Issues in the Financing of Corporate Tender Offers

STATEMENT BEFORE THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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Editor's Note: *In December 1975, General Cable Corporation made a tender offer for publicly held shares of Microdot Inc. The offer was opposed by Microdot's management, which charged, among other things, that the principal bank financing the tender offer had a conflict of interest because both corporations were its borrowing customers. The following statement was made by Mr. Debs on February 16, 1976 before the Senate Committee in hearings called to consider the issues raised by the case.*

The subject of these hearings—the Microdot case and the issues raised by it—presents many provocative and complex questions, none of which have simple answers. They touch upon a wide spectrum of public policy issues, ranging from policy governing business mergers and acquisitions to principles of fiduciary responsibility and safeguards against conflicts of interest. They range from broad policy considerations to the narrow application of rules of conduct to specific findings of fact. They also involve the securities laws, the banking laws, and the general civil law itself, as well as codes of conduct and business ethics.

As a Federal Reserve official, I intend, of course, to focus on the issues of this case relating to banks and banking. Before doing so, however, it would be useful to put these issues into better perspective by reviewing briefly some of the other—separate, but closely related—considerations involved.

To begin with, there is the issue of public policy toward mergers and acquisitions in general. In brief, I think it is fair to say that public policy does, and should, recognize the importance of mergers and acquisitions in contributing to the effective functioning of our economic system. Such acquisitions are, of course, subject to certain limitations—primarily in the antitrust laws, designed to encourage competition, and in the securities laws, designed to protect investors. Apart from such limitations, however, it seems clear that it is not public policy to discourage mergers and acquisitions in general.

The next question relates to public policy *vis-à-vis* "unfriendly" takeovers. This is a somewhat more complex question, but the basic economic issues are essentially the same as in any acquisition. The complexities arise because the acquisition is "unfriendly", which normally means that the management of the target company does not wish to have the company acquired. But public policy is not primarily concerned with the interests of management—whether of the bidders or of the target company. Public policy is concerned primarily with the interests of the public at large. Not the least of these broader public interests is a basic concern with the effective functioning of our competitive economic system. That system will not function effectively if incumbent managements of all firms—no matter how well or how poorly managed—are protected from tender offers which they do not accept but which otherwise would be beneficial to the owners of the company or to the general public. Other things being equal, such acquisitions should be beneficial to the economy.

Of course, other things are not always equal, and because of that there is indeed a public policy issue here. That issue is whether shareholder interests are adequately protected under present laws and practices and whether, in fact, the nation's experience with unfriendly takeovers over the past several years indicates that they have been beneficial to the shareholders involved and to the economy in general. In addressing this issue, one of the central questions is whether shareholders are able to make rational and informed judgments in takeover situations.

This is an important question and is the subject of current study within the Congress. I do not know what the answer is, or will be, and there is no need to seek an answer within the context of these hearings today. However, it is important to agree on the basic policy issue involved: that issue is not whether unfriendly takeovers are contrary to the public interest *per se*. The issue is, given the potential economic benefits of business mergers or acquisitions, what kinds of safeguards are necessary to prevent abuses, thereby protecting the interests of shareholders and the public in general?

I think it is important to state the issue in these terms in order to separate the public policy question on unfriendly takeovers from some of the other questions raised in the Microdot case, particularly as they relate to banking. If public policy on takeovers is to be neutral, banks should be able to finance them just as they would any other business transaction. If public policy is to discourage them, or to subject them to limitations, all parties involved —banks as well as others—should be subject to the same limitations.

To return to the present case, and the specific question of banking laws and practices, the issues here relate to conflicts of interest and the responsibilities of banks to their customers. The issues arise because we have a case where a bank grants a loan to one of its customers for the purpose of an unfriendly takeover of another customer. (By "customer", I mean a party with whom the bank has a credit relationship and who has given to the bank confidential financial information in connection with that relationship.) The case also involves a situation in which three directors of the acquiring company are on the board of the bank or of its parent corporation and a former officer of the bank is on the acquiring company's board. I would like to address each of these questions separately.

To begin with, when a bank deals with two of its customers in an unfriendly takeover situation, there is clearly a potential conflict of interest. It exists because there is the possibility that the bank may use confidential information given to it by one of its customers, the target company, to the detriment of that customer. As a general principle, it seems clear that a bank has an obligation to safeguard any confidential information given to it by a customer and not to use that information, without the customer's consent, for the benefit of any other party.

The fact that a bank finances an unfriendly takeover involving two customers does not, of course, mean that the bank has failed to meet its obligations. A bank can undertake such a transaction and not breach its obligations to the target customer as long as it maintains the confidentiality of the information given to it by that customer. The question of whether or not it has indeed maintained the confidentiality of the information is a question of fact.

The problem, of course, is that inherent in this situation is the potential for a conflict of interest. One of the legislative remedies that might be proposed to prevent such conflicts would be a law prohibiting bank participation in any unfriendly tender offer where two customers are involved. I do not believe that such legislation would be desirable or necessary. For one thing, it would severely limit the possibility of bank financing of a tender for the shares of a major firm. Large firms often have customer relationships with many of the major banks in the country. Such legislation would thus put large corporations in a specially protected position with regard to tender offers, since both the target company and the acquiring company would probably be customers of the same banks. Although very substantial sums of money would be required for such acquisitions, most major banks would be precluded from supplying such funds because of the customer relationships, and the supply of funds from smaller banks would be restricted by loan limits. Smaller corporations, with fewer major bank relationships, would not enjoy comparable protection.

Beyond such a discriminatory effect, I would be very concerned that such legislation could impede arrangements for the acquisition of major firms in serious financial difficulties. It is not hard to imagine situations in which the public interest would be better served by the acquisition of a major firm—even if the acquisition terms are unfriendly to the management of that firm—than by a continuation of a deteriorating situation. However, such firms are likely to be indebted to many banks, and a blanket prohibition on financing the acquisition of a customer could prevent the working-out of a salvage operation that would be in the public interest.

As I said, I do not believe that such legislation would be desirable; and I also do not believe that it would be necessary, because there are other remedies available.

Before turning to them, however, I would like to review briefly the question of interlocking directorates, which is somewhat complicated in this case and sometimes confusing.

In its narrow sense, the issue of interlocking directorates in this case presents essentially the same problems of potential conflict of interest as exist in any case in which a bank finances an unfriendly takeover involving two customers. Regardless of whether the borrowing company is represented on the bank's board, the basic issue is the same: whether the bank—including its directors—uses confidential information entrusted to it by a customer for the benefit of the bank or any third party. The presence of the borrowing company's representatives on the bank board—and their influence on bank decisions—would be taken into account in determining the findings of fact as to whether the bank misused confidential information. But the basic issue is still whether, as a matter of fact, the bank did misuse such information and thereby breach its obligation to a customer who had entrusted it with the information. Thus, the presence of interlocking directorates in a case such as this should not change the nature of the basic question.

I would like to turn now to the safeguards and remedies that are available in cases such as this. I would also like to note again the basic problem that these safeguards and remedies are meant to address. The problem, which is common to all of these situations we have discussed, is the potential for abuse that is inherent in any case where a bank may use confidential information entrusted to it by a customer for the benefit of other parties. To do so, it seems to me, would be a breach of that bank's obligation to that customer.

At the present time, there are three possible ways in which such abuses might be checked: the judicial process, the processes of the marketplace, and to a limited degree the bank supervisory process.

The judicial process is available to any party harmed by the action of a bank in improperly dealing with or otherwise misusing confidential information entrusted to it by the aggrieved party. There are no provisions in the banking laws that apply directly to abuses of this kind. But there are principles of the common law that could provide remedies for parties harmed by such abuses. The courts are particularly well-equipped to deal with such cases, since they would presumably involve critical findings of fact as to whether confidential information was indeed misused.

Another safeguard works through the private marketplace. A bank, like any other business enterprise, must have and maintain the confidence of its customers to survive. In the case of banks, however, the need for confidence is particularly essential and particularly delicate. There is a special relationship between banks and their customers that is based on confidence and trust in the bank itself, and in the bank's commitment to safeguard the confidential affairs of its customers. If a bank does not maintain the highest standards of integrity in its dealings, that confidence and trust will be eroded, and the bank will suffer the consequences. A bank realizes this as it enters into areas of potential conflicts of interest, and wise bank management will make sure that the bank acts with utmost probity in undertaking transactions that may be questioned because of possible appearances of abusing its trust. And it will do so not only because of its obligation to do so, but also in recognition of the future impact upon the bank if it should lose the confidence of its customers. This is, of course, not a legal safeguard, nor does it offer a remedy to an aggrieved party in cases in which there has been a breach of that trust, but it should be recognized as an important constraint on the actions of banks in these circumstances.

Another possible avenue available is the bank supervisory process, although there are limitations on the use of this process as a safeguard or remedy in a case such as this. The primary purpose of a bank examination, of course, is to ensure the safety and soundness of the bank. The examiner reviews the bank's transactions with this in mind. However, the examiner is also concerned with the quality of the bank's management. If, during the course of his review of the bank's loans, he discovers a situation in which the management has clearly misused confidential information or is otherwise involved in self-dealing, he can criticize the management in his report. Bank management is sensitive to such criticism, and the fact that management knows that its actions are subject to review in the examination process is in itself a constraint on its actions. However, there are limits to what the examiners can do—or should do—in such situations. Since the Federal banking laws do not deal with such cases, the bank probably cannot be cited in a violation of law.* This is not unlike other situations where banks may have breached their civil obligations—under the law of contracts, for example—but where they have not violated any provisions of the banking laws that impose specific penalties or

* With the limited exception of such matters as loans by banks to their own executive offices (Section 22(g) of the Federal Reserve Act) and cases involving such clear financial risk to the bank as to constitute "unsafe or unsound" banking practices (Section 8(b) of the Federal Deposit Insurance Act).

sanctions upon them. Nor can an examiner—because of the nature of the bank examination process—cause a bank to reverse its action or to compensate a party harmed by its action. Thus, in this respect, the proper legal remedy for the aggrieved party lies in the judicial process.

All of these safeguards and remedies are available today to deal with the conflict of interest issues posed by this case. In the Committee's considerations of any proposals for additional measures as a result of these hearings, I would hope, as indicated earlier, that a distinction will be maintained between the public policy issues relating to unfriendly takeovers and the specific questions posed by this case, which relate to potential conflicts of interest in situations involving bank financing of unfriendly takeovers where two bank customers are involved.

In this latter connection, it should be noted that under present law there is no Federal requirement that the name of the bank involved in such a financing need be disclosed to anyone, including the bank's customer which is the target company. When the basic law governing tender offers (Public Law No. 80-439) was being discussed in the Congress in 1967, the bill under study provided for the disclosure of all sources of financing for tender offers, but with a specific exemption for banks. A question was raised as to whether such an exemption was necessary. It was finally decided that it would not be advisable to require that the names of the financing banks be disclosed in all tender offers. However, the Committee adopted an alternative provision which required that the name of the bank involved be filed with the SEC but that, "if the person filing such statement so requests, the name of the bank shall not be made public". That provision was incorporated into the law as it exists today.

Thus, this matter has been considered by the Congress before, and it was decided then that it would not be advisable to require the public disclosure of the names of the banks involved in tender offers in general. That judgment may well continue to be valid today. However, in view of the questions raised in the present case, it might be timely to reconsider this question as it applies to situations such as this, where the potential for a conflict of interest exists. Perhaps such a requirement might be implemented through the SEC's rules and regulations.

If there is any way in which we might assist the Committee in exploring any of these issues further, we would be pleased to do so.