STATEMENT OF CHARLES T. MUNGER

To the Subcommittee on Telecommunications,
Consumer Protection and Finance
of the Committee on Energy and Commerce
U. S. House of Representatives
May 23, 1984

I am a former practicing lawyer, generally familiar with the securities laws, having been active in law and public-corporation business for over 35 years. I have no connection, except as a paying client, with the Munger, Tolles & Rickershauser law firm in Los Angeles, from which I retired many years ago. I am now affiliated, as shareholder and Vice Chairman, with Berkshire Hathaway Inc., a publicly-traded conglomerate with particularly large interests in casualty insurance companies owning large portfolios of securities held as a passive investor. I am also a shareholder and director of a publicly-traded registered investment company, New America Fund, Inc. In those capacities I participate in investment where results depend in part on the legislative rules governing security investment and security trading and the duties of corporate managements. The companies with which I am affiliated have not engaged in unfriendly take-overs and are not threatened by unwanted take-over because an absolute majority of their stock is owned by a few people. So far as I know I have no commercial axe to grind in giving testimony. I believe that the legislative changes I recommend, if they had any effect at all on me, would impair my economic interests. My opinions are my own and not those of corporations with which I am affiliated.

Politically, I am a right-wing Republican, with a strong general prejudice in favor of unregulated markets.

But even from my right-wing perspective, I have come to the opinion that the current legislative rules have been demonstrated to be inadequate to prevent a lot of socially undesirable activity, ultimately posing some risk to the very existence of free markets. I think the country would be improved by some fairly simple changes in the laws.

I believe that the condition now facing Congress is a huge and increasing mass of: (a) actual and threatened hostile take-overs of publicly-traded corporations, plus (b) various actions by corporate managers in response to and in anticipation of the take-over threats. The reactive corporate actions include: (1) "golden-parachute" contracts for executives; (2) reducing shareholder power (including power of long-term investor shareholders) by creating directorships in three classes, "super-majority" provisions applicable to mergers, and generally more difficult procedures for exercise of shareholder will; (3) "going private" transactions under which encumbent managements join financial promoters in buying their employer's assets, mostly with loans based on those assets, injecting enormous financial leverage into the continuing business; (4) essentially forced mergers between corporations and "white knights," that is corporations perceived as less undesirable than "dark knights," particular aggressors who, by first threatening take-over, put the corporations "into play," and often profit in the "white knight" mergers from stock positions accumulated in anticipation of the aggressor's own take-over threats, and (5) "greenmail" transactions wherein corporations repurchase, at premium-over-market prices, shares owned by the "greenmailer," a person who has recently accumulated a control-threatening block of stock in the repurchasing corporation.

Although there are probably some "good" hostile tender offers, creating some benefit as well as harm to the general public in the massive, recent activity related to hostile take-overs of corporations, I believe that, on balance, most of the activity

is not in the public interest. The "greenmailers" and aggressive, hostile-take-over operators who profit time after time, even when they fail to obtain control, by first buying stock then putting the corporation "into play" and selling to a "white knight," deserve particular attention. They are now making a lot of easy money without, on average, making any net social contributions, or even taking much risk. The too-easy money-making by "greenmailers" and other hostile take-over threateners is rightly perceived as the social equivalent of the trout fisherman who uses dynamite, or gill nets, instead of a fly-rod. I think the success of these activities, with large rewards to unadmirable economic behaviour, endangers the whole capitalistic system by tending to diminish its repute, thus threatening the cornucopia of goods and freedoms which only capitalism can provide. I believe these activities tend to do for the reputation and prospects of capitalism in the United States what the court of Louis the XVI did for the reputation and prospects of monarchy in France.

I suggest that there is almost nothing to lose, and much to gain for the Republic, if Congress changes the laws to eliminate or greatly reduce the worst of the above-mentioned activities. I believe that a few simple changes in the laws would constructively diminish the present frenzy of threatened, hostile take-overs and reactions thereto by corporate managements:

(1) I agree with the general approach of Martin Lipton that no party or "group" should be allowed to acquire by purchase more than ten per cent of the voting power of a corporation with publicly-traded stock, except by tender offer under Williams Act rules. However, I would exempt purchases beyond ten per cent either from the corporation as a knowing issuer, or otherwise with the corporation's written consent. It should be noted that the Lipton approach is not radical. It parallels British law, passed with "establishment" support, although the Lipton numbers are different.

(2) But I do not believe the Lipton proposal goes far enough. A 9.9% ownership position is quite threatening to many corporate managements as evidenced by the recent transaction in which Texaco repurchased a position of this size from the Bass interests. In addition, I think the recovery-of-insider-trading-profit rules of Section 16 of the Securities Act of 1934 should be revised so as to define as non-retainable "insider" profits:

(i) any profit on any of its stockholdings made by a party or "group" owning more than five per cent of a corporation's stock, unless the stock sold has been owned at least five years; and

(ii) any profit on any stock, owned for less than five years and not originally purchased from or with the written consent of the corporation concerned, by a party or "group" which first puts a corporation "into play" by in any way making or encouraging a take-over transaction.

The law revision proposed in subparagraph (i) above would be likely to deter almost all stock positions except those below five per cent of total shares outstanding. Five per cent positions are large enough to meet almost all needs of pension fund trustees and other institutional investors and are inherently much less threatening to control than the ten-per-cent positions permitted under the Lipton proposal with no

adverse effects at all. Essentially, the revision of Section 16 of the Securities Act of 1934 which I propose in subparagraph (i) modestly changes the numbers and concepts in the present rules of a long-established statute, which now forces disgorgement of profit, after a ten-per-cent-of-shares-outstanding position is reached, on any sales of stock where the holding period is under six months.

The law revision proposed in subparagraph (i.i) above would go further and would be designed to take the virtually sure profit out of the common practice of first buying, on a totally secret basis, less than five per cent of a corporation's stock, then making or encouraging a take-over proposal which is outbid by some "white knight," creating a profit realized as a direct result of threats posed by the investor, as distinguished from the normal profit realized passively by the ordinary successful investor in stock.

(3) In addition, I think there should be an absolute bar against any hostile tender offers except properly financed offers for all outstanding shares on an all-cash basis. [As the current law allows, any form of tender offer by or with the consent of the target corporation should be permitted so long as all shareholders were treated alike.] With respect to the hostile-tender-offer situation, I join Martin Lipton in believing that the front-end-loaded, two-tier cash offer is inherently unfair to ordinary shareholders and tends to create excessive debt. I also believe that tender offers involving newly-issued securities are both (i) almost always inherently difficult to appraise properly under pressure, (ii) under certain conditions are likely to cause enormous undesirable concentrations of power in "chain letter" promotional operations like those of many conglomerates in the 1960's, and (iii) generally assist book strap aggressiveness of a paper-shuffling type, which is negative in average socio-economic effect, and a tendency toward undesirable diminishment of pluralism in American business.

If no changes in law are made as outlined above, I do not agree with the SEC's proposal for a total bar to corporate payment of "greenmail," that is a bar to stock repurchases which are not made either at or below market prices or under registered tender offer available to all shareholders. Standing alone the SEC "anti-greenmail" proposal would tend to create even more successful hostile corporate take-overs and forced mergers with "white knights" than we see now, which, in turn, would tend to attract even more people into trying to make hostile take-overs, a result I think Congress should conclude is undesirable.

In short, under current law, inelegant and unfair as many "greenmail" transactions appear, I think the hostile take-over attempts they avoid would be worse.

However, assuming that the Lipton-amplified-by-Munger proposals were adopted into law, which I think would reduce "greenmail" transactions by about 95%, the question presented by the SEC proposal becomes more difficult. I see no clear preference, under such circumstances, for or against a total bar to corporate payment of "greenmail" in the few instances of "greenmail" possibilities which would remain (for instance, on stock positions held for more than five years or of a size under five per cent of total shares outstanding).

In favor of the SEC proposal for a general bar to "greenmail," I point out that I have lived with similar law for many years as a corporate manager with no serious

inconvenience. This has happened at New America Fund, Inc., which as a registered investment company, governed by the Investment Company Act, is barred by present law from repurchasing stock except at market prices or under tender offer available to all shareholders.

A last matter of concern is the SEC proposal, in the face of dispute about the meaning of law now in effect, that new legislation explicitly prevent all corporate repurchases of stock in defensive response to a pending registered tender offer. This SEC proposal also would tend to tilt the balance of probabilities in favor of success for hostile-take-over attempts and would ultimately encourage more hostile-take-over activity. Under such circumstances, despite some good aspects, it, too, should probably not be favored except by those who consider the current level of hostile-take-over-realted activity undesirably low.

Moreover, the SEC proposal, if I understand it right, would appear not to take into account some difficult income tax problems. Take the case of a corporation with one founder, owning 40% of corporate shares outstanding, with the balance of the stock scattered. If an acquisition-minded aggressor tenders for 100% of the stock, the corporation could retain control for its founder through responding by repurchasing 20% of shares outstanding, from individual shareholders desiring to sell all their holdings, without imposing on tendering stockholders any income tax consequences except those normal upon sale of stock. In contrast, if the corporation repurchases the same 20% of shares outstanding pro-rata, as required by registered tender offer rules, then each tendering shareholder would reduce his percentage ownership of the corporation from his former share of 60/100ths to this same share of 50/100ths, or by less than 20%. In such case, the entire proceeds from tendering shares to the corporation are likely to be subject to federal income tax as ordinary corporate dividends, instead of stock sale proceeds' 60% exempt from taxation when the holding period is at least one year. If the SEC proposal is to be enacted it needs complex coordination with income tax law, or concurrent changes in income tax law. Otherwise the equality among shareholders sought by the SEC will in many cases not be achieved. Indeed, equality, tax effects considered, may actually be lessened in many cases by the SEC proposal.

These income tax questions are, of course, secondary. I think it can not be emphasized too strongly that the main problem is that, however nobly motivated, the SEC proposal for a total bar to corporate repurchases of stock during pendency of hostile tender offers has a vast potential for increasing hostile take-over attempts. As matters now stand, where some large, permanent, pro-management block of stock exists, a corporation is virtually immune from hostile take-over. When a hostile tender offer is made, the corporation can simply buy enough stock in a few private transactions or (possibly, depending on one's interpretation of existing law) in the market, so that the large, permanent, pro-management block becomes an absolutely controlling block of stock. Knowing this, potential hostile tender offerors are ordinarily deterred from attempting take-overs where large, permanent blocks of pro-management stock exist. If the law were changed to make it clear that a hostile tender offer creates a bar to all corporate stock repurchases until the take-over struggle is over, the single most likely competitive buyer would be removed from the aggressor's arena. Under such circumstances, a corporation's only choices might be take-over by a "dark knight" or take-over by a "white knight," even when active founders still have large ownership positions. This result strikes this observer as preposterous. For instance, do we really want to add Hewlett Packard, where both founders are large shareholders, to the list of likely hostile-take-over targets?

To some extent, I think sentiment in favor of rules which allow easy hostile corporate take-overs is caused by resentment of perceived perpetual power and rationalization of self-serving conduct in managers of many large corporations. But, paradoxical as it may sound, I think that even people with this anti-management attitude should

be in favor of making hostile take-overs harder to accomplish, rather than easier. If Congress makes hostile take-overs easier, we will end up with industry as a whole in fewer, larger corporations. And, Lord Acton being roughly right that power corrupts, these people who wanted to limit the power and prerogative of corporate managements by facilitating hostile take-overs, would, after more concentration of corporate power, perceive even more of what originally caused them to resent corporate managers and seek to facilitate their removal from office.

Generally, the whole approach of trying to make American corporate managers behave better by making them more threatened by sudden removal from office by outside forces is suspect. The evidence, created by many "golden parachute" contracts, "scorched earth" defensive tactics, etc., is plainly that threatened managers behave worse. Benjamin Franklin correctly pointed out that "it is hard for an empty sack to stand upright," and his folk wisdom is still apposite. Desirable as it may be that American managers behave more than they do now in accord with the true long-term interests of shareholders, that objective won't, in practice, be achieved by making hostile corporate take-overs easier. I think that the result, instead, will be less managerial attention to real shareholder interests and more managerial attention to somehow creating more security for management from the enhanced threats of changes in corporate control which would be caused by new anti-management-abuse legislation.

Counter-intuitive as it may seem to some, if we protect corporate managers more, instead of trying to limit their abuses by new legislation, I think corporate managers, on average, will act more in the long-term interests of shareholders. The job of the corporate manager has a big "balancing" or judicial aspect as difficult choices are presented. Not only among the Japanese do groups of managers act a lot like a panel of appellate court justices. And just as we improve our highest judges, on average, by making them secure from sudden removal from office, we may well, on average, improve our highest corporate managers by making them more secure from hostile corporate take-overs.

Nor do I think the nation has much to fear, generally, from entrenched managerial power. Managers of big corporations have limited power and less in relationship to other forces over each decade.

I sympathize greatly with those, in the SEC and elsewhere, who are appalled by instances during hostile-take-over struggles of rationalized, extreme defensive tactics by some corporate managements, rightly perceived as breaches of trust in the relationship between management and shareholders. Much has been done, of a "scorched earth" defensive nature, which I would not do as a corporate manager. But, none the less, I consider it very unwise for Congress to intervene with responsive new law. A brain surgeon faced with a small tumor which mildly impairs balance, removable only by causing gross impairment of cognition, would wisely restrain his scalpel. Likewise, the legislative correction of an abuse should be withheld when it has foreseeable, inevitable consequences as by-products which are worse for the nation than the abuse. That is, I think, the situation here.

I find my position awkward, in disagreeing in part with the SEC, because for many years I have regarded the SEC as the most intelligent, most honest, most efficient government department I know. I believe our different opinions now arise almost entirely from differing views on one major assumption. The SEC seems to feel it has neither the macro-economic, sociological expertise nor the governmental charter to be other than neutral as to whether a mass of hostile-corporate-take-over-related activity, averaged out, is a good or bad thing for the nation. Starting from this major assumption of neutrality, the SEC wants rules, attractive to it as umpire, which make hostile-corporate-take-over contests orderly and balanced.

Congress, with a broader charter than the SEC, should plainly be less reticent than the SEC and should develop an opinion on the major assumption if it wants to maximize the rationality of its law-making. And in my opinion Congress will be very wrong to be neutral regarding the present explosion of hostile-take-over-related activity, which I respectfully suggest is harmful to the country whether viewed from the point of view of right-wing Republicans, left-wing Democrats, or anything in between, except possibly aggressors in the take-over struggles and a small group of investment bankers, lawyers and arbitrageurs.

I think that, averaged out, the wrong sort of people are gaining corporate power under the present rules. Under those rules the power of the Jay Gould types is increasing while the power of the Boss Kettering types is being diminished, while a host of Russell Sage types is being enriched without producing much of anything useful to the general citizenry.

To the extent increased values are apparently being created in the current scene by gross increases in financial leverage, it largely represents a simple transfer of wealth from the taxpaying (or inflation suffering) general citizenry to a financially-oriented group which is not very useful, if it is not absolutely harmful, in the production of goods and services. A large amount of talent is plainly being attracted by too-easy money into unproductive activities promising large amounts of quick wealth, earned by skills not much greater than those of a good bridge player. I know the subject well, being to some extent a fellow sinner, here in atonement.

The present level of hostile-take-over-related activity in the stock market and elsewhere reminds me of Keynes' shrewd observation when he looked back at 1929 and wrote: "when the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done." It seems to me that the present frenzy ought to be dampened down by legislation designed to wring out the easy money and to divert talent and effort into "making money the old fashioned way."

I hope Congress will share my appraisal of the "big picture" and my desire that legislation address "big picture" problems. If Congress shares my view it will not be diverted by inherent complexity of detail into swatting flies when the leopards are loose.

I think Congress should intervene promptly with legislative changes designed to make hostile corporate take-overs, and related stock speculation akin to catching trout with dynamite, a very much less attractive field of activity.

Charles T. Munger

Charles T. Munger