essential - and will clearly serve to strengthen Duracell's position and competitiveness.

Increased R&D and Marketing

Management's financial plans prior to the LBO included increased R&D and marketing spending at record high levels. Planned spending in these areas has not been reduced; indeed, our forecasts have increased since the LBO. Research and development spending is up 25% versus the last year as a part of Kraft. Worldwide marketing spending - vital to Duracell's competitiveness versus Eveready, Matsushita, Panasonic, Kodak, Varta, Rayovac, Toshiba, Sony, etc., - will increase by 37 percent.

Duracell management - as well as KKR - is committed to aggressive spending for strategically important programs. The financial plan supporting the investment in Duracell recognized this need, and the plan to invest in the core business is now being implemented.

In the future, no year-to-year reduction in R&D or marketing spending should be needed to overcome the effects of an economic recession. First, the business - like most businesses acquired through an LBO - is quite recession resistant. Duracell sales have never declined - even during the recession years of 1974/75 and 1981/82. Second, contingency plans are in place. And, finally, the cash flow and interest coverage plan can tolerate a volume reduction without threatening Duracell's vitality or ability to repay its debt.

Financial Payoff

For all shareholders - most notably the 35 Duracell managers who have invested most of their net worth to acquire their shares, and 200 other employees with incentive compensation based on the value of Duracell's equity - the fruits of their labor and a satisfactory return on their investment will not be realized unless Duracell maintains its competitiveness. And, attractive returns will only be achieved if Duracell competes successfully in the short term, while at the same time strengthening its competitive position and, thus, its prospects for strong future cash flow. The market value of the shares management holds - the key to the financial payoff - will not increase without this competitiveness. Thus, maintaining/ building Duracell's competitive posture is management's top priority. Short-term, strategically undesirable cost-cutting - whether R&D, marketing, capital, product development - has not been considered.

Entrepreneurial Empowerment

Beyond the most senior management investors and those other 200 people whose incentive compensation is tied to shareholder value, Duracell employees - like employees written about in many LBO articles - have assumed a different attitude as a part of an independent, private Duracell. At Duracell, we call it entrepreneurial empowerment. The reasons for the change are not entirely clear. The ability to make more rapid decisions is one reason; clearer direction or better focus, another; pride in our self-sufficiency, another. Whatever the reason, the impact of the change is unmistakable - unified, outwardly focused, competitively oriented spirit rather than "Kraft-bashing;" concern for individually small, but collectively large cost control; new, innovative approaches - indeed, a complete rethinking of how we serve customers better, more productively. It's been said - and financial statistics seem to support - that

"LBO companies" are the most competitive. The Duracell experience would support this observation.

FREQUENTLY RAISED LBO CONCERNS

At cocktail parties, in news articles, and in serious discussions of public policy, many concerns are expressed about the impact of LBO's. Although some of the concerns may only be addressed by understanding the aggregate effect of many LBO's over several years, the Duracell experience does offer some evidence on several of the concerns. The remaining paragraphs of this statement address these concerns from the perspective of the CEO of Duracell.

- Are LBO's unfair to shareholders?

  This concern centers on the theory that selling shareholders do not receive the value that buying shareholders ultimately receive.

  In general, natural market forces should guard against overpayment or underpayment. Of course, in every rational transaction, differences do exist between buyer and seller in the expected value of future returns. In the Duracell sale, Kraft received $1.8 billion for assets valued at much less than $1.0 billion on the books. The price exceeded shareholder expectations - they were ecstatic. And, the press and market praised the Kraft transaction. At the same time, KKR - as well as Duracell management - believed that a fair return could be realized on the very substantial investment and was willing to pay the price to achieve such return.

- Are LBO's inhospitable to long-term planning?

  LBO critics/skeptics believe interest payments will result in excessive focus on the short term and a willingness/need to sacrifice long term corporate health to survive. In the

Duracell case, the Kraft bureaucracy, Kraft's food mission, Kraft management's relative naivete in respect to batteries, as well as quarterly reported profit pressures, proved much more inhospitable to Duracell's long term plans than have any of our LBO strategies.

- Are LBO's vulnerable to interest rate rises?
  Tighter credit conditions, it is feared, will result in higher interest payments which will force many LBO's into bankruptcy. Importantly, sophisticated investors, such as KKR, account for this interest rate risk in pricing and in the financial restructuring of an LBO. In the Duracell case, floating rate debt amounts to only $617 million or 32 percent of the total of debt and equity. And of this amount, $280 million or 45 percent, is foreign debt. Thus, if the average interest rate on Duracell's floating rate debt were to increase by one percent (which would require a far greater increase in general interest rates because of the maturity structure of the debt), Duracell's interest expense would increase by $6.2 million, an immaterial percentage of net cash flow. The fixed portion of the capital structure includes subordinated debt with not only fixed rates (for Duracell), but also gradual and delayed pay-down schedules. And, Duracell's cash interest coverage (i.e., cash flow divided by cash interest payments) provides an indication of the cushion against rising interest rates (moving from 2.2 in Year 1 after the LBO, to 4.9 in Year 5 after the LBO).

- Do LBO's threaten employment?
  The LBO, per se, has not and will not result in lost jobs. For Duracell, continued strong employment is best achieved by effectively competing with the other large European, Japanese, and U.S. battery companies. In this sense, Duracell will continue to focus on productivity programs that can help the company remain competitive.

- Will LBO's result in higher prices to consumers?

  The marketplace for batteries is highly competitive. Eveready (U.S.A.), Matsushita/Panasonic (Japan), Varta (Germany), Kodak (U.S.A.), and dozens of other competitors are fighting for a share of consumer expenditures. Pricing in the industry thus reflects supply/demand considerations and cannot be affected by one LBO competitor like Duracell.

- Are LBO's vulnerable to an economic recession?

  All businesses are to some extent vulnerable. LBO investors look, however, for recession-resistant investments such as food . . . and consumer batteries. Several factors help insulate Duracell from critical effects of a recession: continued growth of the market; demonstrated stability of demand in downturns; international business mix and healthy interest coverage.

My viewpoints are not those of a macro economist or a venture capitalist. I am an experienced business executive who has seen an LBO at close range. From that perspective, leveraged buy-outs seem to be a natural and powerful response to the need to enhance the competitiveness of American business in an increasingly global market. I and the other employees who built this one American company, Duracell, into a global leader, understand, believe, and have financially committed ourselves to this view.

Some six months into the new Duracell, we are confident that we have made the right decision. Duracell is stronger, more vital, more competitive, and more optimistic about the future than we have ever been in my ten years with the company.

PREPARED STATEMENT OF THOMAS H. LEE

I am President and founder of the Thomas H. Lee Company, a private investment firm located in Boston, Massachusetts which has specialized in Leveraged Buyouts for the past fifteen years. Prior to founding the firm, I was a Vice President at the Bank of Boston and ran the research based lending department which made loans to fast growing, high technology firms. My senior partners include Thomas R. Shepherd, formerly President of two major Sylvania units at GTE, and John W. Childs, former Senior Managing Director in charge of the Capital Markets Group at Prudential Insurance.

We specialize in the acquisition of growing companies in the middle market. Last year we acquired major interests in some 14 companies and the purchase price of these transactions ranged from a low of $30 million to a high of $1.3 billion. Over 90% of the transactions we are involved in are private companies which is contrary to the general impression that most leveraged buyouts involve enormous public deals like RJR Nabisco. In a study just completed by Venture Economics, attached as an exhibit, the total number of buyouts publicly announced in 1988 was 304 of which 54% were under $100 million in purchase price which suggests private companies were involved; only 6% were over $1 billion.

The public/private distinction is an important one because LBO's provide the primary capital market to companies for which the public markets are inappropriate or, often, unavailable. LBO's have been an important mechanism for transferring family owned businesses. Frequently, this transfer is not to the next generation, but to the management which helped create the enterprise. The sale of a family business to another company instead of an LBO often means plant closings and loss of jobs in the name of reducing duplication for greater efficiency.

LBO's have also created an important market for the sale to management of the orphan subsidiary or division of larger corpora-

tions, those entities that are not part of the core business. These companies usually run better as freestanding, focused enterprises run by a manager/entrepreneur rather than a corporate bureaucracy. Again, the alternative to an LBO of the sale to another company would probably involve some painful downsizing in the name of efficiency.

Our investment process usually focuses on 100 companies which we are analyzing closely out of 1,000 opportunities we see annually. We try to understand the competitive nature of the firm, structure of the industry in which it operates and the strengths and weaknesses of its management. If and only if we determine that a leveraged buyout can be safely organized and financed, and that a company can withstand the effects of a possible future recession, will we proceed to enter a bid to be the sponsoring acquiror. Approximately half our time is spent in the analysis and study of investment opportunities and the other half is spent in working with the management of companies to assist them in their growth plans. While we have occasionally closed down an unprofitable plant or division, the overwhelming emphasis of our firm is placed on expanding companies after the buyout. We insist that the managements of the companies which we buy invest along with us, and it would not be atypical to find hundreds of management personnel owning up to half the equity of a buyout which we sponsor.

We were asked by Kenneth Lehn, Chief Economist of the SEC, to prepare a study of those companies which we have taken private. You will find this study in the appendix of this memorandum. We also studied all other companies acquired by us between 1980 and 1987 because only a few of our investments have involved public companies. Contrary to popular opinion, we have found that the vast majority of our companies have grown faster in terms of sales, capital expenditures and employment after the buyout than before. Specifically, of companies acquired between 1980 and 1987, employment rose from 45,000 employees at the time of acqui-

sition, to 59,000 employees either currently or at the time an acquisition was divested. In the aggregate, annual capital expenditures have risen from approximately $70 million to approximately $130 million annually after the buyout. The total sales of these companies since the buyouts, have grown at a compound annual rate of 14.5% far surpassing the GNP growth of 6.5% for the comparable period. Notably, this analysis is not skewed by a concentration on one faster growing sector of the economy or geographic area and includes retailing, service, and manufacturing firms.

On the following pages we have provided abbreviated histories of two growth buyouts. They are illustrative of many more.

1) One of our largest acquisitions is Hills Department Stores, Inc. ("Hills"). Hills was formerly part of SCOA Industries, Inc. which operated department and shoe stores, leased domestic departments, a chain of off-price apparel and housewares stores, leased footwear departments, and an importer of footwear. Although SCOA's sales were growing at a compound annual growth rate of 11% for two years prior to LBO in December 1985, its operating income margins remained relatively low at 6% of sales. Hills, which was SCOA's core business segment, opened only 2 stores during 1985 although Hills' return on capital investment historically had been high. This was due, in part, to a lack of entrepreneurship and strategic focus by the company's corporate management. The management of Hills continually tried to present plans to grow the department store division and felt constrained by corporate management of the parent.

Since the company was taken private through an LBO in December 1985, it has taken a number of new strategic paths to expand the company's business. In the first two years after the LBO, Hills opened 27 stores. In October 1988, Hills acquired 35 Gold Circle stores, formerly a division of Federated Department Stores, enabling Hills to expand its

market penetration in New York, Ohio and Kentucky. Furthermore, it allowed Hills to capitalize on economies of scale in purchasing and merchandising. The total number of employees also increased 37.7% from 21,200 in 1985 to 29,200 in 1988 giving an annual employment growth rate of 11.3%. The Lee Company and management almost doubled the capital investment during the three years subsequent to the LBO compared to the three years prior. The company's annual sales growth since the LBO has been 17% versus an annual growth rate of 11% in prior years. The company's operating profits are currently 39% higher than before the LBO.

2) The second company, Boston-based J. Baker, Inc., is engaged in the retail sale of footwear through self-service licensed shoe departments in discount department stores. The company also supplies shoes on a wholesale basis and provides related merchandising services to two major mass merchandising department store operators. The company's licensed departments are located in 18 states in the Northeast, Midwest and Mid-Atlantic regions. Thomas H. Lee Company and management of J. Baker acquired the company in July 1985; at the time of our acquisition, the company generated $95 million of sales with approximately 1,700 employees. Since the buyout, the company has expanded its business through increasing its licensed sales and opening its own new stores. The company has completed two public offerings since the buyout and is currently traded OTC. As a result of its rapid growth, J. Baker now employs approximately 3,000 people, a 75% increase since the LBO, for a compound annual growth in employment of 17.5%. The company has grown from 580 stores at the time of the buyout to 1,181 today. The company has on average spent $5 million a year since the management buyout to finance its growth, which is twice the amount prior to LBO.

We believe that part of the impetus for the buyout trend has been the unwinding of the conglomerate movement of the 1960s. The theory that a small group of financial managers could manage many disparate divisions and subsidiaries has not stood up well under close scrutiny. Many American corporations have found that without a core focus of key businesses which management can operate intensively, that corporate productivity and competitiveness suffers.

A large number of the transactions in which we become involved consist of these orphan divisions of large corporations which no longer fit into a core strategy. Additionally, we feel that the lack of ownership by managements of American corporations leads to bureaucratic inertia. LBO's are giving many managers who never would have had an opportunity otherwise to become owners of businesses. LBO's represent an investment in human resources. We think the re-entrepreneuring of America is just as important as the re-tooling. Every major American corporation started as a small enterprise run by an owner/operator who developed both the management and leadership capability necessary to business success. In a larger sense, since we never invest without being partners with management, we are facilitating the return to a focused owner/operator business environment. While we certainly are not against big business per se, you will find as you study the leveraged buyout markets that much of it revolves around the re-focusing of American businesses into more efficient operating units.

If buyouts were eliminated or impaired through adverse legislation, it would mean that the sellers of private companies would only be able to sell to other corporations. Typically, the acquisition of a company by another corporation results in layoffs and plant closings in the name of corporate efficiency. In the case of the acquisition of an entire company in a buyout, one needs to preserve all of the productive work force and virtually all of the plants involved in the operation. This would not be the case in

large corporate consolidations, which would be the only remaining market if one were to eliminate buyouts as a mechanism for corporate divestiture.

Most of our transactions are financed with our own money and the capital of the Fund which we manage and in which we have a major personal economic interest. Having our own money at stake has a sobering influence on the risks we are willing to take. We understand well the problems of investing in a company whose management or products might not be able to withstand an economic downturn.

A number of our companies have been tested by the three severe recessions of the past fifteen years and have come through. Let me give you a brief recount of one of those, Hendrix Wire and Cable of Milford, New Hampshire.

Hendrix manufactures power cable for utility companies. This cable is used to distribute power to homes and new home sub-divisions. When interest rates went to 20% in the early 1980's our buyout was in serious trouble, both from the high cost of our floating rate debt and the impact of high rates on our customers. Our backlog and operating margins diminished dramatically. We were able to pull this company through, however, with an intensive two-year effort to improve the company's use of assets, including collecting receivables faster and reducing inventory. We convinced our suppliers to give us longer credit terms and we pared down our labor force on both a direct and indirect basis. We were able to create a much more efficient Hendrix. We have subsequently expanded the company's production capacity, and today Hendrix' sales are approximately $60 million, in contrast to the $16 million when we purchased it, and employment is substantially ahead of where it was at acquisition. I don't want you to think that pulling Hendrix through a recession was easy -- as a matter of fact, it involved extremely hard work and sleepless nights -- but it was a very severe recession for the company and its industry and we were able to weather that storm.

The popular press has spoken of the increase in the debt level in America. A study which we have attached based on Federal Reserve data compiled by Merrill Lynch has shown that aggregate debt level in the country has indeed risen from 110% of GNP in 1970 to 144% today. In that time, however, corporate debt in America has only risen from 35% of GNP to 37% of GNP, and we don't really see, from our own point of view, the need for an alarmist or extreme view on this point.

As you know, much of the senior debt in buyouts is supplied by banks. Many of the major banks in America have LBO specialists and specialized LBO departments, and these departments are staffed by people who intensively scrutinize every acquisition opportunity and who are as capable as we are at analyzing a company's future prospects. The professionalism of the major LBO lending banks is excellent. The banks in turn are closely scrutinized by the Federal Reserve, and indeed since Chairman Greenspan started to jawbone them following the announcement of RJR, you will find in our marketplace a distinct absence of anything like a feverish pace. Banks are very concerned today about the nature of their risk assets, and while they may be enjoying fee income from the financing of leveraged buyouts, their fear of loan losses is greater than their desire for fee income.

I think you should worry about what happens if you eliminate or impair LBO's. Companies for sale will only be sold to large corporations - frequently foreign - increasing concentrations of economic power, precipitating plant closing and job loss as part of the consolidation and, most importantly, eliminating the opportunity for talented managers to become owners.

I think you should also worry about the effect on the stock market. The availability of LBO pools of capital has put a safety net under stock prices. The fear of losing acquisition interest deductibility and its impact on LBO's contributed to the market crash in October 1987.

Paradoxically, I think you should also worry about the tax revenue impact of limiting LBO's. Much has been written about how LBO's are subsidized by the deductibility of interest on acquisition debt at a cost to the Treasury. Almost all of this ignores the capital gains taxes paid when a company is acquired, again when it is sold, and anytime there is a disposition of assets along the way. It ignores the secondary market effect on capital gains from stocks whose prices are higher because they are in the same industry as an LBO'd company or because the overall level of the market is higher. It ignores taxes paid on high interest bonds and bank loans used to finance LBO's. There should be serious study about whether LBO's reduce or increase tax revenue. It is hard to see how creating wealth for shareholders, bondholders and employees alike, which LBO's do, ultimately reduces tax revenue.

We strongly urge you not to create legislation which would adversely impact this vital part of the American capital markets.

Leveraged Buyouts in 1988 by Transaction Size
(dollars in millions)

Transaction Size	Number of Buyouts	Percent of Total	Cumulative Percent	Dollar Volume	Percent of $ Total	Cumulative Percent
Under $50 million	105	34.5%	34.5%	2,206.6	2.2%	2.2%
$50-$99.9 million	58	19.1%	53.6%	4,086.8	4.2%	6.4%
$100-$499.9 million	105	34.5%	88.2%	22,334.0	22.7%	29.1%
$500-$999.9 million	19	6.3%	94.4%	13,961.0	14.2%	43.3%
Over $1 billion	17	5.6%	100.0%	55,687.0	56.7%	100.0%
Totals	304	100.0%	100.0%	98,275.4	100.0%	100.0%

LBOs in 1988 without RJR Nabisco Inc.
(dollars in millions)

Transaction Size	Dollar Volume	Percent of $ Total	Cumulative Percent
Under $50 million	2,206.6	3.0%	3.0%
$50-$99.9 million	4,086.8	5.6%	8.6%
$100-$499.9 million	22,334.0	30.5%	39.1%
$500-$999.9 million	13,961.0	19.1%	58.1%
Over $1 billion	30,687.0	41.9%	100.0%
Totals	73,275.4	100.0%	100.0%

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MEMO

TO: Thomas H. Lee
For Kenneth Lehn, Chief Economist at SEC

FROM: Michael B. Hong, Mitchell S. Vance

SUBJECT: Summary on Public to Private LBO Analyses

DATE: January 23, 1989

Cumulative data for the period immediately preceding the public to private transactions of four (4) portfolio companies has been compared to the most recent fiscal year results of these companies. All four companies were taken private in the 1984 and 1985 calendar years making the pre/post LBO analysis comparable. Amerace Corporation was excluded from the study due to the break-up nature of the transaction subsequent to being taken private by First Boston which was prior to T.H. Lee's ownership. Highlights are as follows:

($000)

GROWTH IN:	APPROX. FOR 1984-1985 PRE-BUYOUT PRIOR OR AT PUBLIC TO PRIVATE TRANSACTION	APPROX. FOR 1988 POST-BUYOUT LATEST FYE RESULTS	APPROX. % GROWTH	APPROX. % ASSOCIATED WITH ACQUISITIONS
NET SALES	$2,167,229	$3,108,512	43%	3%
EBDITA(1)	$150,616	$ 214,489	42%	3.2%
CAPITAL & R&D EXPENDITURES	$47,388	$85,606	80%	12%
TOTAL # EMPLOYEES	37,987	43,031	13%	2.5%

(1) Earnings before depreciation, interest, taxes and amortization

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

CHADCLIFF CORPORATION
(Chadwick Miller)

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE			APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/31/81	12/31/82	12/31/83	10/3/84	3/31/86	3/31/87	3/31/88	
# Stores	N/A	16	18	18	31	35	39	
Net Sales	28,038	24,186	31,174	N/A	34,196	42,040	49,673	16%
EBDITA	3,816	2,312	3,924	-	4,209	5,069	5,703	13%
Capital Expenditures	143	541	594	-	873	1,211	1,553	38%
Total Debt/Net Worth	.29	.23	.30	-	4.65	4.0	3.16	
# Store Employees	N/A	-	-	211	331	383	461	
G & A Employees	N/A	-	-	26	34	44	46	
Total Employees(1)	N/A	-	-	287	415	475	552	24%

DEBT HOLDERS: (As of 1/15/89)	TYPES OF SECURITIES	$
Commercial Banks	Term, Mortgage, Revolving	$18,200
Finance Companies	Subordinated Debt	5,000
ML-Lee Acquisition Fund, L.P.	Subordinated Debt	15,000

COMMENTS:

Chadwick-Miller conducts its business through 2 separate divisions. The Retail Division operates 24 retail book stores under the Lauriat's name and 15 discount book stores under the Royal Discount Books name. The Import Division markets a broad range of novelty and giftware items imported form the Far East.

The Thomas H. Lee Company purchased Chadcliff Corporation on 10/31/84.

(1) Total includes other unclassified employees.

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

J. BAKER, INC.
Fiscal Years Ending ($000)

	PUBLIC		PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	1/28/84	2/2/85	7/9/85	2/1/86	1/31/87	1/30/88	1/31/89	
# Stores	535	546		581	771	1,105	1,181(1)	
Net Sales	78,788	95,186		116,677	165,796	200,680	250,000(1)	27.3%
EBDITA	5,947	7,774		9,378	16,168	17,847	NA	
Capital Expenditures ($000)	2,584	2,471		2,463	5,085	4,901	NA	
Total Debt/Equity				89.2	1.2	2.1	NA	
# Employees								
HQ Executive		131		152	193	234	292	
HQ Union		98		118	149	150	166	
Stores Union		1,248		1,520	2,127	2,675	2,452	
Total #		1,477		1,790	2,469	3,059	2,910	18.5%
Avg. Wage Rates ($)								
HQ Executive (weekly)		630.20		642.35	653.95	653.88	664.64	
HQ Union (hourly)		6.23		6.55	7.02	7.35	7.69	
Stores Union (hourly)		4.05		4.17	4.43	4.69	5.01	

DEBT HOLDERS (as of 10/29/88)	TYPES OF SECURITIES	AMOUNT ($000)
Commercial Banks	L/C & B/A Financing(2)	52,400
Insurance Company	Senior Term & Revolver	21,025

COMMENTS:

J. Baker is engaged in the sale of footwear as an operator of licensed shoe departments in mass merchandising department stores, as a supplier of shoes at wholesale and related merchandising services to mass merchandising department store operators, and as an operator of "one price" shoe stores in the Company's Parade of Shoes and Step In Shoes chains.

(1) Estimates (2) Fluctuates with business cycle

THOMAS H. LEE COMPANY/PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

HILLS DEPARTMENT STORES

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/29/83	1/28/84	1/26/85	12/10/85	1/25/86	1/31/87	1/30/88	1/31/89(4)	
# Stores			123		125	137(3)	152	202	
Net Sales	1,155,051	1,304,579	1,423,613		1,483,600	1,343,102	1,514,329	1,672,000(2)	4.1%
Operating Profit bef. Nonrecurring Inventory Charge	66,981	80,872	84,760		86,389	94,412	103,535	103,000(2)	5.0%
Capital Expenditures	32,015	36,983	24,380		13,154	27,062	46,897	75,000 (2)	
Total Debt/Net Worth					7.4	7.0	34.7		
# Employees									
Management					1,741	1,878	2,152	2,447 (1)	
Hourly					20,484	20,896	21,635	23,122 (1)	
Total #					22,225	22,774	23,787	25,569	4.8%
Avg. Hrly. Wage ($)									
Management					$21.10	24.80	24.40	24.50 (2)	
Hourly					5.03	5.74	5.99	NA	

DEBT HOLDERS	TYPES OF SECURITIES	AMOUNT
Commercial Banks (as of 1/16/89)	Revolver	75,000 145,000
Insurance Companies	Sr. Notes, Sr. Sub Notes Sub. Notes, Pfd. Stock Common Stock	172,130
Savings & Loans	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	11,838
Pension Funds	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	8,913
Other	Sr. Notes, Sr. Sub. Notes Sub. Notes, Pfd. Stock Common Stock	110,209

COMMENTS

Hills Department Stores, Inc. is a leading regional discount retailer offering a broad range of brand name and other first quality general merchandise. The Company's stores are located in 13 states in the eastern and central regions of the U.S.

The Thomas H. Lee Company acquired Hills on December 11, 1985.

(1) As of the end of third quarter of FY 1988
(2) Estimates
(3) During FY 86, the Company sold Retail Footwear for $42.5 million, The Dry Goods for $13 million and SCA International for $4.2 million. All of these divestitures were made because of incompatability within the strategic focus of the Company.
(4) In September 1988, the Company acquired 35 Gold Circle stores to expand its market penetration in New York, Ohio and Kentucky.

THOMAS H. LEE COMPANY PUBLIC TO PRIVATE TRANSACTION ANALYSIS
JANUARY 17, 1989

COLE NATIONAL CORPORATION

Fiscal Years Ending ($000)

	PUBLIC				PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE
	1/30/81	1/30/82	1/30/83	1/30/84	9/17/84	2/2/85	2/1/86	1/31/87	1/30/88	TRANSACTN
# of Stores						1,629	1,764	1,827	1,955	
Net Sales	173,992	407,662	500,319	617,256		686,325	780,800	928,357	1,136,839	18.3%
EBDITA	N/A	34,832	30,545	54,158		57,161	71,759	74,798	87,939	15.4%
Capital Expenditures	N/A	12,978	11,589	19,943		24,721	20,902	28,540	32,315	
Total Debt/Net Worth	N/A	N/A	1.81	1.91		3.85 (2)	N/A (1)	4.18	N/A	
# Store Employees	N/A	N/A	N/A	8,450		9,404	10,134	11,390	12,297	
#G&A Employees				1,250		1,703	1,346	1,366	1,610	
Total Employees				9,700		10,750	11,500	13,000	14,000	9.6%

DEBT HOLDERS (As of 1/16/89)	TYPES OF SECURITIES	COMMITTMENT $	
Commerical Banks	Revolving, Working Capital	$375,000	
	IRBs	8,900	
Insurance Company	Senior Sub Notes	148,578	(carrying value)
Savings & Loans	Junior Sub Notes	56,000	
Insurance Companies	Junior Sub Notes	13,100	
Pension Funds	Junior Sub Notes	15,000	
Investment Banks	Junior Sub Notes	5,000	
Other Investors	Junior Sub Notes	10,900	
Management, T.H. Lee Company & Institutional Investors	Redeemable Pfd. Stock (Series A & B)	113,106	

COMMENTS

The Company operates several specialty retail businesses under names like Child World, Inc., Cole Vision, Cole Eyeworks, Things Remembered, Cole Key and French Oven.

Starting with 1,827 stores as of 1/31/87, the company opened 128 new stores in 1987. The Company plans to open additional 176 stores in 1988. On January 31, 1989, store count will total 2,131.

The Thomas H. Lee Company purchased Cole National on 9/4/87.

NOTES ON ACQUISITION & DIVESTITURES

(1) Cole National acquired Eyelab, Inc. in 12/86 to supplement its existing Eyeworks Stores. Operating Statistics since acquisition:

	FYE 1/30/88
Sales	56,052
EBIT	4,931
Capital Expenditures	5,772
# of Employees	975

(2) Cole National Sold The Original Cookie Company in 3/85 for an offer substantially in excess of perceived value. Operating statistics prior to acquisition:

	FYE 2/2/85
Sales	30,694
EBIT	3,426
Capital Expenditures	3,625
# of Employees	1,005

(3) Total includes other unclassified employees

AMERACE CORPORATION

Fiscal Years Ending ($000)

	PUBLIC			PUBLIC TO PRIVATE TRANSACTION	PRIVATE				APPROXIMATE CAGR SINCE PUBLIC TO PRIVATE TRANSACTION
	12/31/82	12/21/83	11/1/84	11/1/84	10/31/85	10/31/86	10/31/87	10/31/88	
Net Sales	247,502	265,880		155,109	140,778	150,582	211,053	244,536	12%
EBDITA	15,493	26,053		30,044	31,035	30,986	36,096	N/A	N/A
R&D Expenditures	6,973	8,788		6,295(3)	5,071	5,592	5,509	5,700	
Capital Expenditures	7,175	6,811		4,821	6,747	5,826(4)	7,320(5)		
Total Debt/Net Worth	.74	.80		21.3	14.4	14.6	N/A	N/A	
			(3)			(1)	(2)		
# Hourly - Non-Union		1,390		1,465	871	810	797	994	
Hourly - Union		1,469		1,350	96	110	256	277	
Salaried		1,439		1,370	682	648	663	680	
Total Employees		4,298		4,185	1,649	1,568	1,716	1,971	
Average Hourly Wage		7.87		8.04	8.21	8.63	8.87	9.09	

DEBT HOLDERS	TYPES OF SECURITIES	AMOUNT ($000)
Commercial Banks	Term, Revolver, IRB	24,428
Drexel Public Bonds	Senior Sub. Notes	84,100
Finance Companies	Term Notes	700
Sub. Debt Funds (ML-Lee Acquisition Fund L.P.)	Jr. Sub. Notes	30,000

COMMENTS

Amerace is a leading manufacturer of electrical components and highway safety products.

The Thomas H. Lee Company made its first investment in Amerace in June, 1986. A follow on investment was made with the ML-Lee Acquisition Fund in February of 1988.

ACQUISITION & DIVESTITURE NOTES

(1) Amerace acquired Conductron in 10/86 congruent with a strategy to growth through acquisition. Conductron's annual impact during its first full year of operation:

	10/31/87
Sales	48,164
EBIT	2,387
R&D Expenditures	0
Capital Expenditures	690
# Employees	161

(2) Amerace acquired Russellstoll in 4/87 for the same strategic reason as Conductron. Russellstoll's annual impact in its first full year of operation:

	10/31/88
Sales	30,138
EBIT	3,852
R&D Expenditures	830
Capital Expenditures	N/A
# Employees	249

(3) Amerace divested three companies in 1985. Their impact for the last full year of operations:

	Sales	EBIT	R&D Exp.	# Employees
Custom Molded Products Division Date Divested: 10/85	17,290	<2,040>	257	411
Esna & Caco -Pacific Division Date Divested: 4/85	42,025	1,195	974	618
Anchor Swan Date Divested: 1/85	87,318	5,018	1,421	1,437
Totals	146,633	8,253	2,652	2,466

Had expenditures associated with the three divested companies been added, the total R&D expenditures would have been $8,947,000 for YE 11/1/84

(4) Excludes capital expenditures for the acquisition of Conductron of $14,650

(5) Excludes capital expenditures for the acquisition of Russellstoll of $26,252

SELECTIVE PORTFOLIO ANALYSIS BY THOMAS H. LEE COMPANY FOR THE PERIOD 1980-87

Company Name	Closing Date	Fiscal Year End	($000) Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales Compound Annual Growth Rate	GNP Growth (Comparable Period)	Comments
Guilford Industries, Inc.	3/29/82 sold in 12/86	3/31	$40,838 (YE 1/31/82)	$74,784 (YE 3/30/86)	16.3%	7.1%	Guilford is a leading designer, marketer and integrated manufacturer of specialty fabrics used in the office interiors industry. The Company entered this market in 1975, and has since established itself as the leading supplier of panel fabrics for the open plan office furniture systems and interiors markets. Because the open plan concept offers many advantages over conventional office designs, including more efficient floor space utilization, reduced energy consumption and greater flexibility to redesign existing space, the open plan office systems market has grown rapidly during the 1980's. Thomas H. Lee Company continued and enhanced the growth of this company throughout the early and mid 1980's.
	Total No. of Employees		1,180 as of 3/82	1,490 as of 12/86	26.3%		
	Capital Expenditures		The Company mande an annual capital expenditure of $7.8 MM after LBO whereas its annual capital expenditure was $2.7 MM between 1979-81.				
Chadwick-Miller, Inc.	10/3/86	3/31	$30,505 (YE 3/31/85)	$53,500 P (YE 3/31/89)	15.1%	6.3%	Chadwick-Miller conducts its business through 2 separate divisions. The Retail Division operates 24 retail book stores under the Lauriat's name and 15 discount book stores under the Royal Discount Books name. The Import Division markets a broad range of novelty and giftware items imported from the Far East. The number of Lauriat's and Royal stores increased from 18 at the time of acquisition to 39 today.
	Total No. of Employees		287 as of 10/86	611 as of 12/88	212.0%		
	Capital Expenditures		$1.3 MM total capital investment between 1981 and 1983. $3.6 MM total investment between 1985 and 1987.				
Sterling Inc.	6/25/85 sold in 8/87	1/31	$59,318 (YE 1/26/85)	$100,419 (YE 1/25/87)	30.1%	6.0%	Sterling Inc. is a specialty retailer of fine jewelry. The Company's stores are located predominantly in enclosed regional shopping malls concentrated in the West, Midwest and Mid-Atlantic regions, including Ohio, Michigan, Wisconsin, Minnesota, California and West Virginia. The company operates its stores under the names of Shaw's Jewelers, LeRoy's Jewelers, Sterling Jewelers, Hudson-Goodman Jewelers, Goodman Jewelers and Friedlander Fine Jewelers. The number of stores increased dramatically from 75 at the time of closing to 114 for the year ended 1/25/87.
	Total No. of Employees		850 as of 6/85	1,335 as of 7/87	57.1%		
	Capital Expenditures		$2.1 MM for YE 1/84 $7.7 MM per year on avg. after LBO				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
J. Baker, Inc.	7/10/85	1/31	$95,186 (YE 2/2/85)	$250,000 P (YE 1/30/89)	27.3%	6.3%	J. Baker is engaged in the sale of footwear as an operator of licensed shoe departments in mass merchandising department stores, as a supplier of shoes at wholesale and related merchandising services to mass merchandising department store operators, and as an operator of "one price" shoe stores in the Company's Parade of Shoes and Step In Shoes chains. The Company's licensed deaprtments are operated under license from Ames Department Stores, Inc., a major mass merchandising retailer in the Northeast and from Fishers Big Wheel, Inc., a large chain concentrated in Michigan, Ohio and Pennsylvania. The Company supplies footwear at wholesale and related merchandising services to two major department store chains--Gold Circle and Pamida Stores, Inc. It also operates Parade of Shoes stores located in New England. The number of stores increased dramatically from 580 at the time of buyout to 1181 stores as of 1/89.
	Total No. of Employees		1,700 as of 7/85	3,000 as of 12/88	76.5%		
	Capital Expenditures		$2.5 MM per year on avg. prior to LBO (CY 83-84)				
			$5.0 MM per year on avg. after LBO (CY 86-87)				
Hills Department Stores, Inc.	12/10/85	1/31	$1,213,700 (YE 1/25/86)	$1,672,000 P (YE 12/31/88)	11.3%	6.2%	Hills is a leading regional discount retailer with stores located in 13 states in the eastern and central regions of the United States, including Pennsylvania, Ohio, Indiana, New York, Michigan, Tennessee, Virginia and West Virginia. Although Hills opened only 2 stores in the year prior to LBO, it opened 12 stores in 1986 and 15 stores in 1987. In October 1986, Hills acquired 35 Gold Circle stores to expand its market penetration in New York, Ohio and Kentucky. Total number of stores owned as of 1/30/89 will be 202.
	Total No. of Employees		21,200 as of 12/85	29,200 as of 12/88	37.7%		
	Capital Expenditures		$26.6 MM per year on avg. (1982-85)				
			$49.7 MM per year on avg. (1986-88)				
Amerace Corporation	7/2/86	10/31	$150,582 (YE 10/31/86)	$244,536 (YE 10/31/88)	27.4%	6.8%	Amerace is a leading manufacturer of electrical components and highway safety products. The Company acquired Conductron Corporation in October 1986 and the Russellstoll Division of Midland-Ross Corporation in April 1987 which extended and complemented existing product lines, provided opportunities to streamline the manufacturing process and added to the strength of Amerace's management.
	Total No. of Employees		1,189 as of 7/86	1,771 as of 11/88	48.9%		
	Capital Expenditures		An annual capital investment of app. $7.2 MM prior to the Lee Company's involvement in the Company. Since July 1986, the Company spent $62.8 MM in capital investment through acquisitions and purchase of machinery & equipment.				
Cole National Holding	9/4/87	1/31	$928,357 (YE 1/31/87)	$1,241,000 P (YE 1/31/89)	15.6%	6.8%	The Company operates several specialty retail businesses under names like Child World, Inc., Cole Vision, Cole Eyeworks, Things Remembered, Cole Key and French Oven. Starting with 1,827 stores as of 1/31/87, the company opened 128 new stores in 1987. The Company plans to open additional 176 stores in 1988. On January 31, 1989, store count will total 2,131.
	Total No. of Employees		13,000 as of 1/87	15,000 as of 1/89	15.4%		
	Capital Expenditures		$19.8 MM per year on avg. prior to THL's LBO (CY 1981-86)				
			$36.2 MM per year on avg. after THL's LBO (CY 1987-88)				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
Lee-Continental Corporation (Health o meter)	4/28/88	12/31	$24,581 (YE 12/31/87)	$31,800 (YE 12/31/88)	29.4%	7.0%	Health o meter is a manufacturer of people-weighing scales and other ancillary products. The Company is dominant in the upright scale segment with 87% of the market--the industry segment with the highest margins and greatest growth potential. Since the acquisition of the Company, it has opened new accounts with such customers as J.C. Penney and Sears.
	Total No. of Employees		253 as of 4/88	279 as of 12/88	10.3%		
	Capital Expenditures		$239,000 per year on avg. prior to LBO $350,000 in 1988				
Corhart Refractories Corp.	5/85 (sold in 7/87)	3/31	$63,453 (YE 12/31/84)	$60,003 (YE 3/31/87)	NA	6.0%	Corhart is a manufacturer of specialty, high-performance refractories used in glass and metallurgical melting applications. Corhart's business had been historically cyclical even before the acquisition by THL Co., although the Company has maintained profitable operations and positive cash flow through all phases of the business cycle. The Company closed down a plant supplying to the steel industry.
	Capital Expenditures		$2.1 MM per year on avg. for 3 years prior to LBO the same level of capital expenditures after LBO.				
Carlin Foods Corp.	7/83 (sold in 7/87)	3/31	$58,900 (YE 3/31/83)	$80,111 (YE 12/31/86)	8.5%	7.6%	Carlin Foods Corp., formerly three divisions of Mallinckrodt, is a manufacturer and marketer of specialty ingredients and systems to the food industry. The Company has four plants in Seattle, Washington;Englewood, New Jersey;and Gardina, California. The Company expanded its business by broadening geographic markets it serves.
	Total No. of Employees		350 as of 7/83	420 as of 7/87	20.0%		
	Capital Expenditures		$510,000 per year on avg. between 1977 and 1982 $1.6 MM per year on avg. after LBO				
Federal Communications Corp.	1/84 (sold in 12/86)	12/31	$3,127 (YE 12/25/83)	$6,520 (YE 12/31/86)	27.8%	7.6%	Federal Communications Corp. was formed to acquire 2 AM/FM broadcast properties in Providence, Rhode Island. In July, 1985, Federal Communications also acquired 2 Louisville, Kentucky radio properties. The investment strategy was to acquire and build a group of broadcast properties.
O'Donnell-Usen Fisheries Corporation	12/83 (sold in 5/87)	12/31	$82,444 (YE 12/31/83)	$94,173 (YE 12/31/86)	4.5%	7.6%	Based in Boston, Massachusetts, O'Donnell-Usen consists of a group of companies which constitutes an integrated manufacturer and marketer of frozen fish products, including trawler operations, filleting plants and processing and packaging operations. The Company expanded its business by introducing new packaging and developing new product lines such as microwavable products. Its operations are located in Massachusetts and Maine.
	Total No. of U.S. Employees		439 as of 12/83	464 as of 12/86	7%		
	Capital Expenditures		no significant capital investment in the company prior to LBO. $1.9 MM capital investment in the company since LBO.				
Miller Import Corp.	10/82	5/31	$11,666 (YE 5/31/82)	$16,564 (YE 5/31/88)	6.0%	7.4%	Miller Import Corp. is an importer and merchandiser of leaded glass crystals and porcelain figures, primarily from Germany and Italy. The Company's business growth was accomplished by an expansion of the Company's product lines and the development of brand names recognized in the trade.
	Total No. of Employees		52 as of 5/82	56 as of 12/88	7.7%		
	Capital Expenditures		$108,000 per year on avg. prior to LBO $139,000 per year on avg. since LBO				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
Merson-Marvel	5/5/87	12/31	$44,841	$50,500 P	6.1%	6.6%	Merson is a manufacturer and supplier of automotive products primarily for the professional and consumer aftermarkets. Marvel is a manufacturer and supplier of specialty incandescent and fluorescent light bulbs. The Company has increased its business through the expansion of product lines and market penetration while it modernized its operation by acquiring new equipment.
			(YE 12/31/86)	(YE 12/31/88)			
	Total No. of Employees		408 as of 5/87	394 as of 11/88	-3.4%		
	Capital Expenditures		$755,000 in FY 86 (YE 12/31/86)				
			$750,000 in FY 88 (YE 12/31/88)				
Image Carpets, Inc.	6/30/87	6/30	$53,574	$65,783	10.8%	6.8%	Image Carpets is a vertically integrated manufacturer of residential and commercial carpet. The Company enjoys a strong niche position with innovative, value oriented products in a highly competitive market. The Company is currently building a new spinning mill in Alabama which is expected to begin its operation by the end of 1989. It is anticipated that the new plant will create about 160 new jobs.
			(YE 12/31/86)	(YE 7/1/88)			
	Total No. of Employees		789 as of 6/87	840 as of 12/88	6.5%		
	Capital Expenditures		$2.81 MM for YE 12/31/86				
			$6.75 MM for YE 6/30/88				
Panache Broadcasting Corporation	3/18/87 (sold in 12/88)	12/31	$8,072	$10,600 P	14.6%	6.8%	Panache consists of four broadcast properties including WADB-FM, Philadelphia; WBLZ-FM, Cincinnati; and WTUX-AM/WTLC-FM, Indianapolis. It sold WBLZ station in 10/88 for $7.8 million to William Dalton Group, Inc.
			(YE 12/31/86)	(YE 12/31/88)			
	Total No. of Employees		175 as of 3/87	125 as of 12/88	-28.6%		
	Capital Expenditures		$100,000 in the first two years of LBO; the first significant capital investment in the Company since the early 1980's				
Autotote Systems, Inc.	1979	6/30	$23,669	$37,000 P	4.6%	7.7%	Autotote designs, engineers, manufactures, markets and operates computerized wagering systems, commonly referred to as totalisators. These systems, which include proprietary software programs, are used at horse and greyhound racetracks throughout North America, South America and Europe.
			(YE 6/30/79)	(YE 6/30/89)			
	Total No. of Employees		323 in 6/79	319 in 12/88	-1.2%		
	Capital Expenditures		$38.4 MM capital investment in the Company since 1982.				
Alliance International Group, Inc.	12/31/87	12/31	$39,700	$41,900	5.50%	NA	Alliance is the leading producer of light gauge, porcelain enamel on steel (PES) surfaces. PES surfaces are used principally as the base material for writing boards and as interior and exterior walls. PES is growing in writing surface and architectural applications because of its extreme durability, cleanability, resistance to heat and chemicals, and general ease of maintenance.
			(YE 12/31/87)	(YE 12/31/88)			
	Total No. of Employees		154 as of 12/87	160 as of 12/88	3.90%		
	Capital Expenditures		$588K per year on avg. prior to LBO; $250K in FY 88 (YE 12/31/88). The Company plans to spend appr. $1.7 MM in 1989 to consolidate the U.S. manufacturing operations, expand the U.S. sales effort, and invest in technological improvements.				

Company Name	Closing Date	Fiscal Year End	Annual Sales (at Closing)	Est/Act. Annual Sales (Most Recent)	Sales CAGR	GNP Growth (Comparable Period)	Comments
First Security Services Corporation	12/31/85	12/31	$32,000 (YE 12/31/85)	$47,000 (YE 12/31/88)	17.6%	6.2%	First Security provides guard services to facilities located in the Northeast of the United States, including Massachusetts, Connecticut, New York and New Hampshire. Founded in 1973, it is one of the fast growing security service companies in the U.S.
	Total No. of Employees		2100 as of 12/86	2900 as of 12/88	38.1%		
	Capital Expenditures		Total of $1.3MM in the Company since LBO in 12/85 which is consistent with the pre-LBO level.				
Black Oak Industries, Inc. (Shepard Clothing)	6/86	12/31	$45,653 (YE 9/30/85)	$48,749 (YE 12/31/88)	3.0%	6.2%	Black Oak Industries designs, manufactures and markets men's tailored clothing consisting of private label sport coats and suits. Through company salesmen, the Company sells products to a broad customer base comprised of major department stores, men's specialty stores, general merchandise chains, discount outlets and catalogue houses.
	Total No. of Employees		835 as 6/86	886 as of 12/88	6.1%		
	Capital Expenditures		$242,000 in FY 1985 (YE 12/31/85) $294,000 per year since LBO				
TOTAL SALES GROWTH					14.50%	6.5%	
TOTAL EMPLOYMENT GROWTH			at the time of LBO: 45,284	most recent: 59,250	30.8%		

P: Preliminary

*This chart does not include two transactions, Dolfin Corporation and Kelley Manufacturing Co. Dolfin underwent a major restructuring and Kelley liquidated due to pressures caused by the Houston building depression and foreign import competition.

Debt Levels

Although total debt has risen steadily over the past two decades, corporate debt is not the main cause of the rise in debt. Corporate debt in 1988 made up a smaller portion of total debt than it did in the 1970's, while both Federal debt and Household debt made up larger portions of total debt, as the table below shows.

Total Debt

	1970	1975	1980	1985	1988
Corporate	32%	31%	28%	26%	26%
Federal	26%	25%	24%	30%	30%
Household	42%	44%	48%	44%	44%

Even when measured as a percent of gross national product corporate debt has not risen as dramatically as federal and household debt have risen relative to the size of the economy. As the table below shows, while total debt as a percentage of GNP has risen over the past two decades, corporate debt as a percentage of GNP is only slightly higher than it was in 1970, while federal and household debt are considerably higher.

Debt As % of GNP

	1970	1975	1980	1985	1988
Total	110%	107%	109%	131%	141%
Corporate	35%	33%	30%	33%	37%
Federal	29%	27%	27%	40%	42%
Household	46%	47%	52%	58%	62%

High-Yield Debt

Although high-yield debt has grown rapidly in the last few years, it constitutes a very small percentage of total debt in our economy. As the table below shows, high-yield debt in 1988 consituted only 3 percent of total debt.

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	Amount (in Billions)	% of Total
Total Debt	$6,732	100%
Household Debt	2,937	44%
Federal Debt	2,013	30%
Corporate Debt Other than High-Yield	1,594	23%
High-Yield Debt	187	3%

Source of Data: Merrill Lynch Economics

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SENATE COMMITTEE ON FINANCE
CONCERNING LEVERAGED BUYOUTS

Chairman Bentsen and Members of the Committee:

I appreciate this opportunity to present the views of the Securities and Exchange Commission on the important issues for the nation's securities markets and economy as a whole presented by leveraged buyouts ("LBOs").

The term "leveraged buyout" has been used to describe a variety of transactions. Practically all corporate acquisitions today are leveraged to some extent. They may be conducted by management, corporate affiliates, or third parties. They may be hostile or friendly. They may be conducted by tender offer or negotiated merger. They may involve the sale of assets or securities. 1/ For purposes of understanding the area under discussion, all of these leveraged transactions have a common characteristic: assets of the subject company are used as collateral for a loan that is obtained to pay all or part of the purchase price of the company or to accomplish a restructuring of the company. 2/

1/ In addition, many leveraged transactions undertaken to recapitalize or restructure a corporation present many of the same disclosure and economic issues as leveraged acquisitions. For example, Proctor & Gamble's recent decision to increase the funding of its ESOP by $1 billion through increased borrowings, issuance of preferred shares, and a stock buyback constitutes a leveraged transaction. Schellhardt, "P&G to Boost Its Employees Stake to 20%," Wall St. J., January 12, 1989.

2/ See Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies, A Report Prepared by the Economics Div. of the Congressional Research Service (continued...)

Leveraged buyout transactions recently have attracted particular public attention. Perhaps the most notable example is the pending acquisition of RJR Nabisco by Kohlberg Kravis Roberts & Co. ("KKR"). One measure of LBO activity is the "going private" transaction. In "going private" transactions, shareholders of publicly held corporations are bought out, typically at a large premium, by a bidder who takes a concentrated ownership position in a reconstituted, privately held firm. The Commission's staff has collected data on the number and pre-transaction equity value of companies that went private during 1980-1987. 3/ The number of going private transactions increased from 101 during the first four years of this period to 169 during the last four years. Similarly, the total equity value of firms that went private increased from $10.26 billion during 1980-1983 to $54.24 billion during 1984-1987. Approximately 84% of the

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2/(...continued)
for the House Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce, 100th Cong., 2d Sess. (Dec. 1987) (Comm. Print No. 100-R) (hereinafter Leveraged Buyout Trends).

3/ See Table 1. Management buyouts of divisions of public corporations are also frequently referred to as going private transactions or leveraged buyouts. The data in Table 1 do not include these transactions and are based solely on going private transactions of publicly traded, free-standing companies.

For transactions completed during 1988 having a value greater than $100 million, the increase in equity value after the transaction was 54.4%.

value of going private transactions during 1980-1987 occurred during the last half of this sample period.

The data also reveal that the average size of firms going private increased over this period. The mean equity value of these firms increased from $101.6 million during the first four years to $321.0 million during the last four years. The latter half of this period was characterized by several going private transactions involving large companies, including Beatrice Co., Safeway Stores, R.H. Macy, and Owens-Illinois. 4/

Finally, the Commission's staff found that the value weighted average premium corresponding to these transactions was approximately 32.2%. Using some simplifying assumptions, the staff estimates that more than $20 billion in premiums were paid to stockholders in going private transactions during 1980-1987. 5/

4/ Significant differences exist across industries in the number and equity value of companies that went private during 1980-1987. The industry with the largest number of going private transactions was food and kindred products (22), followed by textile mill products (15), apparel (14), rubber and miscellaneous plastic products (14), and general merchandise stores (13). The equity value of companies that went private during this period was largest for food stores ($45.8 billion), followed by food and kindred products ($4.8 billion), communications ($3.8 billion), general merchandise stores ($3.4 billion), and transportation equipment ($3.1 billion).

5/ This estimate was computed as the average premium (36.84%) multiplied by the pre-transaction equity value of companies that went private during this period ($54,921.3 million). The staff presently is computing (continued...)

The federal securities laws protect investors in these transactions by mandating the disclosure of material information. Perhaps of principal significance are the tender offer and merger proxy rules that are designed to provide the subject company's shareholders with information concerning the transaction in which they are asked to sell their securities. The disclosure concerns generated by highly leveraged transactions, however, reach beyond the interests of the subject company's shareholders and affect holders of senior debt securities, as well as investors in the leveraged buyouts who can be either purchasers of the debt securities issued to finance the transaction or equity participants in the surviving entity. In addition, investment vehicles that allow small investors to participate in these transactions indirectly and on a diversified basis through so-called "junk bond" 6/ and LBO mutual funds, or through employee stock ownership plans, raise significant disclosure concerns. Further, to the extent that publicly-held institutions are the source of financing for these transactions, the potential effect on investors in banks,

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5/(...continued) the value of these premiums, transaction by transaction, which will allow for a more precise estimate of aggregate premiums.

6/ The term "junk bond" is used to refer to high-yield, non-investment grade bonds. Because they carry more risk, junk bonds, which are also sometimes referred to as "high-yield bonds," must pay a higher rate of interest to attract investors.

thrifts, insurance companies, broker-dealers, and investment banking firms also must be considered.

Management-led leveraged buyouts ("MBOs") also present questions of fairness, because management has an inherent informational advantage over nonaffiliated shareholders and is presented with conflicts of interest when dealing with their corporation's own shareholders. The Commission has focused on those issues at least since 1975 and has adopted a detailed disclosure scheme designed to protect the interests of shareholders in those situations.

Finally, the proliferation of leveraged buyouts in the 1980s has raised several economic policy issues reaching beyond the scope of the securities laws, including the following:

(1) Tax Policy - To what extent does the existing tax code encourage corporate debt generally, and leveraged buyouts in particular?

(2) Participation of Federally Insured Institutions - Are federally insured deposit institutions investing "excessively" in the debt used to finance leveraged buyouts?

(3) Macroeconomic Policy - Will the debt used to finance leveraged buyouts and corporate restructurings exacerbate an economic downturn?

(4) Corporate Performance - What effect do leveraged buyouts have on corporate profitability, wages and employment, and expenditures on research and development?

Although all of these issues will be investigated by legislators and regulators during the next several months,

the Commission's testimony today will focus on disclosure issues that have been raised by LBO activity. The Commission's staff will continue to generate data on leveraged buyouts to assist in ongoing policy discussions.

I. Disclosure Requirements Under the Federal Securities Laws Governing Leveraged Buyouts

The nature and extent of the disclosure requirements governing a leveraged buyout depend on both the type of transaction chosen to accomplish the acquisition and the affiliation of the participants in the transaction. In addition, different disclosure schemes exist to protect different classes of investors.

A leveraged buyout can be accomplished through a negotiated merger, a third-party tender offer, an issuer self-tender offer, a sale of assets, a reverse stock split and repurchase of resulting fractional interests, a payment of a large extraordinary dividend financed by borrowings and resulting in a disproportionate change in ownership, or any combination of these transactions. The financing for these transactions can be provided by a variety of means, each of which has different implications under the federal securities laws. These include a public offering of debt securities, an exchange offer of debt securities for the publicly-held common stock of the issuer, and a private placement of debt or equity securities, typically with institutional investors. Commercial banks often provide the

senior financing secured by the target's assets and securities purchased in the transaction. 7/ With the increased size of leveraged buyouts, equity financing frequently is provided through the placement of limited partnership or other equity interests, again frequently with institutional investors.

This section outlines the current federal securities law disclosure requirements with respect to leveraged buyouts. Subsequent sections focus on other federal securities law concerns raised by leveraged buyouts and on the role of state law in protecting the interests of investors in these transactions.

A. Tender Offers

Third party and issuer tender offers are governed by provisions of the Securities Exchange Act of 1934 added by the Williams Act Amendments of 1968, 8/ and the Commission's rules adopted thereunder, which are designed to require

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7/ E.g., "Banks Offer Glimpse at LBO Portfolios, Showing that Many Loans Are Resold," Wall St. J. Dec. 13, 1988, p. A3. See Memorandum of Robert L. Clarke, Comptroller of the Currency, to Chief Executive Officers of All National Banks, dated December 15, 1988 (setting forth examination guidelines to be used by OCC examiners to assess bank lending activities in connection with all forms of highly leveraged transactions).

8/ The Williams Act, enacted in 1968 and amended in 1970, added Sections 13(d), 13(e), 14(d), 14(e), and 14(f) to the Securities Exchange Act. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454; Act of Dec. 22, 1970, Pub. L. No. 91-567, §§ 1, 2, 84 Stat. 1497 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f) (1970)).

disclosure of material information to the marketplace and to protect the ability of public shareholders to act on that information. With respect to third party tender offers, Regulations 14D and 14E 9/ prescribe detailed procedural and disclosure requirements for third party tender offers, including a minimum offering period, withdrawal and proration rights, and protection to ensure equal treatment of all shareholders. The bidder is required to file a Schedule 14D-1 10/ and to disseminate to shareholders a disclosure document containing information concerning the identity and background of the bidder, the purpose of the transaction, any agreements or understandings with respect to the issuer's securities and, where material, financial statements. Commission Rule 14e-2 11/ requires the target company to respond to the offer and any revised offer and discuss the reasons for its position with respect to the offer, as well as any negotiations it has commenced in response to the offer.

Of particular relevance in the leveraged buyout context is the requirement that the bidder disclose the source and amount of financing for the acquisition. 12/ While a bidder

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9/ Regulation 14D, 17 CFR 240.14d-1 et seq.; Regulation 14E, 17 CFR 240.14e-1 et seq.

10/ 17 CFR 240.14d-100.

11/ 17 CFR 240.14e-2.

12/ 17 CFR 240.14d-100, Item 4.

need not have its financing in place at the time it commences the offer, the obtaining of a significant portion of this financing represents a material change that requires dissemination of that information and possibly an extension of the offer. 13/ A bidder in an LBO also must disclose any plans to liquidate or sell the subject company's assets or subsidiaries or change its capital structure or business. 14/

Rule 13e-4 15/ prescribes substantially identical requirements with respect to issuer tender offers, including the filing of a Schedule 13E-4. 16/

Securities issued as consideration in the tender offer must be registered under the Securities Act of 1933, unless an exemption is available. The securities usually will be registered with the Commission on Form S-4. 17/ In contrast, pursuant to Section 3(a)(9) of the Act, an issuer's offer to exchange securities for an outstanding class of its own shares generally does not require that those securities be

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13/ See IU International Corp. v. NX Acquisition Corp., 840 F.2d 220 (4th Cir. 1988); Newmont Mining v. Pickens, 830 F.2d 1448 (9th Cir. 1987). See also Letter dated March 28, 1988, from Daniel L. Goelzer, General Counsel of the Securities & Exchange Commission, filed in R.H. Macy & Co. v. Campeau Corp., 683 F. Supp. 422 (S.D.N.Y. 1988).

14/ 17 CFR 240.14d-100, Item 5.

15/ 17 CFR 240.13e-4.

16/ 17 CFR 240.13e-101.

17/ Form S-4, adopted in Securities Act Release No. 6578 (April 23, 1985) [50 FR 18990].

registered, unless fees or commissions are paid to persons soliciting the exchange. 18/

B. Merger Transactions

A leveraged buyout also can be carried out solely as a merger transaction 19/ or as a two-step transaction involving a tender offer followed by a merger transaction to acquire the non-tendered shares. 20/ A negotiated merger transaction generally will involve a proxy solicitation subject to the proxy rules under Regulation 14A adopted by the Commission pursuant to Section 14(a) of the Securities Exchange Act. 21/ The proxy rules are intended to provide the shareholders of the affected corporations adequate information upon which to make an informed voting decision. The proxy rules require the filing with the Commission and the dissemination to

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18/ 15 U.S.C. 77c(a)(9).

19/ E.g., First Boston Inc., Definitive Proxy Materials filed December 2, 1988.

20/ E.g., Schedule 14D-1 filed by KKR for the common stock of RJR Nabisco, Inc., filed October 27, 1988; Schedule 14D-1 filed by Morgan Stanley & Co. for the common stock of Burlington Industries, filed May 26, 1987.

21/ Section 14(a) of the Securities Exchange Act applies where proxies are solicited from holders of securities registered under Section 12 of the Securities Exchange Act, 15 U.S.C. 78l. Section 14(a), 15 U.S.C. 78n(a). See also Regulation 14A of the Securities Exchange Act, 17 CFR 240.14a-1 et seq. Regulation 14C of the Securities Exchange Act, 17 CFR 240.14c-1 et seq., adopted under Section 14(c) of the Exchange Act, 15 U.S.C. 78n(c), requires that the issuer disseminate an information statement if it does not solicit proxies with respect to matters to be acted upon at a meeting.

shareholders of a proxy statement containing information called for by Schedule 14A. 22/ In particular, Schedule 14A requires extensive disclosure concerning the merger transaction and the parties to the transaction, including detailed historical and pro forma financial information. 23/ As with tender offers, if all or part of the consideration will consist of securities, absent an exemption from registration, the securities must be registered with the Commission on Form S-4.

C. Going-Private Transactions

As discussed more fully in the following section, if the issuer or an affiliate undertakes a tender offer or merger that results in a class of equity securities no longer being publicly held (a "going-private transaction"), Commission Rule 13e-3 24/ imposes an additional level of disclosure concerning the purpose of the transaction and the fairness of the transaction to nonaffiliated shareholders. This rule requires reasonably detailed disclosure of not only the terms of the transaction, but, in addition, detailed disclosure of

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22/ 17 CFR 240.14a-101.

23/ 17 CFR 240.14a-101, Item 14.

24/ 17 CFR 240.13e-3. Securities Exchange Act Rule 13e-3 applies to specified transactions involving an equity security of an issuer that has any equity security registered under Section 12 of the Act, 15 U.S.C. 78l, or is required to file reports under Section 15(d) of the Act, 15 U.S.C. 78o(d), or is a closed end investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. See infra n.48.

the process under which those terms were arrived at, including alternatives considered and the factors upon which the required assessment of fairness by the company or its affiliate is based. In addition, Rule 13e-3 requires shareholders to be informed of, among other things, the identity of any affiliates engaged in the transaction; the nature of any contracts or arrangements made by or between the issuer and affiliates with third parties with respect to the issuer's securities; and the source of funds.

These requirements are designed to provide the shareholders of a corporation who are asked to sell their corporation to its management with information necessary to make that decision. The disclosure requirements apply to an acquisition of shares by an issuer or affiliate, a proxy solicitation with respect to any other business combination, recapitalization, reorganization, or similar transaction by an issuer or between an issuer and an affiliate, a sale of substantially all of the issuer's assets to an affiliate, or a reverse stock split involving the purchase of fractional shares, if such a transaction is part of a going-private transaction.

D. Registration Requirements

Before a company that is engaged in or may be considering a leveraged buyout sells its securities, or an acquiror sells securities to finance a leveraged acquisition, Section 5 of the Securities Act 25/ requires that a

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25/ 15 U.S.C. 77e.

registration statement be filed with the Commission and declared effective, unless an exemption from the registration requirements is available. Debt and equity securities issued to finance leveraged buyouts often will not be subject to Commission disclosure or filing requirements, since they frequently are issued in exempt private offerings. Section 4(2) of the Securities Act 26/ exempts transactions by an issuer of securities not involving a public offering. Limited offerings to sophisticated investors are exempt from the registration requirements without regard to the dollar value of the offering. 27/ These private placements of securities generally are conducted through the use of an offering circular that is not subject to specific disclosure requirements, but is subject to the antifraud and civil liability provisions of the securities laws. 28/ Debt issued in these private placements is often subsequently registered for resale in secondary offerings, at which point a registration statement is filed and full public disclosure must be made.

When no exemption from registration is available, the issuer of the securities must file a registration statement.

26/ 15 U.S.C. 77d(2).

27/ SEC v. Ralston Purina Co., 346 U.S. 119 (1953). See also Rule 506 of Regulation D under the Securities Act, 17 CFR 230.506.

28/ Preliminary note 2 to Regulation D under the Securities Act, 17 CFR 230.501. See infra Section I.F.

The registration process provides investors with detailed information concerning, among other things, the issuer and the nature of its business operations -- including the issuer's audited financial statements and, in certain cases, pro forma financial statements 29/ showing the effects of the transaction -- the terms of the security, the use of proceeds, and the risks involved in the investment. Where the issuer intends to use the proceeds to finance the acquisition of other businesses, the identity of the businesses, or if the identity is not known, the nature of the businesses, and the status of any negotiations, must be stated. 30/ An exception to the requirement to provide a detailed discussion of the acquisition is provided for circumstances where pro forma financials otherwise would not

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29/ See Article 11 of Regulation S-X [17 CFR 210.11-01 through 210.11-03]; Item 503(d) of Regulation S-K [17 CFR 229.503(d)]. Pro forma financial statements are usually required in a registration statement for the issuance of securities concurrently with a leveraged buyout or subsequent to such a transaction. Such pro forma financial statements would reflect the change in the capital structure as a result of the leveraged buyout, the revaluation of assets and the identification of any goodwill created in the purchase, and adjustments to the income statement to give effect to increased interest and depreciation costs and reductions in income tax expense. If plans exist for the disposition of assets, the pro forma balance sheet would give effect to the terms of the disposition of those assets and the income statements would reflect the effect on revenues and expenses that would result from the disposition.

30/ Item 504 of Regulation S-K [17 CFR 229.504].

be required and the disclosure would jeopardize the acquisition. 31/

E. Periodic Reporting Requirements

Apart from the transactional disclosure requirements of the federal securities laws discussed above, an issuer with a class of securities registered with the Commission under Section 12(b) or 12(g) of the Exchange Act 32/ is subject to the continuous reporting requirements of Section 13(a) of the Act. 33/ In addition to companies registered under Section 12, companies that conduct a registered public offering are required by Section 15(d) of the Exchange Act to file reports for the year their registration statements become effective and thereafter until the securities are held by less than 300 persons.

Sections 13(a) and 15(d) and the Commission's rules and regulations thereunder are intended to provide timely dissemination of material information to investors and the marketplace by requiring registrants to file annual,

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31/ Id. at Instruction 6.

32/ 15 U.S.C. 78l(b) and 78l(g). Section 12(b) of the Securities Exchange Act requires companies to register any class of security listed on an exchange whereas Section 12(g) of the Securities Exchange Act and Securities Exchange Act Rule 12g-1 thereunder, 17 CFR 240.12g-1, requires registration of any class of equity security that is held by at least 500 persons if the issuer has total assets exceeding $5,000,000.

33/ 15 U.S.C. 78m(a).

quarterly, and current reports with the Commission. 34/ The annual report on Form 10-K contains three-year audited financial information and other information about the registrant's business, management, and financial condition. Quarterly reports on Form 10-Q are filed for the first three quarters of a registrant's fiscal year and contain, among other matters, unaudited financial information. Registrants also are required to file current reports on Form 8-K to disclose significant events, including the acquisition or disposition of a significant amount of assets and or change in control of the registrant that has not been previously reported in another filing made with the Commission. 35/

F. Antifraud Provisions

In addition to the specific affirmative disclosure obligations imposed by the tender offer, proxy, registration, and periodic reporting requirements, the federal securities laws contain broad antifraud provisions applicable to leveraged buyouts. Although the specific language of the rules varies, they generally prohibit the making of false or

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34/ Annual Report on Form 10-K under the Securities Exchange Act, 17 CFR 240.310; Quarterly Report on Form 10-Q under the Securities Exchange Act, 17 CFR 240.308a; Current Report on Form 8-K under the Securities Exchange Act, 17 CFR 240.308.

35/ 17 CFR 240.308, Items 1, 2 and 5.

misleading statements or the omission of material information necessary to make other statements made not misleading. 36/

The Supreme Court in Basic v. Levinson recently reaffirmed that the materiality of a statement or omission requires an assessment of the specific facts and circumstances and will depend "on the significance the reasonable investor would place on the withheld or misrepresented information." 37/ In Basic, the Court considered whether misstatements concerning the status of preliminary merger negotiations violate the antifraud provisions. The Supreme Court adopted the test urged by the Commission and held that the materiality of merger negotiations depends on an assessment of "the probability that the event will occur" and the "magnitude of the transaction to the issuer." 38/ The same "probability/magnitude" approach should be applied to the question of when management's consideration of a merger or

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36/ See Section 17(a) of the Securities Act, 15 U.S.C. 77q(a); Sections 10(b) and 14(e) of the Securities Exchange Act, 17 U.S.C. 78j(b), 78n(e) and Securities Exchange Act Rules 10b-5, 14a-9 and 14e-3 thereunder, 17 CFR 240.10b-5, 14a-9 and 14e-3. See also Securities Act Rule 408, 17 CFR 230.408 and Securities Exchange Act Rule 12b-20, 17 CFR 240.12b-20.

37/ 108 S. Ct. 978, 988 (1988). See also TSC Industries, Inc. v. Northway, 426 U.S. 438 (1976) (materiality under proxy rules).

38/ 108 S. Ct. at 987.

LBO transaction is material to the issuer's shareholders and debt holders.

Whether and when management has a duty to disclose that information is a separate question. In the absence of voluntary statements with respect to the subject, a company generally has no affirmative duty under the federal securities laws 39/ to disclose ongoing considerations of merger proposals or other potential acquisitions of the company and may elect to remain silent even if the information would be material to investors. 40/ In the absence of voluntary statements, disclosure is required only when a company is trading in its own stock, 41/ when the company is responsible for leaks to the market, 42/ or when the regulations promulgated by the Commission, such as those outlined above, require disclosure. Although a company generally has no duty to disclose ongoing consideration of a leveraged buyout, the existence of one or more of the various

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39/ Disclosure of significant transactions may be encouraged by the relevant listing standards promulgated by the stock exchanges. See, e.g., NYSE Listed Company Manual Section 202.05 (1987); AMEX Company Guide Sections 401-406 (1973).

40/ See Basic v. Levinson, 108 S. Ct. at 987 n.17; Jordan v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), cert. dism., 108 S.Ct 1067 (1988).

41/ See generally Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980).

42/ See, e.g., State Teachers Retirement Board v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981).

factors that may trigger disclosure obligations sometimes requires that disclosure be made.

G. Margin Requirements

Section 7 of the Securities Exchange Act 43/ empowers the Federal Reserve Board to prescribe rules limiting the amount of credit that may be extended for the purchase of securities. Regulation G generally prohibits a lender that is not a bank or a broker-dealer from extending credit for the purpose of purchasing or carrying margin stock ("purpose credit") that is secured directly or indirectly by margin stock, in an amount that exceeds 50 percent of its current market value. 44/

In an interpretation of Regulation G issued in 1986, 45/ the Board stated that debt securities issued by a shell corporation in connection with a takeover are presumed to be secured indirectly by the margin stock of the target corporation in the absence of certain defined circumstances allowing the lenders to look to the target company's assets for repayment. In defining the circumstances in which the presumption would not apply, the Board stated:

> [E]ven where a shell corporation is involved, lenders would not be relying on margin stock where the loan is guaranteed by an operating company with substantial assets or cash flow or where the

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43/ 15 U.S.C. 78g.

44/ 12 CFR 207.3(b), 207.7(a).

45/ 12 CFR 207.112 (Jan. 15, 1986), [51 FR 1771].

> borrower is an operating company with the characteristics.
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> The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow. 46/

The Commission is empowered to enforce the Federal Reserve Board's margin rules and interpretations. 47/ When the Commission staff becomes aware of a potential margin violation presenting significant policy or interpretive issues, it solicits guidance from the Board's staff.

II. Management Buyouts: The Commission's Regulatory Response

Management-led leveraged buyouts represent one of the principal uses of the leveraged buyout financing technique and a type of transaction that raises significant policy concerns. In an MBO, management either alone or, more typically, in conjunction with a group of outside investors (usually an LBO firm), acquires the company from its public stockholders in a going-private transaction of the type

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46/ 51 FR at 1774.

47/ 15 U.S.C. 78u.

described earlier. 48/ The investor group normally contributes only a small portion of the actual purchase price and borrows the balance collateralized by the acquired company's assets. 49/ The management subsequently may take the company public again in a so-called "reverse LBO," 50/ gradually liquidate all or significant parts of the acquired entity by actively pursuing a program of divesting the company's assets, 51/ sell the company to another firm or to

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48/ A "going-private transaction" is a transaction by the issuer or affiliates which results in the elimination of public ownership of a class of equity securities. See Securities Exchange Act Rule 13e-3(a)(3), 17 CFR 210.13e-3(a)(3) (definition of "Rule 13e-3 transaction").

49/ The financing structure of a typical MBO is as follows: 50% senior bank debt; 40% subordinated debt and 10% equity contributions. In return for its participation, the management group may receive 15-20% of the equity in the acquired entity. See, e.g., Schedule 13e-3 filed by Foodmaker Inc. on September 19, 1988.

50/ A "reverse LBO" is a transaction in which a company which is taken private goes public again in an initial public offering ("IPO"). In 1986, there were 30 such transactions. By 1987, the number had reached 45. In 1988, there was a reduction in the number of reverse LBOs due, in part, to the soft IPO market. During the first eight months of 1988, there were five such transactions. These figures include the sale by a public company of a division to its managers, who subsequently take the company public, which transactions may not pose the same concerns under the federal securities laws as the buyout of a public company. "Reverse LBOs Plunge, as Low Valuations, High P/E Ratios Keep Companies Away," 12 Going Public: The IPO Reporter at 1283, August 29, 1988. See generally Wayne, "'Reverse LBO's' Bring Riches," N.Y. Times, April 23, 1988, p. D7.

51/ See Johnson and Cohen, "Beatrice Buy-Out May Net Investors Five Fold Return," Wall St. J., September 4, (continued...)

an ESOP, 52/ or continue to operate the firm as a private entity. 53/ The large profits that these management and investor groups have realized on their investment activities have raised questions as to the fairness of MBOs both to the public shareholders whose stock has been purchased and to the public bondholders, whose securities may have declined substantially in market value because of the manner in which the MBO transaction was structured. 54/

A. Background of Rule 13e-3

The Commission has long been aware of the significant investor protection questions raised by MBOs. In September 1974, the Commission undertook a public investigation of

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51/(...continued) 1987. But see Burrough and Johnson, "Profit From Sale of Beatrice May Be Cut By $1 Billion Due to Stock Market Crash," Wall St. J., Dec. 7, 1987, p. 8.

52/ Miller and Cohen, "Avis Inc. Is Sold For Fifth Time in Four Years," Wall St. J., September 29, 1987, at 3.

53/ Gilson, Scholes and Wolfson, Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-Motivated Acquisitions at 271 (J. Coffee, L. Lowenstein & S. Rose-Ackerman, eds., Oxford Univ. Press, 1988).

54/ E.g., Herman, "RJR Still Haunts Corporate Bonds," Wall St. J., Dec. 14, 1988, at p. C1. Studies have indicated that bondholders suffer small wealth losses on average in going private transactions, but that these losses are far exceeded by shareholder gains. See Lehn & Poulsen, Free Cash Flow and Stockholder Gains in Going Private Transactions 4-11 (December 21, 1988) (hereinafter "Lehn & Poulson").

beneficial ownership of securities and takeovers. 55/ Among other issues, the Commission sought to determine whether it "should adopt a schedule of disclosure items pursuant to Subsection 13(e) of the Exchange Act for issuers making tender offers for their own securities, including when issuers attempt to 'go private' and cease reporting under the Exchange Act." 56/

The Commission, in February 1975, proposed for consideration two alternative rules concerning going-private transactions. These alternatives, denominated Rules 13e-3A and 13e-3B, reflected a two-pronged approach: (1) a requirement that participants in a going-private transaction provide the company's shareholders with material information regarding the transaction; and (2) the adoption of

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55/ Public Fact-Finding Investigation in the Matter of Beneficial Ownership, Takeovers and Acquisitions by Foreign and Domestic Persons, Securities Act Release No. 5529 (September 9, 1974) [39 FR 33835].

56/ Id.

Section 13(e) of the Securities Exchange Act provides, in part, that the Commission may adopt rules and regulations to prescribe means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with a purchase by a Section 12 issuer or a purchase by an affiliate of such issuer of any equity security of such issuer. Section 13(e) was adopted as part of the Williams Act. Pub. L. No. 90-439, 82 Stat. 451 (1968).

substantive rules mandating, among other things, the fairness of the transaction to unaffiliated parties. 57/

On November 17, 1977, the Commission proposed for comment a new version of Rule 13e-3 58/ that combined disclosure with substantive and procedural safeguards. Among other things, the rule would have defined as a fraudulent, deceptive, or manipulative act any Rule 13e-3 transaction that was, among other things, unfair to unaffiliated security holders. The determination of the fairness of the transaction was to depend on the "facts and circumstances of each case."

Commentators were divided on the rule proposals, with many opposing substantive regulation as either unnecessary given the existing federal antifraud protection and the fairness requirements of state law, or as beyond the Commission's authority to adopt. 59/

On August 2, 1979, the Commission adopted Rule 13e-3,

57/ Securities Exchange Act Release No. 11231 (February 6, 1975), [40 FR 7947]. Both proposed rules would have imposed disclosure and fairness requirements. Proposed Rule 13e-3B in addition would have required that the transaction serve a legitimate business purpose.

58/ Securities Exchange Act Release No. 14185 (November 23, 1977) [42 FR 60090].

59/ See Summary of Comments Relating to Proposed Rules In the Matter of "Going Private" Transactions, File No. 4-178.

effective as of September 7, 1979. 60/ The Commission determined not to adopt a substantive fairness requirement in light of: the opposition by commentators; the Supreme Court's decision in Santa Fe Industries v. Green, 61/ restricting the reach of the Exchange Act's antifraud provisions to deceptive and manipulative conduct; and the potential administrative problems in terms of the staff resources and expertise necessary to implement such a rule. The Commission instead decided that it would leave the question of substantive fairness of going-private transactions to the states and limit itself to requiring certain disclosures. 62/

As discussed below, the rule seeks to provide shareholders with information they need to assess the fairness of a transaction and to pursue remedies under state law. There are some limitations on the reach of the rule that can be addressed initially by the Commission. In

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60/ See Securities Exchange Act Release No. 16075 (August 2, 1979), [44 FR 46748].

61/ 430 U.S. 462 (1977). The Court in Santa Fe ruled that a squeeze-out merger of minority shareholders did not violate Rule 10b-5 on the basis of alleged unfairness, where the terms of the transaction were fully disclosed. The Supreme Court recently has reiterated that the antifraud provisions do not proscribe unfair transactions, but it noted that the Commission's rulemaking authority under provisions like Section 13(e) extends beyond the prohibition of fraud to the adoption of prophylactic measures to deter fraud. Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 11 n.11 (1985).

62/ Securities Exchange Act Release No. 16075 (August 2, 1979) [44 FR 46748].

addition, state law has developed significantly since the adoption of the rule in providing shareholders with both substantive and procedural protection.

B. Operation of the Rule

Generally, Rule 13e-3, as adopted, requires that issuers and affiliates involved in going-private transactions to provide material information to the holders of the class of equity securities that is the subject of the transaction. Because a going-private transaction may be structured in a variety of forms, including a tender offer, merger agreement, or reverse stock split, the rule creates an independent filing obligation that supplements rather than replaces any other disclosure obligations that the federal securities laws impose as a result of the underlying transaction. In addition, the rule requires that the information be disseminated to holders of the subject securities at least 20 days prior to the consummation of the transaction.

The heart of the rule is the "Special Factors" requirements of Schedule 13E-3. (Rule 13e-3 and Schedule 13E-3 are attached as Appendix A.) Rather than impose a substantive fairness requirement, the Commission designed disclosure requirements to elicit sufficient information to allow shareholders to assess the fairness of the transaction for themselves and decide whether to participate or seek whatever remedy might be available under state law, including appraisal rights. Since the rule may be enforced privately,

it provides a federal remedy should shareholders be misled or denied the mandated disclosure. 63/ The rule relies on the traditional disclosure approach of the federal securities laws to address the conflicts of interest that exist when management acts in both a proprietary role as a buyer (where its incentive is to pay the lowest possible price), and a representative capacity on behalf of the corporation and the shareholders (where its obligation is to obtain the highest possible price). The Commission, in promulgating Rule 13e-3, was cognizant of this conflict especially in terms of the potentially substantial informational advantage possessed by insiders and their ability to control the timing of such transactions. 64/

Items 7, 8 and 9 of Schedule 13E-3 are the Commission's disclosure alternative to a substantive fairness requirement. Together these disclosure items are designed to address management's informational advantages and allow shareholders to see the transaction through the eyes of management. Item 7 of the Schedule is designed to explore the reason why the issuer or its affiliate chose to engage in the going-private transaction. The item seeks to ascertain the purpose of the transaction, the alternatives that were considered, the

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63/ Nationwide Corp. v. Howing Co., 826 F.2d 1470 (6th Cir. 1987), cert. denied, 105 S. Ct. 283 (1988) (action for damages).

64/ See Securities Exchange Act Release No. 14185 (November 23, 1977) [42 FR 60090].

reasons for the transaction's structure and timing, and the relative advantages and disadvantages to all parties -- the issuer, affiliate and unaffiliated shareholders.

Item 8 requires that the issuer and any affiliate engaged in the transaction state whether each reasonably believes that the transaction is fair to unaffiliated shareholders. In addition, the item requires that such party provide a reasonably detailed description of the factors upon which the issuer or affiliate based its fairness determination, including the analysis and conclusions with respect to each factor. In other words, while the rule does not require that a going-private transaction be "fair," the item is clearly "designed to assist security holders in making their investment decision by providing them with information from the most knowledgeable sources, regarding the terms and effects of the transaction in relation to the business and prospects of the issuer." 65/

The Commission recognized that, on occasion, matters relating to the fairness of the transaction that are not considered by the parties may be as significant as those that are specifically addressed. In construing the Item 8 disclosure requirements, the Commission has stated that "when a factor which would otherwise be important in determining the terms of the transaction is not considered or is given

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65/ Securities Exchange Act Release No. 17719, Question 21 (April 13, 1981) [46 FR 22571].

little weight because of the particular circumstances, this may be a significant aspect of the decision-making process which should be discussed in order to make the Item 8 disclosure understandable and complete." 66/ In this regard, Item 8 provides in an instruction a non-exclusive list of factors that ordinarily should be considered by a party making a fairness determination. 67/ These factors address the value of the company as a going concern, liquidation and breakup values, and values that might be obtained through an alternative transaction. In addition, if firm offers for the sale of all or part of the company have been received, those offers must be discussed. 68/ Thus, if management has engaged in a breakup analysis or explored asset sales, that information normally would be part of the Item 8 disclosure.

The structure of the item also reflects a recognition that the concept of fairness encompasses two components: fair price and procedural fairness. 69/ The item calls for disclosure concerning the existence of certain procedural safeguards "designed to enhance the protection of unaffiliated shareholders in the effectuation of the

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66/ Id.

67/ 17 CFR 240.13e-100, Item 8.

68/ 17 CFR 240.13e-100, Item 8(b), Instruction 1.

69/ See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). See also infra Section II.D.

transaction." 70/ These safeguards include the receipt of an independent report, opinion, or appraisal, the need for approval by at least a majority of unaffiliated shareholders, the appointment of a committee of independent directors, and the retention of a financial adviser to negotiate on behalf of unaffiliated shareholders. Accordingly, an Item 8 discussion may need to include a "statement of the basis for the belief as to fairness despite the absence of these [procedural] safeguards." 71/

Lastly, Item 9 of the Schedule requires that the issuer or its affiliate state whether or not it has received any report, opinion, or appraisal from an outside party that is materially related to the Rule 13e-3 transaction. In addition, the item requires that the issuer, among other things, summarize and file as an exhibit any such report, opinion, or appraisal.

Typically, the report disclosed in an Item 9 discussion is that of a financial adviser. Rule 13e-3 does not mandate that such an opinion be received, only that, if it is received, the nature and limitations of the opinion be disclosed. Nor does it require that any such adviser retained to provide an opinion be independent. Rather, the item addresses concerns about the degree of reliance that

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70/ Securities Exchange Act Release No. 17719, Question 21 (April 13, 1981), [46 FR 22571].

71/ Id.

should be placed on the opinion or report through disclosure of potential conflicts.

Item 9 was designed in recognition of the fact that the fairness opinion of a financial adviser often serves as a primary factor underpinning a board's fairness determination and that shareholders may accord substantial weight to the fact that a favorable opinion has been issued. 72/ Consequently, Item 9 requires detailed disclosure of the qualifications of the adviser rendering the decision, the terms of the engagement, potential conflicts of interest (including the manner of compensation), the procedures followed, and the bases for and methods of arriving at the findings contained in the opinion. 73/

The customary practice that has evolved in an MBO transaction is for an issuer (usually the board of directors or an independent committee of the board) to retain a financial adviser to evaluate the fairness of the transaction from a financial point of view. 74/ Generally, the financial adviser will perform a variety of tasks, depending on the

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72/ See generally Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L.J. 119 (1986) (hereinafter "Note").

73/ 17 CFR 240.13e-100, Item 9(b).

74/ See generally Simpson, The Emerging Role of the Special Committee - Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest, 43 Bus. Law. 665 (1988) (hereinafter "Simpson").

terms of its engagement, including "shopping" the company, employing valuation techniques to ascertain the company's value, and opining upon whether a particular price is fair or unfair on the basis of publicly available information. Often, the adviser will rely solely on information provided by management without generating its own projections, cash flow analysis, or other analysis of the issuer's data. The adequacy of the procedures used by the adviser bears on the degree to which directors will be credited with reasonable care under state law in determining whether they satisfied their fiduciary duties. 75/

The compensation arrangements for the financial adviser often depend on a variety of factors. Usually, the adviser will receive a base fee for rendering a fairness opinion. In some cases, the adviser may receive additional fees if the opinion is filed with the Commission. Moreover, the base fee or an additional fee may be contingent upon the outcome of the transaction or the actual value of the transaction.

It is not uncommon for a financial adviser to have a significant financial interest in the success of the transaction above and beyond the fee received for rendering the fairness opinion. For example, many financial advisers rendering opinions in the transaction also may arrange and/or provide financing for the transaction. In addition, if the

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75/ See infra Section II.D.

adviser initiates the transaction or participates in asset sales, it may receive "broker" fees if the transaction is consummated.

The financial adviser customarily provides the issuer with a short-form opinion that restates the terms of its engagement, contains qualifying language as to the scope of the investigation undertaken, and opines as to the fairness of the transaction from a financial point of view. The opinion usually is preceded or augmented by an oral or written presentation made to the independent committee or full board of directors. In these presentations, the financial adviser generally outlines the valuation methodologies employed and the conclusions reached with respect to those techniques. If the adviser has determined a range of value for the company, this information usually will be provided to the directors. Item 9 requires that the financial adviser's supplemental written and oral presentations to the board describing its analyses be summarized in a reasonably detailed manner, and that any written report or opinion be filed as an exhibit to the schedule. 76/

Item 9 also requires the filing and disclosure of other reports provided to the issuer or affiliate engaged in the going-private transaction. The disclosure requirement is

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76/ See Division of Corporation Finance No-Action Letter to Charles L. Ephraim (September 30, 1987).

construed to provide shareholders with substantially the same information received and considered by the board in approving the transaction. Thus, if the issuer or affiliate receives appraisals, projections, or cash flow analysis from an outside party, those reports would be required to be disclosed. In addition, any material nonpublic information in the possession of an affiliate engaged in the transaction, including projections and appraisals, will have to be disclosed to shareholders under general antifraud principles. 77/

C. Limitations of the Rule

1. Scope. Rule 13e-3 applies only to transactions engaged in by issuers and their affiliates. Transactions by third parties do not necessarily present the same concerns as MBOs because of the lack of a conflict of interest and potential informational advantages. In dealing with a third party bid, the management and board of directors presumably can be relied upon to represent the shareholders' interest. However, LBO practice has blurred the distinction between third-party LBOs and MBOs. In many transactions, purchasers have wanted existing management to remain with the company, and have offered incentives in the form of employment contracts and the opportunity to purchase an equity interest in the surviving company.

77/ See generally Chiarella v. United States, 445 U.S. 222 (1980).

Where management's interest in the surviving company is sufficiently significant so as to render it an affiliate of the surviving company, management is deemed to be engaged in the transaction and is required to comply with Rule 13e-3 and file a Schedule 13E-3. However, in many instances no firm agreement or formal understandings with respect to the nature and extent of management's participation are reached prior to the completion of the transaction. Nonetheless, based upon prior transactions by the LBO firm and actual discussions, management may fully expect to participate in the surviving entity, even though the transaction technically falls outside the rule since it is being conducted solely by a third party. The staff has been examining the issues raised by these circumstances and is considering whether to recommend that the rule be revised to obtain the same level of disclosure as that mandated by Rule 13e-3 with respect to all negotiated transactions.

2. Valuation and Fairness Assessment. The "fairness assessment" does not assure that the price offered is the best price that currently might be realizable by shareholders for their securities. There are examples of prices declared to be fair to shareholders that are quickly topped by 30-40 percent by a number of unsolicited bids; 78/ there also are examples of management making tremendous profits shortly

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78/ *See infra* n.118.

after going private through sale of the company, asset divestitures, or bringing the company public again. 79/

The concept of fairness under state law historically has viewed fairness as a range and explicitly has recognized that a fair price is not necessarily the highest price currently obtainable. This historic view of fairness may reflect in part the inexact nature of modern valuation techniques and the difficulty in predicting the highest currently obtainable price, particularly in a highly active market environment. It is not clear whether recent case law suggesting a need for an auction may change this historic view and require fairness to reflect the best price obtainable for shareholders. 80/ Under the valuation theories applied to the fairness consideration, a fair price is "not the highest value attainable for the firm or a single value but a range of reasonable values." 81/ "[I]f the finest minds in corporate finance have tried to make business valuation a science, it remains an art." 82/ Given the limitations of the valuation techniques in predicting what price a company could obtain,

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79/ See supra n.51.

80/ See infra Section II.D.

81/ Note, supra n.72 at 124. See Chazen, Friedman & Feurstein, Premiums and Liquidation Values: Their Effects on the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 147 (1980).

82/ Metz, "Deciding How Much a Company is Worth Often Depends on Whose Side You're On," Wall St. J., March 19, 1981, p. 29.

it is not clear whether mandating that the transaction be determined to be fair, including the appointment of independent appraisers, would solve the problem. The Commission's staff will be reviewing these issues to determine whether the disclosure requirements of the rule can be revised to obtain better disclosure concerning the nature and limitations of fairness assessments. In this connection, the staff will consider whether it may be misleading for a company or affiliate to opine that a transaction is fair and purport to rely on an opinion when there are limitations placed on the procedures used by the investment banking firm -- such as restrictions on the firm's ability to consider values obtained in recent comparable transactions, or reliance solely on the publicly available information. 83/ Questions have been raised about the adequacy of the fairness assessment when the company has not been shopped. 84/ Management may even carve out such common valuation techniques as liquidation value and comparable sale data on the ground they only intend to operate the entity as a going concern. The staff is exploring means of addressing

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83/ Cf. Securities Exchange Act Release No. 16833 (May 23, 1980) [45 FR 36374] (stating views of the staff that where valuation reports are so qualified and subject to material limitations and contingencies, inclusion of specific values in proxy materials may be unreasonable and violative of Rule 14a-9).

84/ See Longstreth, Management Buyouts: Are Public Shareholders Getting a Fair Deal, Remarks to the International Bar Ass'n. (October 6, 1983).

concerns regarding the reasonableness of management's representations as to fairness. The reasonableness of such representations could turn on whether some minimal procedures and analyses were employed.

Nevertheless, as discussed below, federal law is not the sole source of shareholder protection with respect to MBOs. Recent experience has shown that state courts will entertain legal challenges to the fairness of going-private transactions and will provide shareholders with legal remedies. As indicated in the release adopting Rule 13e-3, the Commission continues to monitor developments in this area and the efficacy of the rule. The Commission vigorously enforces the existing disclosure requirements of the rule by improving disclosure through the informal staff comment process 85/ and, when necessary, by instituting enforcement actions. 86/

D. Relevant State Law Issues

As noted, federal law is not the sole source of shareholder protection with respect to MBOs. Indeed, issues concerning substantive fairness to shareholders, which involve consideration of the obligations and fiduciary duties

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85/ For a discussion of the evolving nature of disclosure required by the Commission staff under Rule 13e-3, *see* Schunk & Willis, *Leveraged Buyouts Wave of the Future*, N.Y. Law Journal, Dec. 15, 1988, p. 39.

86/ *See, e.g.*, *In the Matter of Meyers Parking Systems, Inc.*, Exchange Act Release No. 26069 (September 12, 1988).

owed by management to shareholders, lie at the core of principles of corporate governance, the traditional province of state law. Since the adoption of Rule 13e-3, state law, especially the influential body of Delaware corporate law, has continued to evolve to address issues of fairness and management duties in the changing environment of takeovers and leveraged transactions. 87/

Under long-established principles of corporate law, a corporation's directors owe fiduciary duties, including duties of care and loyalty, to the company and to its shareholders. 88/ Ordinarily, courts will evaluate directors' actions under the business judgment rule, 89/ which is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in

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87/ See generally DeMott, Directors' Duties in Management Buyouts and Leveraged Recapitalizations, Ohio St. L.J. 517 (1988); Gilson & Kraakman, Delaware's Intermediate Standard For Defensive Tactics: Is There Substance To The Proportionality Review?, John M. Olin Program in Law & Economics, Stanford Law School (Working Paper No. 45, August 1988) to be published in 44 Bus. Law (forthcoming February 1989 issue) (hereinafter "Gilson"); Morrissey, Law, Ethics and the Leveraged Buyout, 65 U. Det. L. Rev. 403 (1988); Simpson, supra n.74.

88/ See, e.g., Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Guth v. Loft, 5 A.2d 503 (Del. 1939). In Delaware, these principles have been developed through case law. In other states, statutes define duties to which a director will be held. See, e.g., Cal. Corp. Code § 309(a) (West 1977 & Supp. 1987); N.Y. Bus. Corp. Law § 717 (McKinney 1986 & Supp. 1988).

89/ For a summary of the business judgment rule, see Gilson, supra n.87.

good faith and in the honest belief that the action taken was in the best interests of the company." 90/ Under the rule, directors have broad discretion to make business decisions, but the rule is applicable only where the principles of care, loyalty, and independence are satisfied. 91/

In recent years, cases involving change of control transactions have evidenced increasingly vigilant judicial scrutiny of management conduct. This has occurred even in the absence of management participation in the change of control transaction. For example, in Smith v. Van Gorkum, 92/ the Delaware Supreme Court found directors of a corporation personally liable for a breach of their duty of care, where they approved a cash-out merger without taking adequate time to consider the transaction or receiving adequate information about the sufficiency of the offering price. In these circumstances, the court found that the directors did not "act in an informed and deliberate manner," as required by their fiduciary duty of care, and thus could not invoke the protections of the business judgment rule. 93/

90/ Aronson v. Lewis, 473 A.2d at 812.

91/ Id.; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986).

92/ 488 A.2d 858 (Del. 1985).

93/ Id. at 873. See also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) (directors failed to exercise due care in approving "lock-up" option, where they acted hastily and on (continued...)

Further, the Delaware Supreme Court has introduced a stricter standard for applying the business judgment rule to actions by directors in a change of control context. In Unocal Corp. v. Mesa Petroleum Co., 94/ the court noted that, as is the case in the performance of its other duties, when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. However, the court stated that, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." 95/ Therefore, the court determined that the directors must show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and that the defensive measure was "reasonable in relation to the threat posed." 96/ Although the court in Unocal found the directors' decision -- a self-tender that excluded a hostile bidder -- to be reasonable,

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93/(...continued)
inadequate information, and primarily relied on financial adviser's "conclusory" opinion that option prices were fair).

94/ 493 A.2d 946 (Del. 1985).

95/ Id. at 954.

96/ Id. at 955.

subsequent cases have enjoined other types of defensive tactics viewed to be unreasonable and unfair to shareholders. 97 For example, the Delaware Chancery Court recently found that a board of directors' decision to keep the company's "poison pill" in place was not reasonable in relation to any threat posed by a pending third party tender offer, and therefore was not protected by the business judgment rule. 98/

It further has been recognized that, whether or not there is management participation in a change of control transaction, once the directors decide to put a company up for sale or it is clear that sale of the company has become inevitable, they must act as neutral auctioneers, whose primary responsibility is to realize the best sale price for the benefit of stockholders. 99/ To fulfill their duties, directors are prohibited from "playing favorites" with competing bidders "when the bidders make relatively similar

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97/ See, e.g., Robert M. Bass Group, Inc. v. Evans, [Current] Fed. Sec. L. Rep. (CCH) ¶93,924 (Del. Ch. July 14, 1988) (enjoining defensive restructuring that was found to be economically inferior to third-party bid and was to be adopted without shareholder approval); AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (enjoining partial self-tender because its structure precluded shareholders from accepting a competing hostile offer).

98/ Grand Metropolitan v. Pillsbury Co., [Current] Fed. Sec. L. Rep. (CCH) ¶94,104 (Del. Ch. Dec. 16, 1988).

99/ Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

offers or dissolution of the company becomes inevitable." 100/ Thus, once the "auction process" begins, courts will closely review the reasonableness of potentially favoring tactics such as lock-up agreements 101/ and the exercise of "poison pill" rights. 102/ Moreover, the courts will determine independently whether sale of a company has become inevitable. 103/ As this case law develops, emphasis on the directors' responsibility to seek the best available price may overtake issues related to the fairness of valuations by management and its adviser.

Most importantly, where a transaction involves the potential for self-dealing, such as an MBO, courts have

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100/ Id. at 184. See also Edelman v. Fruehauf, 798 F.2d 882, 887 (6th Cir. 1986) (relying on Revlon in enjoining target corporation's directors from using corporate funds and preempting bidding in order to assist corporation's management in effecting a leveraged buyout); Mills Acquisition Co. v. MacMillan Inc., [Current] Fed. Sec. L. Rep (CCH) ¶94,072 (Del. Nov. 2, 1988)(reversing the Chancery Court's denial of a preliminary injunction where the factual findings demonstrated that the bidding process was neither evenhanded nor neutral).

101/ See Edelman v. Freuhauf, 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1986).

102/ See City Capital Associates Ltd. Partnership v. Interco, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶94,084 (Del. Ch. Nov. 1, 1988).

103/ See, e.g., Black & Decker Corp. v. American Standard Inc., 682 F. Supp. 772, 780-780 (D. Del. 1988); Robert M. Bass Group, Inc. v. Evans, [Current] Fed. Sec. L. Rep. (CCH) ¶93,924 (Del. Ch. July 14, 1988).

imposed even higher standards on directors' conduct. The Delaware Supreme Court has stated that where directors stand on both sides of a transaction, "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." 104/ In such cases, directors of Delaware corporations have the burden of establishing the transaction's "entire fairness" -- that is, the existence of both "fair dealing" and "fair price." 105/ Fair dealing relates to questions of procedural fairness, such as "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." 106/ Fair price relates to the consideration paid for a company's shares, "including all relevant factors: assets, market value, earnings, future prospects and any other elements that affect the intrinsic or inherent value of a company's stock." 107/

In addition to emphasizing substantive and procedural fairness issues, Delaware courts have also been responsive to concerns about the need for adequate and timely shareholder remedies. Until recently, shareholders who dissented from

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104/ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

105/ Id. at 710-711.

106/ Id. at 711.

107/ Id.

cash-out mergers were limited to an "appraisal rights" remedy, a judicial determination of the fair value of their shareholdings under Section 262 of the Delaware Corporation Code. 108/ An appraisal value was traditionally assigned by determining the value of a shareholder's proportionate interest in the company, valued on a going-concern rather than a liquidated basis. However, the Delaware Supreme Court in Weinberger v. UOP, Inc. 109/ not only liberalized this process by permitting the use of all generally accepted techniques of valuation for determining fair value, but also recognized that an appraisal proceeding may be inadequate where there has been "fraud, misrepresentation, self dealing, deliberate waste of corporate assets, or gross and palpable overreaching." 110/ Accordingly, in these situations, shareholders are no longer limited to their statutory appraisal rights. Thus, in Cede & Co. v. Technicolor, Inc., 111/ the court upheld the right of a shareholder to pursue both an appraisal remedy and a subsequent action for rescissory damages based on a later-discovered claim of fraud in the merger. By recognizing the right of dissenting shareholders to bring a fraud action including fair dealing and fair price

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108/ Del. Code Ann. tit. 8 § 262 (Supp. 1986).

109/ 457 A.2d 701 (Del. 1983).

110/ Id. at 714.

111/ 542 A.2d 1182 (Del. 1988).

claims, the court assured the availability of whatever relief the facts of a particular case may require, including an injunction or damages. 112/

All of these legal developments have affected the context in which LBOs and MBOs take place. There is now stricter judicial review of actions in change of control transactions, and more emphasis on safeguards designed to assure the fairness of such transactions. As a practical matter, the existence of a committee of independent directors to negotiate and evaluate a transaction appears especially important. 113/ Even the actions of disinterested directors

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112/ See id. at 1187. See also Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099 (Del. 1985) (unfair dealing claims which raise issues appraisal cannot address are sufficient to defeat dismissal of an action to enjoin a proposed merger); Joseph v. Shell Oil Co., 498 A.2d 1117 (Del. Ch. 1985) (motion to dismiss injunction in favor of appraisal denied since it was uncertain that appraisal would provide an adequate remedy).

113/ See, e.g., Weinberger v. UOP, 457 A.2d at 709-710, n.7 (noting absence of independent committee). See also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d at 272 (establishing an independent committee to negotiate with an LBO bidder that included management interest would have been appropriate); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 946 (proof of good faith and reasonable investigation when a threat of control is involved is materially enhanced by use of a committee of outside independent directors); Simpson, supra n.74 (business judgment rule protection is more likely to be available to decisions made through a committee of independent directors).

will be examined to ensure that they acted fairly. 114/ Similarly, it is generally thought advisable for the independent committee to retain a financial adviser to evaluate the fairness of the transaction. While the courts have recognized that opinions as to reasonable value may differ, 115/ they will scrutinize the thoroughness and adequacy of the fairness analysis. 116/ If information is withheld from the financial adviser, or if the circumstances demonstrate that an opinion was hastily prepared or not based on careful analysis, the courts have not permitted the directors to rely on the opinion to justify the fairness of their act. 117/ Moreover, once it is determined that a

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114/ See, e.g., Edelman v. Freuhauf Corp., 798 F.2d at 886 (authorization of transaction by disinterested directors not sufficient to establish its fairness where evidence indicates that these directors merely "rubber stamped" the management buyout proposal).

115/ See, e.g., Joseph v. Shell Oil Co., 482 A.2d at 347 (court well aware that expert appraisers usually express different opinions as to value even when they use the same data for arriving at opinion). See also Weinberger v. UOP, 457 A.2d at 712-714 (discussing various factors relevant to determination of fair price).

116/ In Dynamics Corp v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1988), rev'd on other grounds, 107 S. Ct 1637 (1987), the court discounted an investment banking firm's fairness opinion, where the firm was to have received a bonus if the takeover attempt was defeated.

117/ See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) ("conclusory" opinion that price of lock-up option was "within the range of fair value," although adviser had not even calculated a range of fairness); Weinberger v. UOP, 457 A.2d 701 (Del. 1983) (hastily drafted fairness opinion); Joseph v. (continued...)

company is for sale, it is the directors' obligation to obtain the best price for shareholders through an auction process. Accordingly, the responsiveness of the courts to developments in the change of control area has promoted the use by corporate boards of extensive procedures and safeguards that result in greater substantive protections for shareholders. Indeed, recent change of control transactions reported by the press suggest that this heightened sensitivity has in fact resulted in higher values for shareholders. 118/

III. Other Concerns Arising Under the Federal Securities Laws

In addition to these concerns about the treatment of target shareholders of the target companies in leveraged transactions, there are concerns about other investors affected by such transactions, including: senior debtholders of the target company; investors in funds created by investment banks for equity participation in such transactions; purchasers of the so-called "junk bonds" issued to finance these transactions; and investors in institutions that are purchasers of large amounts of junk bonds. An

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117/(...continued)
Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984) (adviser who prepared fairness opinion was not given information about value of important company asset).

118/ The prevailing offer in the RJR transaction was 45% higher than that originally proposed to the board by the management group. See generally Gibson and Smith, "How Pillsbury Failed to Act Decisively in Bid to Repel Grand Met," Wall St. J., Dec. 19, 1988, p. A1 (table).

important issue under the federal securities laws is whether all these participants receive full and fair disclosure about their investments.

One issue that has recently received much attention is the effect of leveraged transactions upon the market for the existing debt of an issuer. When an issuer creates large amounts of new debt through a leveraged buyout, thereby increasing its debt-to-equity ratio, it may also increase the risk of default. Consequently, the market may perceive the issuer's existing debt obligations as less creditworthy, and the price of the issuer's bonds may decline. In some recent cases, there have been reports that, following announcement of leveraged transactions, the bond prices of the target companies experienced substantial declines. 119/ The risk that a bond will decline in value because of a leveraged transaction is known as "event risk."

Although current bond indentures include a variety of protective covenants, 120/ it appears that covenants in

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119/ Winkler, "Wall Street Is Devising the Takeover-Proof Bond," Wall St. J., Nov. 3, 1988, p. C1 (reporting 20% decline in some RJR Nabisco bonds); Wallace, "A Bruising Battle Over Bonds," N.Y. Times, Nov. 27, 1988, Sect. 3, p. 21 (prices of Federated Department Stores bonds fell 17% during its takeover battle with Campeau Corporation). *But see* Lehn & Poulsen, *supra* n.54.

120/ A bond contract is set forth in an indenture, which may contain covenants that restrain the issuer from taking certain actions that may harm the bondholder's interest. An indenture also is subject to the Trust Indenture Act of 1939, absent an exemption thereunder. 15 U.S.C. 77aaa *et seq*.

existing large investment grade issues have not generally provided for protection against event risk. Recent events demonstrate that the market may respond to this risk by requiring more protective covenants for senior debtholders in new issues. 121/ In particular, one development has been the creation of debt offerings containing so-called "poison puts," which provide that upon the occurrence of certain events, such as a major restructuring, the debtholder is granted the right to require the issuer to buy back the security at a specified price. If such covenants are effective, and if the company has the financial capability of meeting its obligations under the put, then bond purchasers in issues protected by such indenture provisions may be able to reduce the event risk associated with holding those debt instruments.

There have been questions about whether such covenants provide bondholders complete protection from certain types of restructurings. Many of these covenants have in the past, applied only to transactions not approved by the board, and thus would offer little protection against MBOs proposed by management and approved by the board. 122/ A new generation

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121/ Cox, "'Poison' Bonds May Get Higher Moody's Rating," Wall St. J., Nov. 21, 1988. p. C18; Lipin, "Agencies May Look to Covenants When Rating Debt," Investment Dealers' Digest, Nov. 14, 1988, p. 8.

122/ Herman, "How Bond Buyers Can Avoid an LBO Hit," Wall St. J., Oct. 24, 1988, p. C1.

of poison put provisions is, however, intended to provide greater protection to bond purchasers by protecting against "overleveraging" even if it has been approved by the issuer's board of directors. 123/ The Commission staff is monitoring all filings containing such covenants to see that the limitations in these provisions are adequately disclosed.

It should be noted that bondholders have argued that they have several legal remedies available to protect them from event risk. State law provides one potential avenue for relief. 124/ In addition, as discussed above, if an issuer

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123/ See supra n.119. Two variations of these new provisions have emerged. One type would allow bondholders to put back the debt security to the company in the event of any acquisition or recapitalization that results in the bond rating being downgraded. See Form S-3 filed by Harris Corp., Nov. 14, 1988. The other variation provides the issuer the option in such circumstances to redeem the bonds or adjust the interest rate upward to compensate for any loss of market value. See Form S-3 filed by Northwest Pipeline, Inc., Nov. 18, 1988.

124/ A Delaware court recently held that, "among the duties owed by directors of a Delaware corporation to holders of that corporation's debt instruments, there is no duty of the broad and exacting nature characterized as a fiduciary duty." Simons v. Cogan, 542 A.2d 785 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). In reaching this conclusion, the court noted that debtholders can "turn to documents that exhaustively detail the rights and obligations of the issuer *** and of the holders of the securities. Such documents are typically carefully negotiated at arms-length. *** Accordingly, it is elementary that rights of bondholders are ordinarily fixed by and determinable from the language of documents that create and regulate the security." Id. at 786-87. Violations of statutes and fraud in the inducement can, however, create rights that are not articulated in the bond contract. Also, "in narrow circumstances," the contractual documents may be "held to imply obligations (continued...)

makes material misrepresentations or omissions in selling securities, it is subject to liability under the antifraud provisions of the federal securities laws, either in a Commission enforcement action or in a private action brought by purchasers of those securities. 125/ More generally, however, the Commission staff is considering the adequacy of disclosure currently provided to bondholders concerning matters such as the issuer's plans to engage in transactions that could affect the value of the bonds, and the potential risks involved if such transactions occur. The Commission

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124/ (...continued) arising from an implied covenant of good faith and fair dealing." Id. at 787 (citing Katz v. Oak Industries, 508 A2.d 873, 878-80 (Del. Ch. 1986)); Continental Illionis National Bank and Trust Corp. v. Hunt International Resources Corp. C.A. No. 7888, (Feb. 27, 1987) (debenture holders have no independent right to maintain a claim for breach of fiduciary duty and their rights are defined by the terms of the indenture, absent fraud, insolvency, or a statutory violation). Moreover, state law theories of relief, such as theories based upon the law of fraudulent conveyances, may be available. See, e.g., McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986). A private action against RJR Nabisco has been brought by bondholders alleging state law claims, including breach of contract, breach of duty, and fraudulent conveyance of property. Metropolitan Life Insurance Co. v. RJR Nabisco, Inc. and F. Ross Johnson, (N.Y. Sup. Ct.)

125/ Since the RJR Nabisco buyout announcement, private actions have been brought under the federal securities laws by bondholders, alleging that, in connection with a public offering of its bonds, the company misrepresented its future plans, and failed to disclose its consideration of a major restructuring transaction. Hartford Accident and Indemnity Co. and Hartford Fire Insurance Co. v. RJR Nabisco, Inc. (S.D.N.Y.); Gekoski v. Johnson, 88 Civ. 8636 (KTD) (S.D.N.Y.).

staff will be considering whether additional disclosure concerning the effect of the transaction upon debtholders should be required in the context of leveraged change of control transactions.

A second category of investors involved in leveraged transactions are those who have invested in funds that provide equity participation in takeovers and leveraged buyouts. Many investment banks and other major participants in leveraged buyouts have raised funds from investors to create pools of assets, often in the form of limited partnerships, to use for the equity share in a leveraged transaction. 126/ These funds are often created through unregistered private placements involving large institutional investors, such as pension funds, although some may be registered offerings. Typically, when the investment is made in such a fund, the investor does not know what transactions will be entered into by the fund. In some situations, this has led to controversy because investors have claimed that their fund has made a hostile bid although there was a commitment that the fund would engage in only friendly transactions. 127/

126/ Bartlett, "New Type of Owner Emerges in Wave of Company Buyouts," N.Y. Times, Nov. 8, 1988, p. A1.

127/ *See* White, "Cuomo Seeks Freeze in New York State Pension Fund's Investment in Buy-Outs," Wall St. J., Nov. 29, 1988, p. C21.

A third class of investors involved in leveraged buyouts consists of the purchasers of the debt issued to finance the LBO, the so-called "junk bonds." This category includes the purchasers in the initial placement of the bonds and subsequent purchasers in the secondary market. These investors are primarily institutional investors, who are attracted by the high rate of return. 128/ Individual investors also may indirectly participate in this market by investing in mutual funds that specialize or make significant investments in high-yield bonds. 129/ The offer or sale of high-yield bonds is subject to the same securities law requirements as the offer or sale of other securities. However, because of the complexity of the terms of the transaction and the possibility of higher risk, there may be heightened concerns about the adequacy of risk disclosure. For example, questions have been raised about illiquidity of the junk bond market. 130/ A further question is whether junk bond investors are being informed about the possible

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128/ Quint, "The Rapid Growth of 'Junk Bonds,'" N.Y. Times, Nov. 17, 1988, p. D1.

129/ Peers, "How to Take a 'Junk' Bond Plunge ...," Wall St. J., Nov. 15, 1988, p. C1.

130/ Farrell, "Junk Bonds Finally Face the Acid Test," Bus. Week, Nov. 16, 1987, p.64. In this regard, the staff has required disclosure in all registered debt offerings of whether the underwriter intends to make a secondary market in the securities, and if no decision has been made, the effect on market liquidity if the underwriter does not make a market.

need for future debt restructuring. Although such restructurings are typically exempt from registration pursuant to Section 3(a)(9) of the Securities Act, these transactions may raise questions about the adequacy of disclosure concerning additional risk of default, the reasons for the restructuring, or the issuer's alternative plans for avoiding default.

Finally, the need for adequate disclosure to investors in institutions that purchase large amounts of high-yield bonds or engage in lending in leveraged transactions, also must be considered. There has been considerable concern expressed recently that institutions such as banks, thrifts, or insurance companies may be concentrating their assets too heavily in LBO-related debt. 131/ Similarly, investment banks and broker-dealers provide bridge loan financing for LBOs. These financing arrangements can commit large amounts of capital from the firm's parent holding company or affiliate. 132/

131/ See, e.g., Taylor, "Agencies May Press Banks in Risky LBOs to Build Reserves, Raise Capital Levels," Wall St. J., Dec. 16, 1988, p. B2; Knight, "Regulators Worry About Risk in Financing of Big Takeovers," Wash. Post, Nov. 28, 1988, p. A1; Forde, "Analysts Study Effects of LBO Lending," Amer. Banker, Nov. 8, 1988, p. 2; Kilborn, "Borrowing Limits Urged by Greenspan," N.Y. Times. Oct. 27, 1988;

132/ A bridge loan is a form of temporary financing for a transaction in which an investment banker makes a loan to the target for a interim period until permanent financing can be arranged. On October 28, 1987, the (continued...)

Such commitments may limit the flexibility of the institution in other areas of its business, and expose the firm to additional risk in the event of rising interest rates or a recession. A particular concern in these situations is that the failure of a leveraged borrower can cause significant losses to these institutional creditors. Recent reports indicate that some large banks engaged in LBO lending syndicate a large percentage of their loans and retain only a small portion of the LBO loans they originate. 133/ Nevertheless, some banks do not sell substantial portions of

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132/(...continued)
Commission released two staff studies on bridge financings, describing specific transactions in which investment banks or their affiliates put their own capital at risk to facilitate acquisitions, and the structure of the affiliates used to do so. The studies discuss the Commission rules that require disclosure, prohibit manipulative activity in the securities markets, and require investment banks to have adequate net capital to conduct their businesses. See SEC News Release No. 87-77.

Subsequent to the release of those studies, and in response to a letter from the Commission addressing concerns about the conflicts of interests arising from the refinancing of bridge loans, the National Association of Securities Dealers amended its rules with respect to underwritings of securities where a portion of the proceeds are intended for the underwriter (i.e., underwritings used, at least in part, to repay a bridge loan). The NASD's rule amendment requires the appointment of an independent qualified underwriter to price the offering in bridge loan refinancings. See Securities Exchange Act Release No. 25629 (April 29, 1988) [53 FR 16207], amending Article III, Section 1 of the NASD's Rules of Fair Practice.

133/ Guenther, "Banks Offer Glimpse at LBO Portfolios, Showing that Many Loans are Re-sold," Wall St. J., Dec. 13, 1988, p. A3.

their portfolio and there may be a period shortly after the loan transaction in which the lending risk is high because exposure has not been diversified. Investors in institutions engaged in LBO lending should be adequately informed about the institution's participation in such financing, the risks and potential exposure involved, and the effect on the institution's operations, if such matters are material. The Commission's staff is currently considering whether guidance should be issued concerning disclosure of holdings of financial instruments issued in connection with highly leveraged transactions.

Each of these situations has provoked considerable commentary, but the extent of the problems involved has not been closely examined. It is necessary to study these issues to determine the degree of any problem and the appropriate response. The Commission's Division of Corporation Finance is conducting a review of the level of current disclosure practice in these areas, and, if this review discovers inadequate or misleading disclosure, it will be necessary to consider whether enforcement actions, clarification of existing requirements, or additional disclosure requirements are necessary.

IV. Other Areas of Study

During the next few months, the Commission's Office of Economic Analysis (OEA) will gather data relevant to several issues concerning the economics of leveraged buyouts. In conducting the study, OEA has requested the cooperation of firms that specialize in arranging LBOs. It is hoped that

the private data gathered from these firms can be combined with public data to provide information useful to Congress and to the Commission assessing the LBO phenomenon.

V. Conclusion

Leveraged buyouts raise several public policy issues. Management-led transactions present particularly difficult questions because of the potential for management abuse of its informational advantage over unaffiliated shareholders, as well as the conflicts of interest inherent in such transactions. The Commission has adopted an extensive and detailed disclosure scheme to address these issues and is constantly monitoring its effectiveness. In addition, state law has developed substantive and procedural protections for shareholders in these transactions. The Commission's staff will be exploring proposals to expand or modify the scope of current rules to assure that they address current market practice.

Other investor interests implicated by LBOs, including the interests of senior debt holders and the interests of investors who provide financing directly through investment funds or indirectly through banks, insurance funds, or other sources will also be carefully examined by the Commission. The Commission will further monitor developments under state law with respect to the rights of security holders, as well as the development of restrictive covenants to protect against the event risk that results from certain leveraged transactions. Finally, the staff will gather data on the LBO phenomenon in order to promote a full assessment by Congress and by the Commission of the policy implications of these transactions.

Table 1

NUMBER OF GOING PRIVATE TRANSACTIONS
AND EQUITY VALUE OF COMPANIES GOING PRIVATE,
1980-1988

Year	N	Pre-Transaction Average Equity Value (000)	Pre-Transaction Total Equity Value[1] (000)	Post-Transaction Total Equity Value[2] (000)	Percent Change in Total Equity Value
1980	17	$ 45,510	$ 773,676	$ 1,102,859	42.5%
1981	21	115,192	2,419,041	3,093,422	27.9%
1982	28	82,181	2,301,060	3,333,342	44.9%
1983	35	136,106	4,763,697	6,111,399	28.3%
1984	47	188,550	8,861,866	12,266,156	38.4%
1985	39	423,644	16,522,132	23,099,273	39.8%
1986	39	391,700	15,276,301	19,884,523	30.2%
1987	44	308,723	13,583,805	16,402,455	20.8%
1980-1987	270	238,895	64,501,578	85,293,428	32.2%
1980-1983	101	101,559	10,257,474	13,641,021	33.0%
1984-1987	169	320,971	54,244,104	71,652,407	32.1%
1988[3]	39	727,041	28,354,582	45,007,905	58.7%
Completed	32	367,314	11,754,03[illegible]	18,147,985	54.4%
Pending	7	2,371,506	16,600,544	26,859,919[4]	61.8%
1980-1988	309	300,505	92,856,159	130,301,332	40.3%

[1] Computed as the price of common equity times the number of common shares outstanding, twenty trading days before the first announcement of the going private transaction.

[2] Computed as the price of the common equity on the last day that the common equity traded times the number of shares outstanding.

3 1988 data include only transactions of $100 million or more.

[4] Computed as closing price of common equity on January 20, 1989 times number of shares outstanding.

Source: SEC staff collected the sample of going private transactions by inspecting all corporate entries in annual editions of the Wall Street Journal Index, 1980-1987. Data on stock price data and number of shares outstanding were collected from Standard & Poor's Daily Stock Price Guides.

Dated:——.

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Signature.

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Name/Title.

The original statement shall be signed by each person on whose behalf the statement is filed or his authorized representative. If the statement is signed on behalf of a person by his authorized representative other than an executive officer or general partner of the filing person, evidence of the representative's authority to sign on behalf of such person shall be filed with the statement, *Provided, however,* That a power of attorney for this purpose which is already on file with the Commission may be incorporated by reference. The name and any title of each person who signs the statement shall be typed or printed beneath his signature.

NOTE: Six copies of this statement, including all exhibits, should be filed with the Commission.

ATTENTION: Intentional misstatements or omissions of fact constitute Federal criminal violations (see 18 U.S.C. 1001).

(Secs. 3(b), 13(d)(1), 13(d)(2), 13(d)(5), 13(d)(6), 13(g)(1), 13(g)(2), 13(g)(5), 23, 48 Stat. 882, 894, 901; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 78 Stat. 88a; sec. 2, 82 Stat. 454; secs. 1, 2, 84 Stat. 1497; secs. 3, 10, 18, 89 Stat. 97, 119, 155; secs. 202, 203, 91 Stat. 1494, 1498, 1499; (15 U.S.C. 78c(b), 78m(d)(1), 78m(d)(2), 78m(d)(5), 78m(d)(6), 78m(g)(1), 78m(g)(2), 78m(g)(5), 78w))

[43 FR 18499, Apr. 28, 1978, as amended at 43 FR 55756, Nov. 29, 1978; 44 FR 2148, Jan. 9, 1979; 44 FR 11751, Mar. 2, 1979]

§ 240.13e-1 Purchase of securities by issuer thereof.

When a person other than the issuer makes a tender offer for, or request or invitation for tenders of, any class of equity securities of an issuer subject to section 13(e) of the Act, and such person has filed a statement with the Commission pursuant to § 240.14d-1 and the issuer has received notice thereof, such issuer shall not thereafter, during the period such tender offer, request or invitation continues, purchase any equity securities of which it is the issuer unless it has complied with both of the following conditions:

(a) The issuer has filed with the Commission eight copies of a statement containing the information specified below with respect to the proposed purchases:

(1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;

(2) The purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer or otherwise disposed of, indicating such disposition; and

(3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto; and

(b) The initial statement shall be accompanied by a fee payable to the Commission as required by § 240.0-11.

(c) The issuer has at any time within the past 6 months sent or given to its equity security holders the substance of the information contained in the statement required by paragraph (a) of this section: *Provided, however,* That any issuer making such purchases which commenced prior to July 30, 1968 shall, if such purchases continue after such date, c mply with the provisions of this rule on or before August 12, 1968.

[33 FR 14110, Sept. 18, 1968, as amended at 34 FR 6101, Apr. 4, 1969; 51 FR 2476, Jan. 17, 1986]

§ 240.13e-2 [Reserved]

§ 240.13e-3 Going private transactions by certain issuers or their affiliates.

(a) *Definitions.* Unless indicated otherwise or the context otherwise requires, all terms used in this section and in Schedule 13E-3 [§ 240.13e-100] shall have the same meaning as in the Act or elsewhere in the General Rules and Regulations thereunder. In addition, the following definitions apply:

(1) An "affiliate" of an issuer is a person that directly or indirectly through one or more intermediaries

controls, is controlled by, or is under common control with such issuer. For the purposes of this section only, a person who is not an affiliate of an issuer at the commencement of such person's tender offer for a class of equity securities of such issuer will not be deemed an affiliate of such issuer prior to the stated termination of such tender offer and any extensions thereof;

(2) The term "purchase" means any acquisition for value including, but not limited to, (i) any acquisition pursuant to the dissolution of an issuer subsequent to the sale or other disposition of substantially all the assets of such issuer to its affiliate, (ii) any acquisition pursuant to a merger, (iii) any acquisition of fractional interests in connection with a reverse stock split, and (iv) any acquisition subject to the control of an issuer or an affiliate of such issuer;

(3) A "Rule 13e-3 transaction" is any transaction or series of transactions involving one or more of the transactions described in paragraph (a)(3)(i) of this section which has either a reasonable likelihood or a purpose of producing, either directly or indirectly, any of the effects described in paragraph (a)(3)(ii) of this section;

(i) The transactions referred to in paragraph (a)(3) of this section are:

(A) A purchase of any equity security by the issuer of such security or by an affiliate of such issuer;

(B) A tender offer for or request or invitation for tenders of any equity security made by the issuer of such class of securities or by an affiliate of such issuer; or

(C) A solicitation subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] of any proxy, consent or authorization of, or a distribution subject to Regulation 14C [§§ 240.14c-1 to 14c-101] of information statements to, any equity security holder by the issuer of the class of securities or by an affiliate of such issuer, in connection with: a merger, consolidation, reclassification, recapitalization, reorganization or similar corporate transaction of an issuer or between an issuer (or its subsidiaries) and its affiliate; a sale of substantially all the assets of an issuer to its affiliate or group of affiliates; or a reverse stock split of any class of equity securities of the issuer involving the purchase of fractional interests.

(ii) The effects referred to in paragraph (a)(3) of this section are:

(A) Causing any class of equity securities of the issuer which is subject to section 12(g) or section 15(d) of the Act to be held of record by less than 300 persons; or

(B) Causing any class of equity securities of the issuer which is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed on any national securities exchange nor authorized to be quoted on an inter-dealer quotation system of any registered national securities association.

(4) An "unaffiliated security holder" is any security holder of an equity security subject to a Rule 13e-3 transaction who is not an affiliate of the issuer of such security.

(b) *Application of section to an issuer (or an affiliate of such issuer) subject to section 12 of the Act.* (1) It shall be a fraudulent, deceptive or manipulative act or practice, in connection with a Rule 13e-3 transaction, for an issuer which has a class of equity securities registered pursuant to section 12 of the Act or which is a closed-end investment company registered under the Investment Company Act of 1940, or an affiliate of such issuer, directly or indirectly

(i) To employ any device, scheme or artifice to defraud any person;

(ii) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(iii) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

(2) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with any Rule 13e-3 transaction, it shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of

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the Act, or an affiliate of such issuer, to engage, directly or indirectly, in a Rule 13e-3 transaction unless:

(i) Such issuer or affiliate complies with the requirements of paragraphs (d), (e) and (f) of this section; and

(ii) The Rule 13e-3 transaction is not in violation of paragraph (b)(1) of this section.

(c) *Application of section to an issuer (or an affiliate of such issuer) subject to section 15(d) of the Act.* (1) It shall be unlawful as a fraudulent, deceptive or manipulative act or practice for an issuer which is required to file periodic reports pursuant to Section 15(d) of the Act, or an affiliate of such issuer, to engage, directly or indirectly, in a Rule 13e-3 transaction unless such issuer or affiliate complies with the requirements of paragraphs (d), (e) and (f) of this section.

(2) An issuer or affiliate which is subject to paragraph (c)(1) of this section and which is soliciting proxies or distributing information statements in connection with a transaction described in paragraph (a)(3)(i)(A) of this section may elect to use the timing procedures for conducting a solicitation subject to Regulation 14A (§§ 240.14a-1 to 240.14a-103) or a distribution subject to Regulation 14C (§§ 240.14c-1 to 240.14c-101) in complying with paragraphs (d), (e) and (f) of this section, provided that if an election is made, such solicitation or distribution is conducted in accordance with the requirements of the respective regulations, including the filing of preliminary copies of soliciting materials or an information statement at the time specified in Regulation 14A or 14C, respectively.

(d) *Material required to be filed.* The issuer or affiliate engaging in a Rule 13e-3 transaction shall, in accordance with the General Instructions to the Rule 13e-3 Transaction Statement on Schedule 13E-3 [§ 240.13e-100]:

(1) File with the Commission eight copies of such schedule, including all exhibits thereto;

(2) Report any material change in the information set forth in such schedule by promptly filing with the Commission eight copies of an amendment on such schedule; and

(3) Report the results of the Rule 13e-3 transaction by filing with the Commission promptly but no later than ten days (ten business days if Rule 13e-4 [§ 240.13e-4] is applicable) after the termination of such transaction eight copies of a final amendment to such schedule.

(e) *Disclosure of certain information.* (1) The issuer or affiliate engaging in the Rule 13e-3 transaction, in addition to any other information required to be disclosed pursuant to any other applicable rule or regulation under the federal securities laws, shall disclose to security holders of the class of equity securities which is the subject of the transaction, in the manner prescribed by paragraph (f) of this section, the information required by Items 1, 2, 3, 4, 5, 6, 10, 11, 12, 13, 14, 15 and 16 of Schedule 13e-3 [§ 240.13e-100], or a fair and adequate summary thereof, and Items 7, 8 and 9 and include in the document which contains such information the exhibit required by Item 17(e) of such Schedule. If the Rule 13e-3 transaction involves (i) a transaction subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] or 14C [§§ 240.14c-1 to 240.14c-101] of the Act, (ii) the registration of securities pursuant to the Securities Act of 1933 and the General Rules and Regulations promulgated thereunder, or (iii) a tender offer subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or Rule 13e-4 [§ 240.13e-4], such information shall be included in the proxy statement, the information statement, the registration statement or the tender offer for or request or invitation for tenders of securities published, sent or given to security holders, respectively.

(2) If any material change occurs in the information previously disclosed to security holders of the class of equity securities which is the subject of the transaction, the issuer or affiliate shall promptly disclose such change to such security holders in the manner prescribed by paragraph (f)(1)(iii) of this section.

(3) Any document transmitted to such security holders which contains the information required by paragraph (e)(1) of this section shall:

(i) Set forth prominently the information required by Items 7, 8 and 9 of the Rule 13e-3 Transaction Statement on Schedule 13E-3 [§ 240.13e-100] in a Special Factors section to be included in the forepart of such document; and

(ii) Set forth on the outside front cover page, in capital letters printed in bold face roman type at least as large as ten point modern type and at least two points leaded, the statement in paragraph (e)(3)(ii)(A) of this section, if the Rule 13e-3 transaction does not involve a prospectus, or the statement in paragraph (e)(3)(ii)(B) of this section, if the Rule 13e-3 transaction involves a prospectus, and in the latter case such statement shall be used in lieu of that required by Item 501(c)(5) of Regulation S-K (§ 229.501 of this chapter).

(A) THIS TRANSACTION HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE FAIRNESS OR MERITS OF SUCH TRANSACTION NOR UPON THE ACCURACY OF ADEQUACY OF THE INFORMATION CONTAINED IN THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

(B) NEITHER THIS TRANSACTION NOR THESE SECURITIES HAVE BEEN APPROVED OR DISARPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION. THE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

Instructions. 1. Negative responses to any item of Schedule 13E-3 [§ 240.13e-100] need not be included in the information disseminated to security holders unless otherwise indicated.

2. Although the financial information necessary to present a fair and adequate summary of Item 14 of Schedule 13E-3 [§ 240.13e-100] may vary depending on the facts and circumstances involved, the following historical and pro forma summary financial information normally will be sufficient for purposes of paragraph (e) of this section:

(a) The following summary financial information for (i) the two most recent fiscal years and (ii) the latest year-to-date interim period and corresponding interim period of the preceding year:

Income Statement:

Net sales and operating revenues and other revenues
Income before extraordinary items
Net Income
Balance Sheet (at end of period):
Working capital
Total assets
Total assets less deferred research and development charges and excess of cost of assets acquired over book value.
Shareholder's equity
Per Share:[1]
Income per common share before extraordinary items
Extraordinary items
Net income per common share (and common share equivalents, if applicable)
Net income per share on a fully diluted basis

(b) Ratio of earnings to fixed charges for the same periods required by 2(a) above;

(c) Book value per share as of the most recent fiscal year end and as of the date of the latest interim balance sheet; and

(d) If material, pro forma data for the summarized financial information described in 2(a), (b), and (c) above, disclosing the effect of the transaction, should be provided for the most recent fiscal year and latest year-to-date interim period.

If the information required by Item 14 is summarized, appropriate instructions should be included stating how more complete financial information can be obtained.

(f) *Dissemination of disclosure.* (1) If the Rule 13e-3 transaction involves a purchase as described in paragraph (a)(3)(i)(A) of this section or a vote, consent, authorization, or distribution of information statements as described in paragraph (a)(3)(i)(C) of this section, the issuer or affiliate engaging in the Rule 13e-3 transaction shall:

(i) Provide the information required by paragraph (e) of this section: (A) In accordance with the provisions of any applicable Federal or State law, but in no event later than 20 days prior to:

[1] Average number of shares of common stock outstanding during each period was——(as adjusted to give effect to stock dividends or stock splits).

any such purchase; any such vote, consent or authorization; or with respect to the distribution of information statements, the meeting date, or if corporate action is to be taken by means of the written authorization or consent of security holders, the earliest date on which corporate action may be taken: *Provided, however,* That if the purchase subject to this section is pursuant to a tender offer excepted from Rule 13e-4 by paragraph (g)(5) of Rule 13e-4, the information required by paragraph (e) of this section shall be disseminated in accordance with paragraph (e) of Rule 13e-4 no later than 10 business days prior to any purchase pursuant to such tender offer, (B) to each person who is a record holder of a class of equity securities subject to the Rule 13e-3 transaction as of a date not more than 20 days prior to the date of dissemination of such information.

(ii) If the issuer or affiliate knows that securities of the class of securities subject to the Rule 13e-3 transaction are held of record by a broker, dealer, bank or voting trustee or their nominees, such issuer or affiliate shall (unless Rule 14a-3(d) [§ 240.14a-3(d)] or 14c-7 [§ 240.14c-7] is applicable) furnish the number of copies of the information required by paragraph (e) of this section that are requested by such persons (pursuant to inquiries by or on behalf of the issuer or affiliate), instruct such persons to forward such information to the beneficial owners of such securities in a timely manner and undertake to pay the reasonable expenses incurred by such persons in forwarding such information; and

(iii) Promptly disseminate disclosure of material changes to the information required by paragraph (d) of this section in a manner reasonably calculated to inform security holders.

(2) If the Rule 13e-3 transaction is a tender offer or a request or invitation for tenders of equity securities which is subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or Rule 13e-4 [§ 240.13e-4], the tender offer containing the information required by paragraph (e) of this section, and any material change with respect thereto, shall be published, sent or given in accordance with Regulation 14D or Rule 13e-4, respectively, to security holders of the class of securities being sought by the issuer or affiliate.

(g) *Exceptions.* This section shall not apply to:

(1) Any Rule 13e-3 transaction by or on behalf of a person which occurs within one year of the date of termination of a tender offer in which such person was the bidder and became an affiliate of the issuer as a result of such tender offer: *Provided,* That the consideration offered to unaffiliated security holders in such Rule 13e-3 transaction is at least equal to the highest consideration offered during such tender offer and *Provided further,* That:

(i) If such tender offer was made for any or all securities of a class of the issuer;

(A) Such tender offer fully disclosed such person's intention to engage in a Rule 13e-3 transaction, the form and effect of such transaction and, to the extent known, the proposed terms thereof; and

(B) Such Rule 13e-3 transaction is substantially similar to that described in such tender offer; or

(ii) If such tender offer was made for less than all the securities of a class of the issuer:

(A) Such tender offer fully disclosed a plan of merger, a plan of liquidation or a similar binding agreement between such person and the issuer with respect to a Rule 13e-3 transaction; and

(B) Such Rule 13e-3 transaction occurs pursuant to the plan of merger, plan of liquidation or similar binding agreement disclosed in the bidder's tender offer.

(2) Any Rule 13e-3 transaction in which the security holders are offered or receive only an equity security *Provided,* That:

(i) Such equity security has substantially the same rights as the equity security which is the subject of the Rule 13e-3 transaction including, but not limited to, voting, dividends, redemption and liquidation rights except that this requirement shall be deemed to be satisfied if unaffiliated security holders are offered common stock;

(ii) Such equity security is registered pursuant to section 12 of the Act or re-

ports are required to be filed by the issuer thereof pursuant to section 15(d) of the Act; and

(iii) If the security which is the subject of the Rule 13e-3 transaction was either listed on a national securities exchange or authorized to be quoted in an interdealer quotation system of a registered national securities association, such equity security is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association.

(3) Transactions by a holding company registered under the Public Utility Holding Company Act of 1935 in compliance with the provisions of that Act;

(4) Redemptions, calls or similar purchases of an equity security by an issuer pursuant to specific provisions set forth in the instrument(s) creating or governing that class of equity securities; or

(5) Any solicitation by an issuer with respect to a plan of reorganization under Chapter X of the Bankruptcy Act, as amended, if made after the entry of an order approving such plan pursuant to section 174 of that Act and after, or concurrently with, the transmittal of information concerning such plan as required by section 175 of the Act.

(Sec. 17(a), 19(a), 48 Stat. 84, 85; secs. 3(b), 10(b), 13(e), 14(a), 14(d), 14(e), 23(a), 48 Stat. 882, 894, 895, 891, 901; sec. 209, 48 Stat. 908; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 68 Stat. 686; sec. 5, 78 Stat. 569, 570; secs. 2, 3, 82 Stat. 454, 455; secs. 1, 2, 3-5, 84 Stat. 1497; secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 77g(a), 77s(a), 78c(b), 78j(b), 78m(e), 78n(a), 78n(c), 78n(e), 78w(a); secs. 6, 7, 8, 10, 19(a), 48 Stat. 78, 79, 81, 85, secs. 205, 209, 48 Stat. 906, 908; sec. 301, 54 Stat. 857; sec. 8, 88 Stat. 685; sec. 1, 79 Stat. 1051; sec. 308(a)(2), 90 Stat. 57; secs. 12, 13, 14, 15(d), 23(a), 48 Stat. 892, 895, 901; secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; sec 203(a), 49 Stat. 704; sec. 202, 68 Stat. 686; secs. 3, 4, 5, 6, 78 Stat. 565-568, 569, 570-574; secs. 1, 2, 3, 82 Stat. 454, 455; secs. 28(c), "1, 2, 3-5, 84 Stat. 1435, 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 10, 18, 89 Stat. 117, 118, 119, 155; sec. 308(b), 90 Stat. 57; secs. 202, 203, 204, 81 Stat. 1494, 1498, 1499, 1500; 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 78l, 78m, 78n, 78o(d), 78w(a); secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e) and 23(a) of the Act, 15 U.S.C. 78c(b), 78i(a), 78j(b), 78m(e), 78n(e) and 78w(a))

[44 FR 46741, Aug. 8, 1979, as amended at 47 FR 11466, Mar. 16, 1982; 48 FR 19877, May 3, 1983; 48 FR 34253, July 28, 1983]

§ 240.13e-4 Tender offers by issuers.

(a) *Definitions.* Unless the context otherwise requires, all terms used in this section and in Schedule 13E-4 [§ 240.13E-101] shall have the same meaning as in the Act or elsewhere in the General Rules and Regulations thereunder. In addition, the following definitions shall apply:

(1) The term "issuer" means any issuer which has a class of equity security registered pursuant to section 12 of the Act, or which is required to file periodic reports pursuant to section 15(d) of the Act, or which is a closed-end investment company registered under the Investment Company Act of 1940.

(2) The term "issuer tender offer" refers to a tender offer for, or a request or invitation for tenders of, any class of equity security, made by the issuer of such class of equity security or by an affiliate of such issuer.

(3) As used in this section and in Schedule 13E-4 [§ 240.13e-101], the term "business day" means any day, other than Saturday, Sunday, or a Federal holiday, and shall consist of the time period from 12:01 a.m. through 12:00 midnight Eastern Time. In computing any time period under this Rule or Schedule 13E-4, the date of the event that begins the running of such time period shall be included *except that* if such event occurs on other than a business day such period shall begin to run on and shall include the first business day thereafter.

(4) The term "commencement" means the date an issuer tender offer is first published, sent or given to security holders.

(5) The term "termination" means the date after which securities may not be tendered pursuant to an issuer tender offer.

(6) The term "security holders" means holders of record and beneficial owners of securities of the class of equity security which is the subject of an issuer tender offer.

(7) The term "security position listing" means, with respect to the securities of any issuer held by a registered

termination or withdrawal of the tender offer.

(6) Until the expiration of at least ten business days after the date of termination of the issuer tender offer, neither the issuer nor any affiliate shall make any purchases, otherwise than pursuant to the tender offer, of:

(i) Any security which is the subject of the issuer tender offer, or any security of the same class and series, or any right to purchase any such securities; and

(ii) In the case of an issuer tender offer which is an exchange offer, any security being offered pursuant to such exchange offer, or any security of the same class and series, or any right to purchase any such security.

(7) The time periods for the minimum offering periods and withdrawal rights pursuant to this section shall be computed on a concurrent, as opposed to a consecutive, basis.

(g) This section shall not apply to:

(1) Calls or redemptions of any security in accordance with the terms and conditions of its governing instruments;

(2) Offers to purchase securities evidenced by a scrip certificate, order form or similar document which represents a fractional interest in a share of stock or similar security;

(3) Offers to purchase securities pursuant to a statutory procedure for the purchase of dissenting security holders' securities;

(4) Any tender offer which is subject to section 14(d) of the Act;

(5) Offers to purchase from security holders who own an aggregate of not more than a specified number of shares that is less than one hundred: *Provided, however*, That the offer is made to all record and beneficial holders (other than participants in an issuer's plan, as that term is defined in Rule 10b-6(c)(4) under the Act [§ 240.10b-6(c)(4)], if the issuer elects not to extend the offer to such participants) who own that number of shares as of a specified date prior to the announcement of the offer; or

(6) Any other transaction or transactions, if the Commission, upon written request or upon its own motion, exempts such transaction or transactions, either unconditionally, or on specified terms and conditions, as not constituting a fraudulent, deceptive or manipulative act or practice comprehended within the purpose of this section.

(Secs. 3(b), 9(a)(6), 10(b), 13(e), 14(e), 15(c)(1), 23(a), 48 Stat. 882, 889, 891, 894, 895, 901, sec. 8, 49 Stat. 1379, sec. 5, 78 Stat. 569, 570, secs. 2, 3, 82 Stat. 454, 455, secs. 1, 2, 3-5, 84 Stat. 1497, secs. 3, 18, 89 Stat. 97, 155 (15 U.S.C. 78c(b), 78i(a), 78j(b), 78m(e), 78n(e), 78o(c), 78w(a)))

[44 FR 49410, Aug. 22, 1979, as amended at 47 FR 11467, Mar. 16, 1982; 47 FR 54780, Dec. 6, 1982; 48 FR 34253, July 28, 1983; 51 FR 3034, Jan. 23, 1986; 51 FR 5515, Feb. 14, 1986]

§ 240.13e–100 Schedule 13E–3 [§ 240.13e-3], Rule 13e–3 transaction statement pursuant to section 13(e) of the Securities Exchange Act of 1934 and rule 13e–3 [§ 240.13e–3] thereunder.

Securities and Exchange Commission, Washington, D.C. 20549

Rule 13e–3 Transaction Statement

(Pursuant to Section 13(e) of the Securities Exchange Act of 1934)

[Amendment No.———]

(Name of the Issuer)

(Name of Person(s) Filing Statement)

(Title of Class of Securities)

(CUSIP Number of Class of Securities)

(Name, address and telephone number of person authorized to receive notices and communications on behalf of persons(s) filing statement)

This statement is filed in connection with (check the appropriate box):

a. ☐ The filing of solicitation materials or an information statement subject to Regulation 14A [17 CFR 240.14a-1 to 240.14a-103], Regulation 14C [17 CFR 240.14c-1 to 240.14c-101] or Rule 13e-3(c) [§ 240.13e-3(c)] under the Securities Exchange Act of 1934.

b. ☐ The filing of a registration statement under the Securities Act of 1933.

c. ☐ A tender offer.

d. ☐ None of the above.

Check the following box if the soliciting materials or information statement referred to in checking box (a) are preliminary copies: ☐

Instruction: Eight copies of this statement, including all exhibits, should be filed with the Commission.

CALCULATION OF FILING FEE

Transaction valuation*	Amount of filing fee

* Set forth the amount on which the filing fee is calculated and state how it was determined.

[ ] Check box if any part of the fee is offset as provided by Rule 0-11(a)(2) and identify the filing with which the offsetting fee was previously paid. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

Amount Previously Paid: ____________
Form or Registration No.: ____________
Filing Party: ____________
Date Filed: ____________

GENERAL INSTRUCTIONS

A. Depending on the type of Rule 13e-3 transaction, this statement shall be filed with the Commission:

1. Concurrently with the filing of "Preliminary Copies" of soliciting materials or an information statement pursuant to Regulations 14A or 14C under the Act;

2. Concurrently with the filing of a registration statement under the Securities Act of 1933;

3. As soon as practicable on the date a tender offer is first published, sent or given to security holders; or

4. At least 30 days prior to any purchase of any securities of the class of securities subject to the Rule 13e-3 transaction, if the transaction does not involve a solicitation, an information statement, the registration of securities or a tender offer, as described in 1, 2 or 3 of this Instruction.

5. If the Rule 13e-3 transaction involves a series of transactions, the issuer or affiliate shall file this statement at the time indicated in 1-4 of this general instruction for the first transaction of such series and shall promptly amend this schedule with respect to each subsequent transaction in such series.

B. The item numbers and captions of the items shall be included but the text of the items is to be omitted. The answers to the items shall be so prepared as to indicate clearly the coverage of the items without referring to the text of the items. Answer every item. If an item is inapplicable or the answer is in the negative, so state.

C. If the statement is filed by a general or limited partnership, syndicate or other group the information called for by Items 2, 3, 5, 6, 10, and 11 shall be given with respect to: (i) Each partner of such general partnership; (ii) each partner who is denominated as a general partner or who functions as a general partner of such limited partnership; (iii) each member of such syndicate or group; and (iv) each person controlling such partner of member. If the statement is filed by a corporation or if a person referred to in (i), (ii), (iii) or (iv) of this Instruction is a corporation, the information called for by the above mentioned items shall be given with respect to: (a) Each executive officer and director of such corporation; (b) each person controlling such corporation; and (c) each executive officer and director of any corporation ultimately in control of such corporation.

D. Information contained in exhibits to the statement or in a filing by the issuer, other than filings the incorporation of which is governed by Instruction F, may be incorporated by reference in answer or partial answer to any item or sub-item of the statement, unless it would render such answer incomplete, unclear or confusing. Matter incorporated by reference pursuant to this Instruction shall be clearly identified in the reference by page, paragraph, caption or otherwise. Any express statement that the specified matter is incorporated by reference pursuant to this Instruction shall be made at the particular place in the statement where the information is required. A copy of any information or a copy of the pertinent pages of a document containing such information which is incorporated by reference shall be submitted with this statement as an exhibit and shall be deemed to be filed with the Commission for all purposes of the Act.

E. The information required by the items of this statement is intended to be in addition to any disclosure requirements of any other form or schedule which may be filed with the Commission in connection with the Rule 13e-3 transaction. To the extent that the disclosure requirements of this statement are inconsistent with the disclosure requirements of any such forms or schedules, the requirements of this statement are controlling.

F. If the Rule 13e-3 transaction involves a transaction subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] or 14C [§§ 240.14c-1 to 240.14c-101] of the Act, the registration of securities pursuant to the Securities Act of 1933 and the General Rules and Regulations promulgated thereunder, or a tender offer subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or Rule 13e-4 [§ 240.13e-4], the information contained in the proxy or information statement, the registration statement, the Schedule 14D-1 [§ 240.14d-100], or the Schedule 13E-4, respectively, which is filed with the Commission shall be incorporated by reference in answer to the items of this statement or amendments thereto; this statement shall include an express statement to that effect and a cross reference sheet showing the location in the proxy or information state-

ment, the registration statement, the Schedule 14D-1 or the Schedule 13E-4 of the information required to be included in response to the items of this statement. If any such item is inapplicable or the answer thereto is in the negative and is omitted from the proxy or the information statement, the registration statement, the Schedule 14D-1, or the Schedule 13E-4, a statement to that effect shall be made in the cross reference sheet.

G. If the Rule 13e-3 transaction involves a proxy or an information statement subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] or Regulation 14C [§§ 240.14c-1 to 14c-101] and if preliminary copies of such materials have been incorporated by reference into this statement pursuant to Instruction F of this statement, this Schedule 13E-3 shall be deemed to constitute "Preliminary Copies" within the meaning of Rule 14a-6(e) [§ 240.14a-6] and Rule 14c-5 [§ 240.14c-5] and shall not be available for public inspection before an amendment to this statement containing definitive material has been filed with the Commission.

H. Amendments disclosing a material change in the information set forth in this statement may omit any information previously disclosed in this statement.

Item 1. Issuer and Class of Security Subject to the Transaction. (a) State the name of the issuer of the class of equity security which is the subject of the Rule 13e-3 transaction and the address of its principal executive offices.

(b) State the exact title, the amount of securities outstanding of the class of security which is the subject of the Rule 13e-3 transaction as of the most recent practicable date and the approximate number of holders of record of such class as of the most recent practicable date.

(c) Identify the principal market in which such securities are being traded and, if the principal market is an exchange, state the high and low sales prices for such securities as reported in the consolidated transaction reporting system or, if not so reported, on such principal exchange for each quarterly period during the past two years. If the principal market is not an exchange, state the range of high and low bid quotations for each quarterly period during the past two years, the source of such quotations and, if there is currently no established trading market for such securities (excluding limited or sporadic quotations), furnish a statement to that effect.

(d) State the frequency and amount of any dividends paid during the past two years with respect to such class of securities and briefly describe any restriction on the issuer's present or future ability to pay such dividends.

Instruction: If the person filing this statement is an affiliate of the issuer, the information required by Item 1(d) should be furnished to the extent known by such affiliate after making reasonable inquiry.

(e) If the issuer and/or affiliate filing this statement has made an underwritten public offering of such securities for cash during the past three years which was registered under the Securities Act of 1933 or exempt from registration thereunder pursuant to Regulation A, state the date of such offering, the amount of securities offered, the offering price per share (which should be appropriately adjusted for stock splits, stock dividends, etc.) and the aggregate proceeds received by such issuer and/or such affiliate.

(f) With respect to any purchases of such securities made by the issuer or affiliate since the commencement of the issuer's second full fiscal year preceding the date of this schedule, state the amount of such securities purchased, the range of prices paid for such securities and the average purchase price for each quarterly period of the issuer during such period.

Instruction: The information required by Item 1(f) need not be given with respect to purchases of such securities by a person prior to the time such person became an affiliate.

Item 2. Identity and Background. If the person filing this statement is the issuer of the class of equity securities which is the subject of the Rule 13e-3 transaction, make a statement to that effect. If that statement is being filed by an affiliate of the issuer which is other than a natural person or if any person enumerated in Instruction C to this statement is a corporation, general partnership, limited partnership, syndicate or other group of persons, state its name, the state or other place of its organization, its principal business, the address of its principal executive offices and provide the information required by (e) and (f) of this Item. If this statement is being filed by an affiliate of the issuer who is a natural person or if any person enumerated in Instruction C of this statement is a natural person, provide the information required by (a) through (g) of this Item with respect to such person(s).

(a) Name;

(b) Residence or business address;

(c) Present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment or occupation is conducted;

(d) Material occupations, positions, offices or employments during the last 5 years, giving the starting and ending dates of each and the name, principal business and address of any business corporation or other organization in which such occupation, position, office or employment was carried on;

(e) Whether or not, during the last 5 years, such person has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, give the dates, nature of conviction, name and location of court, and penalty imposed or other disposition of the case;

(f) Whether or not, during the last 5 years, such person was a party to a civil proceeding of a judicial or administrative body of competent jurisdiction and as a result of such proceeding was or is subject to a judgment, decree or final order enjoining further violations of, or prohibiting activities subject to, federal or state securities laws or finding any violation of such laws; and, if so, identify and describe such proceeding and summarize the terms of such judgment, decree or final order;

Instruction: While negative answers to Items 2(e) and 2(f) are required in this schedule, they need not be furnished to security holders.

(g) Citizenship(s).

Item 3. Past Contacts, Transactions or Negotiations. (a) If this schedule is filed by an affiliate of the issuer of the class of securities which is the subject of the Rule 13e-3 transaction:

(1) Briefly state the nature and approximate amount (in dollars) of any transaction, other than those described in Item 3(b) of this schedule, which has occurred since the commencement of the issuer's second full fiscal year preceding the date of this schedule between such affiliate (including subsidiaries of the affiliate and those persons enumerated in Instruction C of this schedule) and the issuer: *Provided, however,* That no disclosure need be made with respect to any transaction if the aggregate amount involved in such transaction was less than one percent of the issuer's consolidated revenues (which may be based upon information contained in the most recently available filing with the Commission by the issuer unless such affiliate has reason to believe otherwise) (i) for the fiscal year in which such transaction occurred or (ii) for the portion of the current fiscal year which has occurred, if the transaction occurred in such year; and

(2) Describe any contacts, negotiations or transactions which have been entered into or which have occurred since the commencement of the issuer's second full fiscal year preceding the date of this schedule between such affiliate (including subsidiaries of the affiliate and those persons enumerated in Instruction C of this schedule) and the issuer concerning: a merger, consolidation or acquisition; a tender offer for or other acquisition of securities of any class of the issuer; an election of directors of the issuer; or a sale or other transfer of a material amount of assets of the issuer or any of its subsidiaries.

(b) Describe any contacts or negotiations concerning the matters referred to in Item 3(a)(2) which have been entered into or which have occurred since the commencement of the issuer's second full fiscal year preceding the date of this schedule (i) between any affiliates of the issuer of the class of securities which is the subject of the Rule 13e-3 transaction; or (ii) between such issuer or any of its affiliates and any person who is not affiliated with the issuer and who would have a direct interest in such matters. Identify the person who initiated such contacts or negotiations.

Item 4. Terms of the Transaction. (a) State the material terms of the Rule 13e-3 transaction.

(b) Describe any term or arrangement concerning the Rule 13e-3 transaction relating to any security holder of the issuer which is not identical to that relating to other security holders of the same class of securities of the issuer.

Item 5. Plans or Proposals of the Issuer or Affiliate. Describe any plan or proposal of the issuer or affiliate regarding activities or transactions which are to occur after the Rule 13e-3 transaction which relate to or would result in: (a) An extraordinary corporate transaction, such as a merger, reorganization or liquidation, involving the issuer or any of its subsidiaries;

(b) A sale or transfer of a material amount of assets of the issuer or any of its subsidiaries;

(c) Any change in the present board of directors or management of the issuer including, but not limited to, any plan or proposal to change the number or term of directors, to fill any existing vacancy on the board or to change any material term of the employment contract of any executive officer;

(d) Any material change in the present dividend rate or policy or indebtedness or capitalization of the issuer;

(e) Any other material change in the issuer's corporate structure or business;

(f) A class of equity securities of the issuer becoming eligible for termination of registration pursuant to section 12(g)(4) of the Act; or

(g) The suspension of the issuer's obligation to file reports pursuant to section 15(d) of the Act.

Item 6. Source and Amounts of Funds or Other Consideration. (a) State the source and total amount of funds or other consideration to be used in the Rule 13e-3 transaction.

(b) Furnish a reasonably itemized statement of all expenses incurred or estimated to be incurred in connection with the Rule 13e-3 transaction including, but not limited to, filing fees, legal, accounting and appraisal fees, solicitation expenses and printing costs and state whether or not the issuer

has paid or will be responsible for paying any or all of such expenses.

(c) If all or any part of such funds or other consideration is, or is expected to be, directly or indirectly borrowed for the purpose of the Rule 13e-3 transaction,

(1) Provide a summary of each such loan agreement containing the indentity of the parties, the term, the collateral, the stated and effective interest rates, and other material terms or conditions; and

(2) Briefly describe any plans or arrangements to finance or repay such borrowings, or, if no such plans or arrangements have been made, make a statement to that effect.

(d) If the source of all or any part of the funds to be used in the Rule 13e-3 transaction is a loan made in the ordinary course of business by a bank as defined by section 3(a)(6) of the Act and section 13(d) or 14(d) is applicable to such transaction, the name of such bank shall not be made available to the public if the person filing the statement so requests in writing and files such request, naming such bank, with the Secretary of the Commission.

Item 7. Purpose(s), Alternatives, Reasons and Effects. (a) State the purpose(s) for the Rule 13e-3 transaction.

(b) If the issuer or affiliate considered alternative means to accomplish such purpose(s), briefly describe such alternative(s) and state the reason(s) for their rejection.

(c) State the reasons for the structure of the Rule 13e-3 transaction and for undertaking such transaction at this time.

(d) Describe the effects of the Rule 13e-3 transaction on the issuer, its affiliates and unaffiliated security holders, including the federal tax consequences.

Instructions: (1) Conclusory statements will not be considered sufficient disclosure in response to Item 7.

(2) The description required by Item 7(d) should include a reasonably detailed discussion of the benefits and detriments of the Rule 13e-3 transaction to the issuer, its affiliates and unaffiliated security holders. The benefits and detriments of the Rule 13e-3 transaction should be quantified to the extent practicable.

(3) If this statement is filed by an affiliate of the issuer, the description required by Item 7(d) should include but not be limited to, the effect of the Rule 13e-3 transaction on the affiliate's interest in the net book value and net earnings of the issuer in terms of both dollar amounts and percentages.

Item 8. Fairness of the Transaction. (a) State whether the issuer or affiliate filing this schedule reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders. If any director dissented to or abstained from voting on the Rule 13e-3 transaction, identify each such director, and indicate, if known, after making reasonable inquiry, the reasons for each dissent or abstention.

Instruction. A statement that the issuer or affiliate has no reasonable belief as to the fairness of the Rule 13e-3 transaction to unaffiliated security holders will not be considered sufficient disclosure in response to Item 8(a).

(b) Discuss in reasonable detail the material factors upon which the belief stated in Item 8(a) is based and, to the extent practicable, the weight assigned to each such factor. Such discussion should include an analysis of the extent, if any, to which such belief is based on the factors set forth in instruction (1) to paragraph (b) of this Item, paragraphs (c), (d), and (e) of this Item, and Item 9.

Instructions. (1) The factors which are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, which should be given to them in a particular context will vary. Normally such factors will include, among others, those referred to in paragraphs (c), (d) and (e) of this Item and whether the consideration offered to unaffiliated security holders constitutes fair value in relation to:

(i) Current market prices,

(ii) Historical market prices,

(iii) Net book value,

(iv) Going concern value,

(v) Liquidation value,

(vi) The purchase price paid in previous purchases disclosed in Item 1(f) of Schedule 13e-3,

(vii) Any report, opinion, or appraisal described in Item 9 and

(viii) Firm offers of which the issuer or affiliate is aware made by any unaffiliated person, other than the person filing this statement, during the preceding eighteen months for:

(A) The merger or consolidation of the issuer into or with such person or of such person into or with the issuer,

(B) The sale or other transfer of all or any substantial part of the assets of the issuer or

(C) Securities of the issuer which would enable the holder thereof to exercise control of the issuer.

(2) Conclusory statements, such as "The Rule 13e-3 transaction is fair to unaffiliated security holders in relation to net book value, going concern value and future prospects of the issuer" will not be considered sufficient disclosure in response to Item 8(b).

(c) State whether the transaction is structured so that approval of at least a majority of unaffiliated security holders is required.

(d) State whether a majority of directors who are not employees of the issuer has retained an unaffiliated representative to act

solely on behalf of unaffiliated security holders for the purposes of negotiating the terms of the Rule 13e-3 transaction and/or preparing a report concerning the fairness of such transaction.

(e) State whether the Rule 13e-3 transaction was approved by a majority of the directors of the issuer who are not employees of the issuer.

(f) If any offer of the type described in instruction (vii) to Item 8(b) has been received, describe such offer and state the reason(s) for its rejection.

Item 9. Reports, Opinions, Appraisals and Certain Negotiations. (a) State whether or not the issuer or affiliate has received any report, opinion (other than an opinion of counsel) or appraisal from an outside party which is materially related to the Rule 13e-3 transaction including, but not limited to, any such report, opinion or appraisal relating to the consideration or the fairness of the consideration to be offered to security holders of the class of securities which is the subject of the Rule 13e-3 transaction or the fairness of such transaction to the issuer or affiliate or to security holders who are not affiliates.

(b) With respect to any report, opinion or appraisal described in Item 9(a) or with respect to any negotiation or report described in Item 8(d) concerning the terms of the Rule 13e-3 transaction:

(1) Identify such outside party and/or unaffiliated representative;

(2) Briefly describe the qualifications of such outside party and/or unaffiliated representative;

(3) Describe the method of selection of such outside party and/or unaffiliated representative;

(4) Describe any material relationship between (i) the outside party, its affiliates, and/or unaffiliated representative, and (ii) the issuer or its affiliates, which existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of such relationship;

(5) If such report, opinion or appraisal relates to the fairness of the consideration, state whether the issuer or affiliate determined the amount of consideration to be paid or whether the outside party recommended the amount of consideration to be paid.

(6) Furnish a summary concerning such negotiation report, opinion or appraisal which shall include, but not be limited to, the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the issuer or affiliate; and any limitation imposed by the issuer or affiliate on the scope of the investigation.

Instruction: The information called for by subitem 9(b)(1), (2) and (3) should be given with respect to the firm which provides the report, opinion or appraisal rather than the employees of such firm who prepared it.

(c) Furnish a statement to the effect that such report, opinion or appraisal shall be made available for inspection and copying at the principal executive offices of the issuer or affiliate during its regular business hours by any interested equity security holder of the issuer or his representative who has been so designated in writing. This statement may also provide that a copy of such report, opinion or appraisal will be transmitted by the issuer or affiliate to any interested equity security holder of the issuer or his representative who has been so designated in writing upon written request and at the expense of the requesting security holder.

Item 10. Interest in Securities of the Issuer. (a) With respect to the class of equity security to which the Rule 13e-3 transaction relates, state the aggregate amount and percentage of securities beneficially owned (identifying those securities for which there is a right to acquire) as of the most recent practicable date by the person filing this statement (unless such person is the issuer), by any pension, profit sharing or similar plan of the issuer or affiliate, by each person enumerated in Instruction C of this Schedule or by any associate or majority owned subsidiary of the issuer or affiliate giving the name and address of any such associate or subsidiary.

Instructions: 1. For the purpose of this Item, beneficial ownership shall be determined in accordance with Rule 13e-3 [17 CFR 240.13d-3] under the Exchange Act.

2. The information required by this paragraph should be given with respect to officers, directors and associates of the issuer to the extent known after making reasonable inquiry.

(b) Describe any transaction in the class of equity securities of the issuer which is the subject of a Rule 13e-3 transaction that was effected during the past 60 days by the issuer of such class or by the persons named in response to paragraph (a) of this Item.

Instructions: 1. The description of a transaction required by Item 10(b) shall include, but not necessarily be limited to: (i) the identity of the person covered by Item 10(b) who effected the transaction; (ii) the date of the transaction; (iii) the amount of securities involved; (iv) the price per security; and (v) where and how the transaction was effected.

2. If the information required by Item 10(b) is available to the person filing this statement at the time this statement is initially filed with the Commission, the information shall be included in the initial filing.

However, if the information is not available to such person at the time of such initial filing, it shall be filed with the Commission promptly but in no event later than seven days (or 2 business days with respect to a tender subject to Regulation 14D [§§ 240.14d-1 to 240.14d-101] or 10 business days with respect to a tender offer subject to Rule 13e-4 [§ 240.13e-4]) after the date of such filing and, if material, disclosed to security holders of the issuer pursuant to Rule 13e-3(e) [§ 240.13e-3(e)], and disseminated to them in a manner reasonably calculated to inform security holders.

Item 11. Contracts, Arrangements or Understandings with Respect to the Issuer's Securities. Describe any contract, arrangement, understanding or relationship (whether or not legally enforceable) in connection with the Rule 13e-3 transaction between the person filing this statement (including any person enumerated in Instruction C of this schedule) and any person with respect to any securities of the issuer (including, but not limited to, any contract, arrangement, understanding or relationship concerning the transfer or the voting of any such of such securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or the giving or withholding proxies, consents or authorizations), naming the persons with whom such contracts, arrangements, understandings or relationships have been entered into and giving the material provisions thereof. Include such information for any of such securities that are pledged or otherwise subject to a contingency, the occurrence of which would give another person the power to direct the voting or disposition of such securities, except that disclosure of standard default and similar provisions contained in loan agreements need not be included.

Item 12. Present Intention and Recommendation of Certain Persons with Regard to the Transaction. (a) To the extent known by the person filing this statement after making reasonable inquiry, furnish a statement of present intention with regard to the Rule 13e-3 transaction indicating whether or not any executive officer, director or affiliate of the issuer or any person enumerated in Instruction C of this statement will tender or sell securities of the issuer owned or held by such person and/or how such securities, and securities with respect to which such person holds proxies, will be voted and the reasons therefor.

Instruction: If the information required by Item 12(a) is available to the person filing this statement at the time this statement is initially filed with the Commission, the information shall be included in the initial filing. However, if the information is not available to such person at the time of such initial filing, it shall be filed with the Commission promptly but in no event later than seven days (or two business days with respect to a tender offer subject to Regulation 14D [§ 240.14d-1 to 240.14d-101] or ten business days with respect to a tender offer subject to Rule 13e-4 [§§ 240.13e-4]) after the date of such filing and, if material, disclosed to security holders of the issuer pursuant to Rule 13e-3(e) [§ 240.13e-3(e)], and disseminated to them in a manner reasonably calculated to inform security holders.

(b) To the extent known by the person filing this statement after making reasonable inquiry, state whether any person named in paragraph (a) of this item has made a recommendation in support of or opposed to the Rule 13e-3 transaction and the reasons for such recommendation. If no recommendation has been made by such persons, furnish a statement to that effect.

Item 13. Other Provisions of the Transaction. (a) State whether or not appraisal rights are provided under applicable state law or under the issuer's articles of incorporation or will be voluntarily accorded by the issuer or affiliate to security holders in connection with the Rule 13e-3 transaction and, if so, summarize such appraisal rights. If appraisal rights will not be available under the applicable state law, to security holders who object to the transaction, briefly outline the rights which may be available to such security holders under such law.

(b) If any provision has been made by the issuer or affiliate in connection with the Rule 13e-3 transaction to allow unaffiliated security holders to obtain access to the corporate files of the issuer or affiliate or to obtain counsel or appraisal services at the expense of the issuer or affiliate, describe such provision.

(c) If the Rule 13e-3 transaction involves the exchange of debt securities of the issuer or affiliate for the equity securities held by security holders of the issuer who are not affiliates, describe whether or not the issuer or affiliate will take steps to provide or assure that such securities are or will be eligible for trading on any national securities exchange or an automated inter-dealer quotation system.

Item 14. Financial Information. (a) Furnish the following financial data concerning the issuer: (1) Audited financial statements for the two fiscal years required to be filed with the issuer's most recent annual report under sections 13 and 15(d) of the Act;

(2) Unaudited balance sheets and comparative year-to-date income statements and statements of changes in financial position and related earnings per share amounts required to be included in the issuer's most recent quarterly report filed pursuant to the Act;

(3) Ratio of earnings to fixed charges for the two most recent fiscal years and the in-

terim periods provided under Item 14(a)(2); and

(4) Book value per share as of the most recent fiscal year end and as of the date of the latest interim balance sheet provided under Item 14(a)(2).

(b) If material, provide pro forma data disclosing the effect of the Rule 13e-3 transaction on: (1) The issuer's balance sheet as of the most recent fiscal year end and the latest interim balance sheet provided under Item 14(a)(2);

(2) The issuer's statement of income, earnings per share amounts, and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period provided under Item 14(a)(2); and

(3) The issuer's book value per share as of the most recent fiscal year end and as of the latest interim balance sheet date provided under Item 14(a)(2).

Item 15. Persons and Assets Employed, Retained or Utilized. (a) Identify and describe the purpose for which any officer, employee, class of employees or corporate asset of the issuer (excluding corporate assets which are proposed to be used as consideration for purchases of securities which are disclosed in Item 6 of this schedule) has been or is proposed to be employed, availed of or utilized by the issuer or affiliate in connection with the Rule 13e-3 transaction.

(b) Identify all persons and classes of persons (excluding officers, employees and class of employees who have been identified in Item 15(a) of this Schedule) employed, retained or to be compensated by the person filing this statement, or by any person on behalf of the person filing this statement, to make solicitations or recommendations in connection with the Rule 13e-3 transaction and provide a summary of the material terms of such employment, retainer or arrangement for compensation.

Item 16. Additional Information. Furnish such additional material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not materially misleading.

Item 17. Material to be Filed as Exhibits. Furnish a copy of:

(a) Any loan agreement referred to in Item 6 of this Schedule;

Instruction: The identity of any bank which is a party to a loan agreement need not be disclosed if the person filing the statement has requested that the identity of such bank not be made available to the public pursuant to Item 6 of this schedule.

(b) Any report, opinion or appraisal referred to in Items 8(d) or 9 of this schedule;

(c) Any document setting forth the terms of any contract, arrangements or understandings or relationships referred to in Item 11 of this schedule; and

(d) Any disclosure materials furnished to security holders in connection with the transaction pursuant to Rule 13e-3(d) [§ 240.13e-3(d)].

(e) A detailed statement describing the appraisal rights and the procedures for exercising such appraisal rights which are referred to in Item 13(a) of this schedule.

(f) If any oral solicitation of or recommendations to security holders referred to in Item 15(b) are to be made by or on behalf of the person filing this statement, any written instruction, form or other material which is furnished to the persons making the actual oral solicitation or recommendation for their use, directly or indirectly, in connection with the Rule 13e-3 transaction.

SIGNATURE

After due inquiry and to the best of my knowledge and belief, I certify that the information set forth in this statement is true, complete and correct.

(Date)————————

(Signature)————————

(Name and Title)————

The original statement shall be signed by each person on whose behalf the statement is filed or his authorized representative. If the statement is signed on behalf of a person by his authorized representative (other than an executive officer or general partner of the person filing this statement), evidence of the representative's authority to sign on behalf of such person shall be filed with the statement. The name and any title of each person who signs the statement shall be typed or printed beneath his signature.

(Sec. 17(a), 19(a), 48 Stat. 84, 85; secs. 3(b), 10(b), 13(e), 14(a), 14(d), 14(e), 23(a), 48 Stat. 882, 894, 895, 891, 901; sec. 209, 48 Stat. 908; sec. 203(a), 49 Stat. 704; sec. 8, 49 Stat. 1379; sec. 10, 68 Stat. 686; sec. 5, 78 Stat. 569, 570; secs. 2, 3, 82 Stat. 454, 455; secs. 1, 2, 3-5, 84 Stat. 1497; secs. 3, 18, 89 Stat. 97, 155; 15 U.S.C. 77g(a), 77s(a), 78c(b), 78j(b), 78m(e), 78n(a), 78n(c), 78n(e), 78w(a))

[44 FR 46743, Aug. 8, 1979, as amended at 51 FR 2477, Jan. 17, 1986]

§ 240.13e-101 Schedule 13E-4. Tender offer statement pursuant to section 13(e)(1) of the Securities Exchange Act of 1934 and § 240.13e-4 thereunder.

Securities and Exchange Commission
Washington, D.C.

Issuer Tender Offer Statement

Pursuant to Section 13(e)(1) of the Securities Exchange Act of 1934

Taxation and Corporate Debt

Lawrence H. Summers
Harvard University

I welcome the opportunity to testify before this distinguished committee on the important subject of the recent wave of corporate restructurings and increases in indebtedness, and its implications for the tax system. While I do not share the fears of some critics that recent trends in corporate debt pose grave threats to economic stability, I do believe they highlight the need to address certain distortions that have long been present in our income tax system.

In my testimony today, I shall make four points. First, there is no reason for a punitive reaction to recent trends in corporate indebtedness. To a significant extent, increased reliance on debt has reduced capital costs and improved incentives for managerial efficiency. While increased reliance on debt may be justified in many instances, there is, however, no justification for tax policies which encourage its use beyond the level that an undistorted market would dictate. Second, the current tax system provides substantial incentives for the excessive use of debt both in the context of corporate restructurings and in the context of ordinary business operations. Claims that LBO transactions benefit the Treasury are misleading in a number of respects. Third, as long as the tax system seeks to doubly tax corporate income, to distinguish between debt and equity, dividends and interest, and interest and capital gains, financial innovation will continue to create substantial problems. Now is not too soon to begin consideration of fundamental changes in traditional tax concepts. Fourth, for the near term the argument for changing tax rules to tax equity that masquerades as high yield debt is overwhelming. Serious consideration should be given to using

the revenues to finance reductions in the tax rate on dividends arising from future new equity issues.

Assessing Recent Corporate Debt Trends

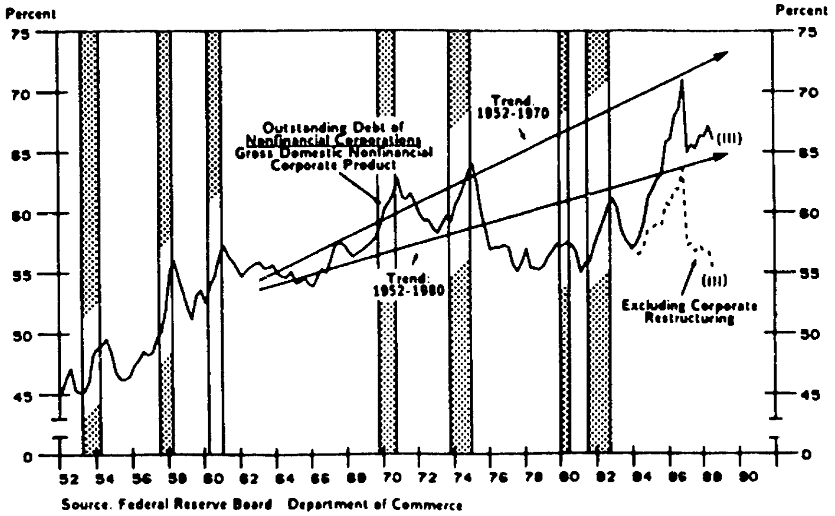
By almost any measure the extent of corporate indebtedness has increased in recent years. Figure 1 illustrates the behavior of one standard measure--the ratio of non-financial corporate debt to GNP. It is evident that there is a long term trend towards increased corporate reliance on debt which dates back to the end of World War II. However, the increases in corporate indebtedness during the 1980s was almost entirely the result of corporate restructurings. But for the effects of these restructurings, there would have been almost no increase in the quantity of corporate debt outstanding relative to corporate GNP during the 1980s.

At the outset, it is important to recognize that not all LBO's represent the type of public deal that has gotten so much attention in recent months. Many transactions occur when the owner-manager of a relatively small company approaches retirement, or when it becomes clear that a profitable line of business no longer fits with a corporation's overall strategy. These deals are almost certainly benign, and it would be unfortunate if public policies directed at larger transactions inhibited them to a substantial extent. In the remainder of my remarks, however, I shall concentrate on the large public LBO's that have been the been the focus of recent discussions.

The proliferation of corporate restructurings in the 1980s is primarily a reflection of financial innovation--particularly the development of the high yield, "junk" bond market. These have made it possible for acquirers, whether

Chart 1

Corporate Debt Burden in Historical Perspective



Reprinted from Goldman Sachs, Financial Market Perspectives, December 1988.

hostile, or friendly, or inside as in the case of management buyouts, to finance acquisitions on a scale that was previously impossible. The recent RJR-Nabisco deal, which accounts for nearly 1/4 of the dollar value of all the LBO activity in the 1980s, suggests that the feasible scale of leveraged transactions is continuing to increase. Because large leveraged buyout transactions are a recent development, only limited evidence on their effects is available. Here I offer my interpretation of the available evidence on various questions that are often raised in discussions of the phenomena.

Why has so much money been made by so few people? In large part, LBO's have succeeded so spectacularly because of general upward trends in the stock market. An individual who bought and held the stock market on 10% margin since 1982 would have earned a return of close to 1000%. Few LBO funds have done better over the last few years. It is always true that those willing to borrow heavily and invest fare well in bull markets. The current experience is no exception. The unlikelihood of another bull market like the one of the last six years, and the increasing competition in the LBO business means that it is very unlikely that the current generation of deals will payoff nearly as spectacularly as the past ones have.

Much has been made of the size of the fees associated with these transactions and the diversion of talent from other pursuits into the investment banking business. Without endorsing the excesses that have been present, it is fair to point out that the number of "doers" diverted into investment banking in recent years is almost certainly more than offset by the reduction in the number of corporate staff functionaries as leveraged transactions have encouraged managerial efficiency and broken apart wasteful conglomerate structures.

There are legitimate concerns about management's ability to fulfill its fiduciary duty to shareholders when it is also seeking to acquire the company. Accumulating evidence that reported earnings and stock prices frequently decline immediately prior to LBOs and rise thereafter is particularly alarming in this regard. This is an issue of securities regulation, not tax policy. Serious consideration should be given to strengthening the role and independence of outside directors as a safeguard against managerial abuse.

This need is highlighted by the recent RJR-Nabisco case. While public reports strongly suggest that the recent auction of RJR-Nabisco was a fair one, there are suggestions that efforts were made to make it otherwise. According to one report "Johnson spoiled his directors with lucrative consulting contracts and always available airplanes. He had led the fight to double directors' pay to $50,000 a year...Some were so close that one commentator jokingly described them as Johnson's kangaroo court."[1] Experience suggests that in the future some boards will respond more strongly to the interests of incumbent management than to the interests of outside shareholders unless current rules are altered.

Why are acquirers able to pay such large premia over previous stock prices? This crucial question continues to be a subject of intense debate among both practitioners and academics. Part of the answer appears to lie in the profitability improvements that managers realize when their feet are held to the fire by large debts, and when a large equity stake sharpens incentives.

[1] Corporate Governance Bulletin, December 1988 p.147. For further allegations about management and board improprieties see the series of articles in Barrons by Ben Stein.

It is not yet clear to what extent these improvements represent real increases in economic efficiency, and to what extent they represent transfers from other corporate stakeholders, such as employers, suppliers, bondholders and neighboring communities. This distinction is crucial. When more output is produced with the same group of employees, economic efficiency is clearly enhanced. On the other hand, when more employees are put to work collecting receivables more quickly, a company may collect more but only at the expense of its customers. This does not represent any improvement in the performance of the economy.

In many transactions, value is created by divesting assets. In these cases the value may come from the ability to sell assets to different Another part of the answer probably lies in the superior information of management. Inevitably, corporate managers know more about their companies than even the most attentive market observers. They will buy when the company looks cheap relative to its fundamental value. The same market mis-pricing that gives them an incentive to buy makes it possible for them to pay a premium over the going market price.

As I discuss in more detail below, because interest is deductible for corporations and dividends are not, the tax system tends to subsidize transactions which replace corporate equity with debt. In many cases, LBO's can nearly eliminate a corporation's tax liability for several years. An additional tax reason for LBO premia is the need to compensate shareholders for the capital gains taxes they are forced to pay when their shares are acquired.

Do Rising Levels of Corporate Debt Threaten Corporate Performance? The evidence here is quite inconclusive. It appears that in most cases operating

profits increase following LBO's even when they are compared with other firms in the same industry. While this reflects, to some extent, inside information on the part of acquirers about trends that would have taken place anyway and efficiencies that come at the expense of corporate stakeholders, there do appear to be some improvements in operating practices. Most LBO's occur in mature industries where spending on research is low, so there is not yet much evidence to support claims that R&D is severely cramped by LBOs. There is evidence that investment outlays decline following LBOs. But the data do not permit us to disentangle the productivity of the investments that are foregone.

Because of the strength of the economy, we do not yet have enough experience to assess the degree of disruption that will be associated with LBO's that go bankrupt. It is important to recognize that LBO bankruptcies will differ importantly from traditional bankruptcies. When traditional, lightly levered companies cannot meet their debt obligations, it is a sign of massive failure in the underlying business. This is not true in the case of LBOs, which may be driven into bankruptcy by events that would simply depress the stock of a normal company by 20 or 30 percent. Because the underlying assets are more valuable, the waste associated with LBO bankruptcies may be greater than in the case of traditional bankruptcies. The more than $1 billion in combined losses suffered by shareholders in Texaco and Pennzoil during the course of their litigation illustrates how serious financial disruptions can be.[1]

[1] For a discussion of this episode and its implications see David Cutler and Lawrence Summers, "The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation", Rand Journal of Economics, Summer 1988.

On the other hand, innovations associated with LBOs may reduce the costs of financial stress. Zero coupon bonds permit companies to ride out transitory financial difficulties. More importantly, strip financing and the more general alignment of interests between high yield debt and equity owners reduce the incentive to force liquidations. It is often remarked that Japanese corporations can tolerate much higher debt equity ratios than their American counterparts, because Japanese banks hold equity and are therefore more patient than American lenders. The same may prove to be true of American LBO firms and their clients.

Do Rising Debt Levels Pose Systemic Risks?

Alarmists regarding the systemic risks posed by increased levels of corporate debt often overlook a fundamental lesson of recent experience: During the early 1980s, the US suffered the steepest post-War recession, saw inflation abate more rapidly than almost anyone anticipated, saw real interest rates reach and remain at unprecedented levels, and saw the dollar gyrate spectacularly, yet with the exception of special situations like Johns Mansville and firms in the energy sector of the economy, there was only a minimal level of bankruptcy among large publicly traded corporations. Financial distress abounded in the banking system, internationally, and for those who had made certain real estate and agricultural investments, but corporations fared remarkably well through very trying times.

It is hardly unreasonable to expect that this experience would lead to some increases in acceptable levels of leverage. As a general proposition, there is little basis for supposing that the total indebtedness of the US

corporate sector is far too high at the present time. Claims that numerous companies that are now publicly traded will be driven into bankruptcy during the next recession overlook the increasing ability of the credit markets to sustain "fallen angels" during periods of temporary distress. It remains the case that levels of leverage in the US are well below those in many of our trading partners.

There will no doubt be some bankruptcies among companies that are in the highly levered early stages of LBOs. While this will hurt naive investors who failed to appreciate the magnitude of the risks for which their high yields were providing compensation, it is doubtful that it will have large economic consequences. If another 1982 recession were to come, which I judge to be quite unlikely, problems in the banking system and in the real estate and farm sectors would dwarf any consequences of recent LBOs.

Overall Judgment

There is no basis for punitive efforts to roll back corporate debt-equity ratios. However, efforts to insure that managers fulfill their fiduciary duties should be increased. Furthermore, nothing in either logic or our experience with debt increasing transactions suggests that they are so desirable as to warrant substantial government subsidies. The beneficiaries of subsidies are surely affluent and the government deficit continues to be a serious problem. Moreover most of the benefits of debt finance accrue privately. If anything, the social or external costs of debt finance probably exceed the benefits. This suggests the need to examine the incentives provided by current tax policies.

Tax Incentives and Corporate Indebtedness

Two related aspects of our current tax system lead to a tax bias in favor of the use of corporate debt. First, corporate borrowers deduct interest payments at a much higher rate than lenders pay on interest payments. Corporate borrowers deduct their interest at a rate of 34 percent. Table 1 presents Federal Reserve estimates of the ownership of corporate bonds. For each category of investors, I have made a crude estimate of the tax rate after making allowance for various kinds of sheltering activity. The average tax rate on the interest income of corporate bondholders is only about 7 percent. This means that On every dollar of corporate interest paid, the government loses about 27 cents. This figure was probably reduced somewhat by the reduction in the corporate tax rate from 46 to 34 percent in the 1986 Tax Reform Act.

The substantial wedge between the tax deductions on corporate income and the taxes paid give taxpayers a strong incentive to use debt finance. Most obviously, this creates an incentive for companies to replace outstanding equity with debt, and to replace dividend payments with interest payments. This is exactly what is accomplished in LBOs. It is also accomplished by a variety of corporate restructuring schemes such as the recent Shearson-American Express deal. More generally, debt replaces equity when a corporation draws down the cash from its cash holdings and uses the proceeds to repurchase its stock. Of course, beyond transactions that have as their explicit purpose the replacement of equity by debt, the tax law encourages the use of debt finance for new capital investments.

TABLE 1

Tax Rates on Interest Receipts

	Interest Receipts ($ billions)	1988 Tax Rate (Percent)
Households (Untaxed)	2.9	0
Households (Taxed)	5.0	28
Foreigners	13.3	0
Commercial Banks	6.0	15
Savings and Loans	3.2	18
Mutual Savings Banks	1.2	6
Life Insurance Companies	32.9	20
Private Pensions	13.3	0
St.&Local Govt. Retirement Funds	11.4	0
Other Insurance	4.6	20
Mutual Funds	4.6	28
Security Brokers and Dealers	1.6	34
Total/Weighted Average Tax Rate	$105.0	7.3%

Sources: Interest Receipts are from the Federal Reserve Board, Flow of Funds. Tax Rates for industries are from Tax Analysts, Quantifying the Impact of the Tax Reform Act of 1986 on Effective Corporate Tax Rates, 1986. Rates for households, foreigners and pension funds are based on 1988 tax law.

The second inducement to the use of debt finance is the double taxation of corporate equity income, particularly when it is paid in the form of dividends. If dividends were deductible in just the same way that interest now is, and if shareholders had the same low tax rates as debt owners do, there would be no reason for corporations to prefer debt to equity finance. However, because dividends are not deductible, corporations have a strong incentive to avoid their use. This leads to a bias in favor of debt finance. It also encourages schemes which transform dividends into capital gains and permit securities to be tailored to the tax situation of their owner. Again the Shearson-American Express deal is a good example.

The conclusion that the tax system creates a general bias in favor of the use of debt finance is to my knowledge almost universally accepted. However a number of observers have pointed out that the Treasury gains from LBO transactions because of forced capital gains realizations by the shareowners who are being bought out. It also gains to the extent that operating improvements increase profitability and therefore raise corporate tax payments. This has led to claims by those some of those engaged in LBO transactions and in the business press, and by some academics that LBO transactions are already tax penalized. The conclusion drawn is that further tax changes that would reduce the benefits associated with these transactions would be inappropriate.

My analysis suggests that such claims are misleading. First, estimates suggesting that the Treasury gains from LBOs are suspect. They do not take sufficient account of the ability of investors who are forced to realize large capital gains to shelter their income in various ways and probably overstate the taxes paid by corporate creditors. More importantly, in many cases they

assume that there will be operating improvements or that after several years assets will be sold at a substantial premium. While this has been the case in recent years, it is much less clear that it will be the case in the future given the strength of the stock market in the past several years. There is also the difficulty that to the extent post-LBO improvements were anticipated by acquirers, they might have taken place even without the LBO. Finally, claims that LBO's help the Treasury do not take account of losses to corporate stakeholders which also affect Treasury revenues.

Second, even beyond these arithmetic points, there is a conceptual point. If, as proponents assume, most LBO deals involve substantial efficiency improvements they would presumably take place without government subsidy. And the government would share in the efficiency improvement just as it shares in efficiency improvements whenever corporations are able to increase their profitability. This does not justify the further subsidy provided by special tax treatment of debt. There is no question that there exist marginal transactions that are profitable only because of the tax benefits of leverage. Modifications of the tax treatment of debt would affect these transactions, but would not, if LBO advocates are correct, eliminate most LBO transactions.

Finally, it is worthwhile to observe that the revenue offsets to increased interest deductions that are suggested in the case of LBOs are not present in the case of other corporate restructurings.

Fundamental Tax Reform

As long as the tax system seeks to distinguish between debt and equity, and taxes equity income from dividends and capital gains differently, there

will be strong incentives for financial engineering to exploit the resulting arbitrage opportunities. Current concern over the excessive use of debt finance is only the latest in a long sequence of policy problems posed by the antiquated categorizations we use in taxing the income from capital. It will not be the last.

As the examples of commodity straddles, zero coupon bonds, and mirror transactions suggest, the private sector is capable of finding an endless array of devices to exploit the differential tax treatment of different individuals and types of income. As the pace of financial innovation has quickened and regulatory barriers have eased, the pace at which these devices are created has accelerated. Patchwork, piecemeal fixes will not forever staunch the tide of financial innovation. It is not too early to begin the process of reconsidering the fundamental principles underlying the way our income tax treats capital income.

Fundamental issues that should be given serious consideration include the following. First, should we tax saving and investment income twice as current law provides? Or should we instead simply tax consumption, thereby taxing capital income when it is consumed but not when it is reinvested? Beyond the strong macroeconomic arguments for moving in this direction provided by our 2% national saving rate, movements towards a cash flow tax would eliminate much of the current scope for abuse. Value added taxes are only one way of taxing consumption. A promising variety of progressive consumption tax schemes have been proposed in recent years.

Should the corporate tax be integrated? As capital markets become more and more perfect, the case for double taxing corporate equity income becomes more and more dubious. Most of our trading partners have tax systems that are

integrated in some way through either partial dividend deductibility or tax credits to individuals for corporate taxes paid on their behalf. While integration has traditionally been opposed by corporate executives who do not want increased pressures to pay out dividends rather than undertake investments or acquisitions, this source of opposition may be muted in the current environment, when market pressures are sharply curbing free cash flows.

Third, is there an argument for wealth or property value based corporate taxation? Business property at the state and local level raise substantial amounts of revenue, without generating nearly the complexity that the current corporate income tax system does. Property value based taxation does not distinguish between debt and equity finance, and has certain other desirable neutrality properties. It is particulary attractive for large publicly traded corporations because the market provides a continuous assessment of property value.

Fourth, can accrual capital gains be taxed on publicly traded securities? The Achilles heal of the current income tax is the fact that capital gains now are taxed only when realized. This makes it impossible to tax all economic income at the same rate, and creates strong incentives to transform income into the form of capital gains. While taxing real estate on an accrual basis would be difficult because of the problem of valuation, it might well be possible to tax capital gains on listed securities on an accrual basis. This would substantially discourage financial engineering.

It is not realistic to expect new legislative answers to any of these questions in the context of the LBO issue. But the LBO issue is really just the tip of an iceberg. It is high time to begin a fundamental reassessment of our current approach to taxing capital income.

Current Policy Options

Drawing precise lines between debt and equity is inevitably difficult in close cases. But some of the securities used in recent LBO transactions do not represent close cases. When debt-equity ratios approach 10, yields on junior debt approach or exceed 20 percent, debt instruments do not require any cash payment for five or more years, and deal participants note that bankruptcy risks are not large because debt securities represent "equity in drag", it is hard to see the public policy justification for permitting the deduction of interest accrued but not even paid out. These conditions are all satisfied in many recent LBO transactions. There are strong arguments for policy changes that tighten up on the definition of debt for tax purposes.

Criteria for disallowing the deductability of interest should include some combination of the following elements: (i) the yield to maturity. Where debt risk premia exceed the roughly eight percent risk premia normally observed on equity securities, there is a case for treating them as equity securities. (ii) the extent to which cash payments are not actually made but interest is only accrued or paid in the form of new debt securities. Where dividends can legally be paid on equity, before any cash interest must be paid, it is unclear in what real sense a debt security can be said to be senior. (iii) the corporate balance sheet. Where substantial new debt is being issued and the ratio of outstanding debt to the market value of equity is high, the debt may well represent disguised equity. (iv) the share of operating earnings paid out in interest or the ratio of interest to dividend payments. Where either of these measures is high there is a presumption that

interest is being used to substantially avoid corporate taxes that would otherwise be paid.

Application of rules based on some combination of these criteria to recent public transactions would probably have eliminated the deductability of a small part, perhaps 10 or 20 percent of interest, used in financing acquisitions. This would probably have led to somewhat greater reliance on equity financing. If the claims of participants in these transactions are correct, this would not have prevented them from taking place, though it would have reduced acquisition premiums somewhat and probably reduced the profits earned by deal participants. It also would have funnelled significant additional revenues to the Treasury.

The challenge in designing tax rules that tighten up on the definition of debt for tax purposes is to avoid throwing out the baby with the bath water. Most high-yield debt is not used in the context of takeovers. Restrictions on all high yield debt would therefore be undesirable. However, it does not appear that high yield zero coupon securities are extensively used outside of the takeover context, so criteria (ii) above should be helpful in targetting tax rules appropriately. There is the additional complication that limitations on interest deductability might give foreign acquirers an advantage over their American competitors. This probably is not an important issue for the modest rule changes envisaged here. The kind of extremely high-yield debt used in recent deals is not yet available abroad.

The approach outlined here is preferable to proposals directed specifically at acquisition transactions. The basic problem of equity masquerading as debt is as present in restructurings as it is in ownership changes. Measures which penalized only acquisition interest would therefore

give strong advantages to incumbents in control contests who could take advantage of tax benefits not available to potential acquirers. The available evidence does not suggest the desirability of such a tilt in the playing field. Even if such a tilt were desirable, it is doubtful that it is best implemented through the tax system.

The approach outlined here will not preserve the existing tax base intact. It does not, for example, address the erosion of the tax base that occurs when corporations use cash to repurchase shares. Nor does it address transactions like the recent Shearson-American Express deal. These problems probably cannot be addressed short of the sort of fundamental tax reform discussed above.

The existing tax bias towards debt can be addressed in two ways--either by reducing the tax advantages of debt or by increasing the tax benefits for new equity issues. I have concentrated on the former approach because of budgetary realities. But I believe that there is a strong case for using any revenues derived from limits on interest deductions to finance reductions in the dividend tax burden on newly issued equity. Because equity issuance is relatively small, this would not be very costly over the next few years. It would also avoid the problem of giving windfalls to existing shareholders that plagues most dividend relief proposals.

Conclusion

Recent increases in corporate indebtedness are probably not primarily tax motivated, and do not pose grave dangers to economic stability. In some cases, they are associated with improvements in economic efficiency. There

is, however, little case for subsidizing debt to the extent done by current tax rules. Reforms that tightened the tax definition of debt would have relatively small effects on acquisition transactions if the proponents of these transactions are to be believed. They would raise some revenue, correct some abuses, and probably improve economic performance by eliminating some marginal buyouts and increasing the equity share in others.

For the longer term, recent developments suggest the need to rethink basic questions about our approach to capital taxation, including the choice of the income tax base, the decision to double tax corporate equity income, the use of income rather than wealth concepts in assessing tax burdens, and the taxation of capital gains on a realization basis.