

PARTICIPATION BY MUTUAL FUNDS IN CORPORATE TAKEOVERS

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INTRODUCTION

The Investment Company Act of 1940, in Section 1, declares the findings that led to its adoption:

[I]nvestment companies are affected with a national public interest in that, among other things—

. . .

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce; . . .¹

While this preamble resulted primarily from observation of the effect that mutual fund activities had on the normal corporate affairs of the funds' portfolio companies, its broad language anticipated a development that could not have been foreseen. The corporate "takeover," the involuntary transfer of corporate control, was virtually unknown prior to 1964.² In the years following, it rapidly became a widely used tool of aggressively managed firms.³ A number of procedural devices, all designed to accomplish a takeover, have developed in response to the practical needs of the outsider seeking

¹ 15 U.S.C. § 80a-1(a)(3) (1970).

² See Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L.F. 269 (1969) [hereinafter cited as Hamilton]. The most common method of business combination continues to be the voluntarily negotiated merger or acquisition. Of a total of 1,200 significant mergers and acquisitions taking place in 1967, for example, only 86 of these resulted from takeover situations. Austin and Fishman, *The Tender Takeover*, 4 *Mergers & Acquisitions* no. 3 at 4, 18 (1969).

³ On March 6, 1969, SEC Chairman Budge testified before a Senate Subcommittee studying the securities industry that during the previous seven months there had been 54 cash tender offers involving \$1.4 billion and 104 exchange offers involving \$9 billion of securities. Hearings on Problems in the Securities Industry Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess., 13-14 (1969). These numbers have fallen off somewhat in subsequent years due to pressure on conglomerates from federal legislation and increased administrative activity. Hamilton, *supra* note 2, at 270 n.5.

control (the offeror), and the necessities of the transfer situation. The principal devices are the cash tender offer, the public exchange offer and the proxy contest.

A cash tender offer is essentially a public invitation to shareholders of the company to be taken over (the target company) to tender their shares to the offeror for purchase at a specified price.⁴ In an exchange offer, the offeror proposes to exchange a package of its own securities for shares of the target company. The package frequently includes debt securities combined with some kind of equity position—*i.e.*, common stock, options or warrants to acquire common stock, or a conversion privilege.⁵ A proxy contest involves an attempt to wrest control from incumbent management through the ownership or voting control of a sufficient number of shares to enable the outsider to elect a majority of the board of directors.

This comment will consider the statutory and administrative measures regulating mutual fund participation in corporate takeovers. It will also analyze the policy underlying the relevant legislation and the effectiveness of present rules in implementing that policy. The succeeding discussion suggests that (1) the present regulatory emphasis on disclosure does not fully realize the legislative purpose of protecting the small investor caught in a control contest involving financial institutions; (2) the SEC should exercise its rule-making power to provide the needed regulation; and (3) under either the present or suggested future regulations, funds wishing to participate in control contests must proceed cautiously if they are to avoid costly litigation and, possibly, investment losses.

I. REASONS FOR MUTUAL FUND PARTICIPATION IN CORPORATE TAKEOVERS

While working control of the target company may often be achieved with a minority stock position, a larger interest is usually necessary to effect a satisfactory takeover. Ownership in excess of fifty percent is usually necessary to discourage competing offers and to consolidate the target company's financial statements with those of the offeror. The ability to consolidate financial statements is particularly important where the target company's earnings are sought to augment the earnings of the offeror.⁶ Furthermore, the use of target company funds to service or retire the debts of the offeror, including those incurred in making the takeover bid, necessitates a statutory merger. In most states this cannot be accomplished without

⁴ See generally S. Hayes and R. Taussig, *Tactics of Cash Takeover Bids*, 45 *Harv. Bus. Rev.* Mar.-Apr. 135, (1967) [hereinafter cited as Hayes and Taussig]; Bromberg, *Tender Offers: Safeguards and Restraints*, 21 *Case W. Res. L. Rev.* 613; Hamilton, note 2, *supra*.

⁵ Hamilton, *supra* note 2, at 293.

⁶ Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2827 (1971) [hereinafter cited as SEC Institutional Investor Study].

the approval of the stockholders by a two-thirds vote.⁷ Finally, eighty percent ownership of the target company is a prerequisite to filing a consolidated tax return, which permits use of the target's operating losses or loss carry-forwards to reduce the offeror's taxable income.⁸

Quite clearly, the direct purchase by the offeror of sufficient target shares to assure it of minimal control would require considerable capital, even where the stock is undervalued. In addition, if an exchange offer is contemplated, the offeror must still make substantial open-market purchases of target company shares preparatory to the offer in order to assure its success. Thus in most cases it is necessary for the offeror to seek economically powerful allies who have the requisite funds available. These may include lending institutions from whom the offeror may borrow the needed capital or institutional investors who can provide the necessary financial strength by participating directly in the takeover. The assistance of such financial institutions may also be sought by target company management in an effort to resist the offeror's bid for control.⁹

Of the various types of institutional investors, mutual funds are eminently qualified to participate in a takeover, offensively or defensively. As of December, 1970, the mutual fund industry had total net assets of approximately \$47.6 billion,¹⁰ of which 80.9 percent were invested in common stocks.¹¹ At that date, mutual fund assets represented 7.48 percent of the total market value of all shares listed on the New York Stock Exchange (NYSE), and mutual fund assets actually invested in securities listed on the NYSE amounted to 5.31 percent of the total value of all such listed shares.¹² The distribution of mutual fund assets within the industry reveals the concentration of this financial power. The total net asset value of the ten largest funds totaled \$16.5 billion in December, 1970, or almost thirty-five percent of total industry assets; one hundred funds had total assets in excess of \$95.7 million.¹³ Furthermore, the ten leading management companies had assets under management amounting to \$26.1 billion, or close to

⁷ *Id.*

⁸ *Id.* See also Int. Rev. Code of 1954, §§ 381, 382.

⁹ See e.g., the case studies of power struggles involving Bath Industries, Inc., discussed in the SEC Institutional Investor Study, *supra* note 6, at 2775, and MGM, discussed in *Fortune*, May, 1967 at 150, where mutual funds held shares representing the balance of power and sided with target company management.

¹⁰ Investment Company Institute, 1971 Mutual Fund Fact Book 3, 7. This figure may be compared with total net assets of \$17 billion in 1960, \$35.2 billion in 1965, and \$52.7 billion in 1968. *Id.*

¹¹ *Id.* at 80. This figure has ranged between 79.0% and 86.5% since 1961. *Id.*

¹² *Id.* at 30.

¹³ The ten largest mutual funds and their total net assets are as follows: Investors Mutual Inc., \$2,615,700,000; Dreyfus Fund, \$2,231,700,000; Investors Stock Fund, \$2,227,100,000; Massachusetts Investors Trust, \$1,955,600,000; Affiliated Fund, \$1,601,000,000; Wellington Fund, \$1,376,900,000; Investment Company of America, \$1,168,100,000; Massachusetts Investors Growth Stock Fund, \$1,164,500,000; United Accumulative Fund, \$1,140,600,000; and Fundamental Investors, \$1,054,300,000. Moody's Investors Services, 1971 Bank and Finance Manual a56.

fifty-five percent of total industry assets.¹⁴ Thus it is evident that mutual funds have the financial resources to play a decisive role in contests for corporate control.

At the 1970 congressional hearings on the Williams Act, a number of industry representatives testified that mutual funds would never seek control of portfolio companies for themselves and that they should, therefore, be exempted from the requirements of that act.¹⁵ While it may be true that funds do not seek corporate control for themselves, their ability to influence the result of a control contest through available investment funds, or by reason of shares already owned, cannot be ignored. Moreover, there is considerable data indicating that funds have, in fact, exercised this power. For example, the Securities and Exchange Commission, in its Institutional Investor Study, examined nine separate corporate takeover attempts involving significant institutional participation; eight of these involved mutual fund participation having a critical impact upon the takeover bid.¹⁶

Mutual fund participation in a takeover bid may occur in either of two basic situations. The first occurs where a fund is suddenly confronted with a corporate takeover attempt involving a company (either offeror or target) whose securities are already owned by the fund. The second occurs where a fund, owning no securities of the companies involved, seeks to participate upon its own initiative or upon the advice or invitation of others. The variations on these basic situations are numerous. While it is more likely that a mutual fund would assist the offeror,¹⁷ there may be situations in which the fund is asked by the target company to purchase its stock as a defensive tactic.¹⁸ In some cases, the fund may be approached by a broker who has himself selected a target company, but who may not yet have found a definite offeror.¹⁹

The factors causing funds to participate, and even to *seek* involvement, with a takeover offeror are many. First, and most obvious, mere rumors of a suspected takeover can raise the price of the target company's stock, and cash tender or exchange offers are usually made at a fifteen to twenty percent premium over the prevailing market

¹⁴ This estimate is based on ownership information for all major mutual funds, and assets-under-management data for all major management firms as contained in Moody's 1971 Bank and Finance Manual, note 13 *supra*.

¹⁵ Hearings on S. 336 and S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. (1970): Statement of Donald Calvin, Vice President, New York Stock Exchange, at 101, 102-3; Statement of Richard Walbert, President, National Association of Securities Dealers, Inc., at 110, 111-12; Statement of Craig Severance, Chairman, Federal Securities Acts Committee, Investment Bankers Ass'n, at 114, 116-20.

¹⁶ SEC Institutional Investor Study, *supra* note 6, at 2775-813.

¹⁷ See pp. 1116-18 *infra*.

¹⁸ See note 9, *supra*. Sales of the offeror's stock may also be solicited by target company management. SEC Institutional Investor Study, *supra* note 6, at 2840-41.

¹⁹ See the cases of Reliance Insurance Co. and United Fruit Co., described in SEC Institutional Investor Study, *supra* note 6, at 2787, 2793.

price.²⁰ Even if the takeover is unsuccessful, the shares may still be sold at a profit. If there are competing offers and a contest develops, the price will rise even higher.²¹ Such a situation offers the alert mutual fund manager an opportunity to increase the net asset value of his fund through trading profits and to improve his own investment performance. Frequently, his assistance in facilitating the takeover is the quid pro quo for advance knowledge of the offer. He is expected to purchase and hold target stock in his portfolio until a public offer is made and then to tender the shares to the offeror.

Second, the takeover situation may offer the fund manager an opportunity to achieve liquidity in a block of portfolio stocks not otherwise readily marketable. As a mutual fund grows through additional sales, the size of its investment in each portfolio security must increase if it is to keep the number of different issues it holds within a manageable range. Increasing institutionalization of the securities markets frequently makes it impossible for a fund to liquidate a substantial investment which has soured without incurring a significant loss; the fund is said to be "locked in."²² The growth of block trading techniques—*i.e.*, negotiated trades between institutions which are executed by a block brokerage specialist, has helped to alleviate this situation, but not entirely.²³ The selection by an offeror of this "bad investment" as a takeover target may go a long way toward helping a fund out of a difficult situation at a favorable price, and funds have been known to seek out an offeror for such a target on their own initiative.²⁴

Third, the financial power which a mutual fund can bring to bear in a contested takeover may result in its receipt of a special price, opportunity or inducement not available to all target company shareholders.²⁵ The fund, for example, may sell its shares to the offeror upon the stipulation that the fund will receive any higher price later offered in a public tender.²⁶ The fund may demand the alternative right to share in any profits made by the offeror upon later disposition

²⁰ See Hayes and Taussig, *supra* note 4 at 140. See also E. Thomas, Warehousing, in *Practicing Law Institute, Mutual Funds, Corporate Law and Practice Transcript Series No. 10* at 191 (1969).

²¹ Hamilton, *supra* note 2, at 300-01.

²² Baum and Stiles, *The Silent Partners: Institutional Investors and Corporate Control* 69, 79 (1965). See also A. Smith, *The Money Game* 216 (1968):

When three funds, each with 100,000 shares to sell, arrive at the opening [of the New York Stock Exchange] on the same morning, the specialist simply cannot handle it. He calls a Governor of the Stock Exchange and asks for time to round up buyers. They "shut the stock down"; it simply ceases trading For that moment, liquidity has come to a halt (When the stock does reopen, it is likely to be a good 20 points lower)

²³ 115 U. Pa. L. Rev. 669, 686 (1967) (remarks of W.B. Moses, Vice Chairman, Massachusetts Investors Trust).

²⁴ See the case of Home Insurance Co. described in SEC Institutional Investor Study, *supra* note 6, at 2778-79.

²⁵ *Id.* at 2780-81.

²⁶ *Id.* at 2780.

of the stock if the takeover is not accomplished.²⁷ Where a public exchange offer is contemplated, the fund may demand the right to sell back to the offeror the shares it receives in exchange or to make a secondary public offering of these shares after the takeover has been completed.²⁸ The fund may also be invited to participate in a non-public offering of the offeror's shares at a favorable price, the proceeds of which will be used to finance the takeover bid.²⁹ In some cases the benefits offered may be directed at the fund manager personally. He may, for example, be promised the right to manage a portion of the target's portfolio, assuming a successful takeover, in exchange for his cooperation.³⁰

II. FUND PARTICIPATION: LEGAL PROBLEMS

A. *Restrictions Arising From Investment Policies*

Participation by a mutual fund in a contest for corporate control inevitably requires it to purchase or hold a sizeable block of shares in a particular company. To the extent that the law prevents a fund from doing this, its ability to participate is curtailed. Although no federal legislation deals specifically with the problem of concentration of mutual fund ownership in portfolio companies, both the Investment Company Act of 1940³¹ and the Internal Revenue Code of 1954 contain provisions which have the effect of limiting such concentration. The relevant sections of these statutes deal with aspects of a fund's investment policies and, specifically, with the requirements for (1) classification as a diversified management company, (2) classification as a regulated investment company, (3) disclosure of investment policies, and (4) alteration of fund classification and investment policies.

Section 5(b)(1) of the Investment Company Act³² requires that, before a fund may be classified as a diversified management company, seventy-five percent of the fund's total assets must be invested in cash, cash items or securities. As to this seventy-five percent, the holdings in any one portfolio company cannot exceed five percent of total fund assets or ten percent of the portfolio company's outstanding voting securities.³³ Approximately ninety-six percent of management companies are diversified.³⁴ This fact is probably due to the desire of the funds to increase their appeal to the average mutual fund

²⁷ Id. at 2773.

²⁸ See the case of Reliance Insurance Co. Id. at 2787, 2791.

²⁹ See the case of Great American Holding Corp. Id. at 2781, 2782.

³⁰ Id. at 2784.

³¹ 15 U.S.C. §§ 80a-1 to 80a-52 (1970).

³² 15 U.S.C. § 80a-5(b)(1) (1970).

³³ Id.

³⁴ G. Maseritz, *The Investment Company: A Study of Influence and Control in the Major Industrial Corporations*, 11 B.C. Ind. & Com. L. Rev. 1, 7 (1969).

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investor, who seeks not only the advantage of professional investment management, but also a diversification of investment not obtainable by a small investor on an individual basis.

Since Section 13(a)(1) of the Investment Company Act prohibits a fund from changing its Section 5 classification without a majority vote of its shareholders,³⁵ classification requirements might be expected to have some effect in restricting a fund's investment in portfolio companies involved in control contests. The mechanics involved in obtaining shareholder approval make it unlikely that a favorable vote could be obtained in time to participate in a particular takeover bid if no action were taken until the opportunity for participation became known to the fund. Nevertheless, a number of factors limit the effectiveness of the classification provision: (1) a diversified company does not lose its status if an investment which represented five percent or less of the fund's assets at the time of purchase subsequently appreciates in value and rises above the five percent limit;³⁶ (2) the limit applies only to individual funds and has no limiting effect on the total holdings of a multi-fund organization managed by a single investment adviser; (3) twenty-five percent of a fund's assets are unrestricted as to concentration;³⁷ and (4) a vote of the shareholders in favor of changing a fund's classification to nondiversified is not difficult to obtain as long as the fund is performing well and sufficient time is available to accomplish the change.

Probably because an unauthorized change in classification would be a clear violation of the statute, there is no reported case involving a direct attempt by management to change its classification without shareholder approval. More commonly, where management has made an investment that is inconsistent with its classification, such investment also violates its investment policy as stated in the registration statement and any resulting suit would arise under Section 8 of the Investment Company Act.³⁸

In addition to the requirements of the Investment Company Act, the Internal Revenue Code contains separate standards for determining whether an investment company is sufficiently diversified to qualify as a regulated investment company; these standards may also inhibit fund participation in a takeover bid. The Code requires that fifty percent of a fund's assets must be invested in cash, cash items or

³⁵ 15 U.S.C. § 80a-13(a) (1970):

No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

(1) change its subclassification as defined in section 80a-5(a)(1) and (2) of this title or its subclassification from a diversified to a nondiversified company

³⁶ 15 U.S.C. § 80a-5(c) (1970).

³⁷ *Id.* at 80a-5(b)(1). This 25% may be considerable, and in the case of the larger funds, exceeds \$250 million. See note 13 *supra*.

³⁸ See text at pp. 1120-24 *infra*.

securities, not exceeding, with respect to any one issuer, five percent of total fund assets or ten percent of the issuer's voting securities.³⁹ This restriction is the same as that imposed upon seventy-five percent of the assets of funds classified as diversified investment companies under the Investment Company Act.⁴⁰ The Code imposes two further restrictions: no more than twenty-five percent of fund assets may be invested in the securities of any one issuer, or of two or more issuers in the same or related business, which the fund controls;⁴¹ and no more than thirty percent of the fund's gross income may be derived from the disposition of securities held for less than three months.⁴²

While the Code standards provide funds with significantly more flexibility than do those of the Investment Company Act, violation of the Code standards may be far more costly. Only by meeting the Code requirements may a mutual fund "pass through" its investment income to its shareholders and avoid the double taxation to which corporate dividends are subject.⁴³ Rarely will the potential gain from participation in a takeover bid suffice to justify the tax liability incurred by a fund through loss of regulated investment company status.

Within the limitations imposed by the Investment Company Act and the Internal Revenue Code, the degree of flexibility retained by a mutual fund to concentrate its assets in a particular portfolio company depends upon the fund's other investment policies. Section 8(b) of the Investment Company Act requires public disclosure of these policies.⁴⁴ The section provides that the registration statements filed with the SEC must reveal the fund's investment policies, with regard to certain enumerated activities, as well as all other investment policies of the registrant which are changeable only by shareholder vote or

³⁹ Int. Rev. Code of 1954, § 851(b)(4)(A)(ii) (Subchapter M).

⁴⁰ See text at note 33 *supra*.

⁴¹ Int. Rev. Code of 1954, § 851(b)(4)(B).

⁴² Id. § 851(b)(3).

⁴³ Id. § 852. "Double taxation" refers to the taxation of general business corporation dividends at the corporate level and then again as personal income in the hands of the shareholders.

⁴⁴ Section 8(b) provides that every registered investment company must file with the SEC a registration statement containing the following information:

(1) a recital of the policy of the registrant in respect of each of the following types of activities, such recital consisting in each case of a statement whether the registrant reserves freedom of action to engage in activities of such type, and if such freedom of action is reserved, a statement briefly indicating, insofar as is practicable, the extent to which the registrant intends to engage therein: (A) the classification and subclassifications as defined in sections 80a-4 and 80a-5 of this title, within which the registrant proposes to operate . . . (E) concentrating investments in a particular industry or group of industries . . . and (H) portfolio turn-over . . .

(2) a recital of all investment policies of the registrant, not enumerated in paragraph (1), which are changeable only if authorized by shareholder vote . . .

(3) a recital of all policies of the registrant, not enumerated in paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy. . .

15 U.S.C. § 80a-8(b) (1970).

which are considered by the registrant to be fundamental.⁴⁵ Section 13(a)(3) prohibits any deviation from these stated policies without the approval of a majority of the fund's shareholders.⁴⁶ In addition, each fund is required to transmit semiannual financial statements to the shareholders, including a list showing the amounts and values of securities owned, so that the investors might see the practical results of the stated policies.⁴⁷

In order to comply with the disclosure requirements and to sharpen their sales appeal, most funds have established a well-defined investment policy which is fully explained in the prospectus. Some funds place primary emphasis on long-term capital appreciation with current income only a secondary consideration; other funds emphasize income and stability of capital, or attempt a balance between income and growth.⁴⁸ Some funds specialize in a particular industry, while a few emphasize investment in a certain geographical area.⁴⁹

The stated investment policies of the so-called "go-go (or performance) funds" are sufficiently broad to include participation in corporate takeovers, leading to a relatively rapid turnover and profit, as a permissible activity.⁵⁰ Income funds, growth funds, or balanced funds, however, might have difficulty justifying participation in such high-risk ventures in light of their more conservative investment objectives.⁵¹ Nevertheless, when a fund is faced with falling market values and redemptions that exceed sales, participation in a takeover bid may have unusual appeal and the pressure to temporarily

⁴⁵ *Id.*

⁴⁶ 15 U.S.C. § 80a-13 (1970):

(a) No investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

...

(3) deviate from its policy in respect of concentration of investment in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a-8(b)(3) of this title

⁴⁷ 15 U.S.C. § 80a-29(d)(2) (1970).

⁴⁸ Investment Company Institute, 1971 Mutual Fund Fact Book 5.

⁴⁹ *Id.* at 33.

⁵⁰ See text at notes 64-66, *infra*.

⁵¹ The risks inherent in such participation are illustrated by the aftermath of *Armour & Co. v. General Host Corp.*, 296 F. Supp. 470 (S.D.N.Y. 1969), discussed at pp. 1138-40 *infra*. General Host induced a number of mutual funds to purchase Armour securities for tender to General Host in an exchange offer by which General Host planned to take over Armour. Although General Host received enough tenders to give it control over Armour, its interest was not sufficient to effect a statutory merger, mainly because of a 33% interest acquired by Greyhound Corp. as a result of a competing cash tender offer. General Host soon became unable to service the debt incurred in the takeover and was forced to sell its interest to Greyhound. Many of the funds holding General Host securities as a result of the exchange sold out, at a considerable loss, within five months of the end of the tender period; the value of the General Host exchange package declined from \$74.65 at the expiration of the tender period to \$30.00 one year later. SEC Institutional Investor Study, *supra* note 6, at 2806-07.

alter investment policy without the formalities required by the Investment Company Act may be substantial.

*Aldred Investment Trust v. SEC*⁵² illustrates the problems that an unauthorized change in investment policy can produce. The Trust declared in its registration statement that it was not its policy to invest in companies for the purpose of exercising control. Although since its formation, antedating the passage of the Investment Company Act, the Trust had concentrated its investments in public utility stocks, its stated policy was to achieve greater diversification while limiting investment in any other single industry to twenty-five percent of the Trust's total assets. The Trust encountered financial difficulties, the market value of the trust assets fell to one-third of the principal amount of its outstanding debentures, and income failed to meet interest payments. New management was able to purchase voting control of the Trust at a foreclosure sale of trust shares. The new managers liquidated thirty percent of the Trust's portfolio, used the proceeds to purchase majority control of a race track, and proceeded to elect themselves directors and officers of the race track. A meeting was held for the purpose of approving the change in investment policy; however, no mention of the race track was made, and the nonmanagement interests represented comprised less than one-tenth of one percent of the voting shares.

The SEC, pursuant to its authority under Section 35 of the Investment Company Act,⁵³ brought suit against the officers and directors of the Trust, alleging that the departure from disclosed investment policies violated Section 13(a). The court was unimpressed by the fact that the new investment had not only proved better than the utility stocks, but had done so well that it had rescued the fund from its financial difficulties.⁵⁴ The court found that management had been motivated primarily by personal interest and had sought personal advantages contrary to the interests of the Trust. The meeting at which shareholders had approved the change in policy was found to have been a sham. The shareholder communication giving notice of the meeting was found to be so misleading as to border on falsehood. The court held that the well-concealed plans of management, and their subsequent execution, constituted a violation of fiduciary duty and a gross abuse of trust. The court therefore ordered the officers and directors removed from office and affirmed the lower court appointment of receivers with power to reorganize or liquidate the Trust.

Although *Aldred* is a rather extreme example of a change in in-

⁵² 151 F.2d 254 (1st Cir. 1945), cert. denied, 326 U.S. 795 (1946).

⁵³ Section 35 authorizes the SEC to bring an action in federal district court against fund officers and directors alleging gross misconduct or gross abuse of trust. The section provides that if the allegations are proved the court shall enjoin the guilty persons from continuing to act in such positions of trust. 15 U.S.C. § 80a-35 (1970).

⁵⁴ CCH Fed. Sec. L. Rep., Fed. Bar Ass'n Conference on Mutual Funds 171 (1966).

vestment policy, it remains as a warning of potential liability to fund managers who seek participation in takeover bids where such participation involves a change in investment policy requiring a stockholder vote. In a more recent case, *Green v. Brown*,⁵⁶ a stockholder of a closed-end diversified investment company brought a derivative action against the fund's directors for permitting investment of more than twenty percent of the fund's total assets in securities of each of two corporations, in contravention of investment policies stated in the registration statement. The statement declared that none of the investment policies set forth therein could be changed without the approval of a majority of the shareholders. Among the policies listed was one indicating that the fund would not invest more than twenty percent of its total assets in the securities of any one private issuer.

Although the court found that the investment in question violated the stated policy and was made without shareholder approval, it nevertheless dismissed the complaint. The policy in question, said the court, was not among those listed in the registration statement as "fundamental." Thus it did not come within the prohibitions of Section 13(a) of the Investment Company Act, which prohibited deviation, without shareholder approval, from any *fundamental policy* recited in the registration statement.⁵⁶ The court was somewhat troubled by this decision, and expressed that feeling in its opinion.⁵⁷ The purpose of the registration statement, the court indicated, is to provide information on policies for the protection of investors. No policy could be more fundamental to an investment company than its investment policy, and investors ought to be able to rely on stated policies. Nevertheless, the language of section 13(a) plainly compelled the curious result that a fund may deviate from its stated investment policies with impunity as long as it has not labeled these policies "fundamental." The court concluded that the remedy lay with Congress and not with the courts.

On appeal,⁵⁸ the SEC filed an amicus curiae brief arguing that

⁵⁶ 276 F. Supp. 753 (S.D.N.Y. 1967), rev'd on other grounds 398 F.2d 1006 (2d Cir. 1968).

⁵⁷ At the time of the case, § 8(b)(2) required "a recital of the policy of the registrant in respect of matters . . . which the registrant deems matters of fundamental policy and elects to treat as such." Investment Company Act of 1940, ch. 686, tit. I, § 8(b)(2), 54 Stat. 803, as amended 15 U.S.C. § 80a-8(b)(2) (1970). Section 13(a)(3) prohibited deviation "from any fundamental policy recited in [an investment company's] registration statement pursuant to section 80a-8(b)(2) of this title." Investment Company Act of 1940, ch. 686, tit. I, § 13(a)(3), 54 Stat. 811, as amended 15 U.S.C. § 80a-13(a)(13) (1970).

Act of Dec. 14, 1970, Pub. L. No. 91-547, § 3(d), 84 Stat. 1414-15, as amended 15 U.S.C. § 80a-8(b)(2) (1970), amended § 8(b)(2) to read as it appears in note 44 supra, and placed the language of the old § 8(b)(2) into § 8(b)(3), note 44 supra. The amendment also added corresponding language in § 13(a)(3) prohibiting deviation "from any investment policy which is changeable only if authorized by shareholder vote . . ."

⁵⁸ 276 F. Supp. at 756.

⁵⁹ 398 F.2d 1006 (2d Cir. 1968). Soon after the suit was brought, the investments in question were ratified by the shareholders of the fund, and were subsequently renegotiated

Congress had intended the term "fundamental" to apply to any investment policy which the registrant indicates is subject to change only upon shareholder approval. The SEC admitted, however, that its printed forms, although in the process of being modified, were inconsistent with this view.⁵⁹ In 1970, Congress settled the problem by deleting "fundamental" from section 13(a), thus prohibiting deviation from any investment policy found in the registration statement.⁶⁰ Were it not for this amendment, the result in *Green* might have meant considerable freedom for funds to participate in takeover bids, in violation of stated policies, as long as they had the foresight to refrain from labeling such policies as fundamental. In light of the amendment, however, the same case would produce the opposite result today.

On balance, the limitations on mutual funds represented by the statutory provisions discussed in this section of the comment may best be viewed as simply a trap for the unwary. To a fund manager aware of these restrictions and sufficiently farsighted to see the desirability of participation in future takeover situations, the restrictions are more form than substance. Under the limitations on concentration required of a fund that is a diversified management company (Investment Company Act) and a regulated investment company (Internal Revenue Code), it is possible for a fund to invest up to thirty percent⁶¹ of its total assets in a single target company and still be in compliance, even though such investment would give the fund ownership of more than ten percent of the target. In the case of most large or medium-size funds, it is possible for funds to enjoy significant participation in a takeover bid with a commitment considerably below this level.

Notwithstanding the potential liability under the Securities Act for the dissemination of false information in a prospectus,⁶² the key to avoiding liability for deviating from a fund's stated investment policies is a carefully drafted registration statement and prospectus.⁶³

so as to come within the 20% limit. Because certain issues were first raised on appeal and also because of possible mootness, the court remanded the case to the district court for a full rehearing.

⁵⁹ *Id.* at 1009. The registration forms used by the SEC permitted the defendant to raise a defense under § 37(c) of the Act, 15 U.S.C. § 80a-37(c) (1970), which applies to actions taken in good faith and in conformity with any rule, regulation or order of the Commission.

⁶⁰ See note 56 *supra*.

⁶¹ Five percent of the restricted 75% may be invested in the securities of a single company as well as the unrestricted 25%. See text at note 33 *supra*.

⁶² A fund is liable for any omissions or misrepresentations in its registration statement or prospectus. Securities Act of 1933, §§ 11, 12, 15 U.S.C. §§ 77k, l (1970). Damages under these sections are compensatory only and cannot exceed the cost of the security to the plaintiff plus interest. *Id.* at §§ 11(e), 12, 15 U.S.C. §§ 77k(e), l (1970).

⁶³ The prospectus is, in effect, an abbreviated reprint of the registration statement on file with the SEC and is used primarily for sales purposes. Items in the registration statement which are omitted from the prospectus may be obtained from the SEC upon payment of the fees prescribed by SEC rules.

MUTUAL FUNDS IN CORPORATE TAKEOVERS

The use of broad, liberal language, combined with specified reservations regarding the activities and investment techniques to be utilized in pursuit of the fund's objectives, should preserve the wide investment appeal of the fund while leaving the fund's adviser sufficient flexibility to seek performance through participation in takeover bids. For example, a prospectus for the Oppenheimer Fund⁶⁴ contains the following language:

Capital appreciation may be sought through investment in "*special situations*" by which is meant a company where *some particular development* has occurred or *is expected to occur* which, in the opinion of management, may prompt an increase in the value of the company's securities, regardless of general business conditions or the movement of the market as a whole.⁶⁵

A forthcoming takeover bid for a target company would surely qualify as a development whose occurrence or expected occurrence creates a special situation that may cause the stock to rise in value. The quoted language leaves the fund free to participate in such a situation without fear of violating its investment policies. Other examples of the use of such language are readily available.⁶⁶ It is submitted that,

⁶⁴ Oppenheimer Fund, Inc., prospectus dated April 8, 1971.

⁶⁵ Id. at 6 (emphasis added).

⁶⁶ The following examples are representative:

Management expects to make investments involving greater than average risks. . . .

To achieve its objectives the Fund may engage in certain *speculative investment techniques*.

The Dreyfus Leverage Fund, Inc., prospectus dated January 6, 1971, at 4 (emphasis added).

The policy of the Fund will be to purchase securities *primarily* for the purpose of investment and not for the purpose of resale. The Fund, however, proposes to make such changes in its portfolio at such times as in the opinion of its Board of Directors are necessitated by market, economic or other conditions. . . .

However, during periods when compliance with the foregoing policies may not be in the interests of investors, the *Management may temporarily invest in other types of security*.

Admiralty Fund, prospectus dated May 4, 1970, at 3 (emphasis added).

In selecting securities based on their appreciation possibilities, investment decisions *generally* involve an assessment of the fundamental values of the securities and consideration of prevailing market conditions. . . . However, the Fund, consistent with its objectives of capital appreciation may acquire or dispose of securities on the basis of *short term market considerations*.

Ivest Fund, prospectus dated December 15, 1971, at 1 (emphasis added).

The investment objective of the Fund [will be realized through investment] in the following types of securities:

1. Securities of companies which have been unpopular for some time but where in management's opinion *recent developments* such as those listed below suggest the possibility of improved operating results:

. . .

(b) *a change in management* . . .

. . .

by thoughtful planning of investment objectives and careful drafting of prospectus language, potential liability for funds participating in corporate takeovers arising from transgression of investment policies may be minimized.

B. *Antifraud, Antimanipulation and Insider Trading*

The wide dispersion of ownership in most large public corporations makes it virtually impossible for an outsider to obtain control without making some kind of offer to all of the target company shareholders.⁶⁷ Equally important to a potential offeror is the initial acquisition of a substantial block of shares, in order to form a power base from which to make a bid. At least a portion of this block must be acquired in secrecy, to prevent any increase in price that might follow public awareness of the impending takeover bid, which would make acquisition more expensive. Secrecy is also necessary in order to minimize the time available for defensive maneuvers by the target company.

Purchases by the tender offeror can be effectively supplemented, and the probability of success thereby enhanced, by enlisting the support of institutional investors owning or willing to acquire substantial blocks of target securities. However, in order to insure that the federal securities laws are not violated in the takeover process, both the offeror who wishes to obtain institutional assistance, and the mutual fund manager who is willing or anxious to participate must be aware of the various legal requirements affecting their relationships and proceed accordingly. This section of the comment, and the two sections which follow it, will consider various aspects of this problem.

One of the fundamental objectives of the federal securities laws, as expressed in Section 10(b) of the Securities Exchange Act of 1934,⁶⁸ is the protection of investors against fraudulent or manipulative securities transactions. Some of the rules promulgated by the SEC under this section significantly affect participation by mutual funds in corporate takeovers. Specific violations may result from fund transactions either before or during a tender offer. They may occur in the context of either a cash tender offer or a public exchange offer. Funds may also be held liable for violations in situations where, although they do not violate the rules directly, they participate in a takeover bid with one guilty of direct violations.

The most obvious problems in this area arise when a fund manager has received confidential information about a planned takeover prior

(e) *the prospect of an acquisition or merger.*

Contrafund, Inc., prospectus dated March 1, 1971, at 1 (emphasis added).

⁶⁷ Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2833 (1971) [hereinafter cited as SEC Institutional Investor Study].

⁶⁸ 15 U.S.C. § 78j(b) (1970); see also Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1970).

to public announcement of the plan. Typically, this information is supplied to the fund by the offeror upon the expectation or explicit agreement that the fund will assist the offeror in its bid for control of the chosen target. This assistance most frequently takes the form of acquisition of target company shares in the market, which are "warehoused" by the fund and tendered to the offeror just prior to the expiration of the public tender offer. The fund may also receive information regarding an impending takeover from a target company requesting the fund to purchase target shares to assist in thwarting the takeover bid.

1. Rule 10b-5

If purchases are made by the fund prior to the public announcement of the tender offer, Rule 10b-5⁶⁹ becomes relevant. The precise problem posed by Rule 10b-5 is whether a fund, having knowledge of an offeror's plans for a takeover, violates the rule by making anticipatory purchases of target company shares in the open market without revealing its information to the public. Rule 10b-5 prohibits, in general terms, the use of manipulative or deceptive practices in connection with the purchase or sale of securities.⁷⁰ While the language of the rule does not seem to compel disclosure where *no* statements are made in connection with a transaction,⁷¹ a long history of judicial interpretations has imposed upon one party to a purchase or sale a duty to disclose material facts not known to the other if a fiduciary or other special relationship exists between them.⁷² This duty may be simply expressed in terms of the following formula: *possession of material facts + fiduciary or special relationship = duty of disclosure*. For a mutual fund, the critical issues under the rule are thus (1) the scope of information deemed to be material, and (2) the circumstances under which a fiduciary or special relationship is said to exist between the parties to a transaction.

⁶⁹ 17 C.F.R. § 240.10b-5 (1971).

⁷⁰ The rule provides that:

It shall be unlawful for any person, directly or indirectly . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) 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 the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1971).

⁷¹ Sections (a) and (c) of the rule make no specific reference to disclosure, while section (b) seems to require disclosure of material facts only where "necessary in order to make the *statements made* . . . not misleading" (emphasis added). See note 70 *supra*.

⁷² See notes 84-88 *infra*. Since the impersonal nature of the securities market makes it unlikely that a fund would have any contact whatever with the other party to the transaction, the requirement that information be disclosed to that party in effect requires a public disclosure.

Various courts have considered the nature of a "material fact," usually expressing their conclusions in broad, general terms.⁷³ Although the definitions differ in some respects,⁷⁴ each decision cites the earlier formulations. A recent SEC enforcement proceeding, *Investors Management Co.*,⁷⁵ posited the basic test emerging from these cases. The SEC stated that material information is that which is of such importance that it could be expected to affect the judgment of investors as to whether to buy, hold or sell securities, and, if generally known, to affect materially the market price of the stock.⁷⁶

The test of materiality, as developed by the courts and thus formulated in *Investors Management* is exceptionally broad. Stock prices move in response to the balance between the supply of and demand for a company's stock, as determined by the collective decisions of all investors. Investment decisions are frequently based upon rumors, hunches, general economic conditions, world politics and other factors bearing little or no relation to a fundamental appraisal of a company's stock. Under such a broad test, corporate management would be encouraged to disclose all corporate information having even a remote possibility of influencing the price of the company's stock, in order to avoid potential liability. No effort would be made to color the facts by separating the significant from the meaningless ones. Far from placing the individual investor on an equal footing with sophisticated institutions or insiders, such disclosures would more likely overwhelm him.

In order to protect the public from premature announcements which might arouse speculative fervor, while concurrently attempting

⁷³ The definitions employed in the principal cases are, in chronological order, as follows: a fact which would materially affect the judgment of the other party to the transaction (*Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947)); a fact affecting the value of the stock which would have affected the judgment of the seller (*Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (Del. 1951)); a fact which in reasonable and objective contemplation might affect the value of the company's securities (*Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963)); a fact to which a reasonable man would attach importance in determining his choice of action in the transaction in question (*List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811, rehearing denied, 382 U.S. 933 (1965) (citing Restatement, Torts § 538 (2)(a), and *W. Prosser, Torts* 554-55)); information which is essentially extraordinary in nature and which is reasonably certain to have a substantial effect on the market price of the security (*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (citing 51 Va. L. Rev. 1271, 1289), cert. denied, 394 U.S. 976 (1968)); a fact which affects the probable future of the company, or which may affect the desire to investors to buy, hold or sell the company's securities (*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 849).

⁷⁴ There is, for example, some distinction to be made between a fact which is reasonably certain to have a substantial effect on the stock price (language of *Texas Gulf Sulphur* decision), and one which might affect the stock price (language of the *Kohler* decision as quoted in *List* and *Texas Gulf Sulphur*). In addition, some courts utilizing multipartite definitions made the parts mutually independent while others using the same definition made the parts interdependent.

⁷⁵ SEC Securities Exchange Act Release No. 9267 (July 29, 1971), reprinted in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,514.

⁷⁶ *Id.* at 80,519.

to avoid any unnecessary narrowing of the type of information requiring disclosure, the SEC in *Investors Management*, imposed certain limitations upon the basic test of materiality. The Commission indicated that included among the factors to be considered in determining whether a particular piece of information falls within the ambit of the broad test are (1) the degree of specificity of the information, (2) the extent to which the information differs from existing public information, and (3) the reliability of the information in light of its nature and source and the circumstances under which it was received.⁷⁷ In *Investors Management* information that the earnings of Douglas Aircraft Co. would be significantly lower than expected was passed to institutional investors by Merrill Lynch, Pierce, Fenner & Smith, Inc., a prospective underwriter for Douglas. The SEC found that this information scored high on all the tests, and that it was indeed material.⁷⁸ Because the case involved sophisticated institutional investors for whom information retrieval was part of the ordinary course of business, the SEC emphasized that the information at issue was not merely a link in a chain of analytical data, but was sufficiently extraordinary to make its significance immediately clear.

Each of the SEC criteria contains an element of subjectivity and the SEC offers no guidelines for determining when each criterion has been met nor any indication as to how many of the criteria must be met before the information will be deemed material. In a separate concurring opinion, Commissioner Smith observed that the materiality test, as qualified by the majority, represented a "relatively high threshold of materiality."⁷⁹ This conclusion is not readily apparent from the majority opinion.

Significantly, the *Investors Management* case did not involve an attempted takeover of a publicly held company. The case, therefore, is distinguishable on its facts from the typical situation in which a mutual fund receives nonpublic information regarding such a takeover. In *Investors Management*, the fact in question—information regarding a reduction in earnings—related to an event, or course of events, which had already occurred. In a takeover situation, the pertinent fact—receipt of information concerning a possible tender offer—relates to a *future* corporate event. Thus, while the qualifications imposed upon the basic test of materiality in *Investors Management* seem appropriate to the facts of that case, they do not appear to accommodate the factual situation in a takeover. More closely on point is the decision in *SEC v. Texas Gulf Sulphur Co.*,⁸⁰ where the court noted that, when facts relate to a particular event, their materiality does not depend solely on the expected impact that the occurrence of the event

⁷⁷ Id.

⁷⁸ Id. at 80,519-80,521.

⁷⁹ Id. at 80,523.

⁸⁰ 401 F.2d 833 (2d Cir.), cert. denied, 394 U.S. 976 (1968).

might have on the company or the market. Rather, the magnitude of the event in the overall corporate picture must be balanced against the *indicated probability that the event will occur*.⁸¹

It is important to recognize that, in the context of a corporate takeover, the relevant event, whose probable occurrence must be assessed, is the tender offer and not the success of the takeover bid. Although the success of the takeover bid may be the more important corporate event, it is well known that the market responds to the announcement of a tender offer. The probability that the tender offer will be made is generally greater than the probability that the takeover bid will succeed. Thus, when a mutual fund receives a tip regarding a possible takeover bid, there is a clear necessity for distinguishing rumor from material facts. This is not always a simple task. The fact that a fund is willing to invest on the basis of certain information should not create a presumption of materiality.⁸² The superior analytical skills and market knowledge of a fund, which enable it to assess the plausibility of a rumor more accurately than the average investor, should not alone render the rumor material. In addition, the imposition upon a fund, or any investor, of the risk that information he possesses, which may be only rumor or projection at the time of the transaction, will subsequently become a material fact subjecting him to liability for nondisclosure is an unwarranted burden. *Texas Gulf Sulphur* appears to indicate that, before liability attaches, the materiality of the information must be established as of the time the possessor acted and not in light of subsequent events.⁸³

Despite the lack of direct precedent with regard to takeover bids, some conclusions can be drawn from the foregoing discussion. Based on the criteria discussed, it seems reasonable to conclude that a fund having direct knowledge from an offeror regarding the latter's extensive but undisclosed financial commitment to make a tender offer for a particular target, and its present ability to do so, possesses material information. Such information is specific, new and reliable. It is likely to affect the target's future, and would, if disclosed, affect both the decisions of investors and the market price of the company's securities. The information is probably material despite the fact that it does not originate with the target company and that the target may not even be aware such information exists. It seems equally reasonable to state that a fund which knows only that someone is interested in accumulating stock in a particular target for a possible takeover bid is not in possession of material facts. This is true even though disclosure of such information might affect the actions of speculative investors as well as the stock price. Between these two situations, however, there is a considerable area of ambiguity.

The typical situation involving fund participation falls closer to

⁸¹ *Id.* at 849.

⁸² *Id.* at 877 (dissenting opinion of Judge Moore).

⁸³ *Id.*

the former hypothetical than to the latter—a fund which is asked to participate in a takeover is informed in some detail of the impending tender offer by the person contemplating the bid. Thus it would appear that, more often than not, the information held by the fund would be deemed material even under a narrow interpretation of the term. The materiality of the information, however, does not alone establish the duty to disclose. As noted, disclosure is required only if a fiduciary or other special relationship exists between the parties to the transaction.

The final issue, then, is whether a fund receiving material information from a prospective tender offeror or from the target company is in a fiduciary position when it makes purchases in anticipation of the tender offer. The cases have uniformly held that "insider" status gives rise to a fiduciary responsibility with respect to transactions to which the insider is a party.⁸⁴ There appears to be unanimous agreement among courts as to the insider status of issuers,⁸⁵ officers and directors,⁸⁶ controlling stockholders,⁸⁷ and other employees.⁸⁸ However, these groups do not exhaust the classes of persons upon whom Rule 10b-5 imposes an obligation. In *Cady, Roberts & Co.*,⁸⁹ which involved an alleged violation of Rule 10b-5 by a registered broker-dealer who had received material inside information directly from a corporate director, the SEC analyzed the obligation of disclosure as resting on two principal elements:

[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.⁹⁰

Thus the Commission extended the traditional concept of a corporate fiduciary to include persons having a special relationship with a company and privy to its internal affairs.⁹¹

Since information possessed by a mutual fund participating in a

⁸⁴ See cases cited in notes 85-88 *infra*.

⁸⁵ *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

⁸⁶ *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952); *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

⁸⁷ *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D.Del. 1951), 135 F. Supp. 176 (Del. 1955), aff'd 235 F.2d 369 (3d Cir. 1956).

⁸⁸ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir.), cert. denied, 394 U.S. 976 (1968).

⁸⁹ 40 S.E.C. 907 (1961).

⁹⁰ *Id.* at 912 (footnote omitted). Also cited in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 848.

⁹¹ *Id.* See also *Strong v. Repide*, 213 U.S. 419, 431 (1909) (citing cases).

takeover bid is not obtained through a direct relationship with the issuer, the fund cannot be classified as an insider in the traditional sense. However, a more difficult question is raised with regard to its status as a "tippee," that is, one unrelated to the corporation who receives inside information from another who *does* stand in a fiduciary relationship with the issuer. A number of cases bear on this question.

In *Ross v. Licht*,⁹² a group of tippees had actively participated in the insider-tippers' plan to defraud the minority stockholders in their close corporation by inducing them to sell their stock at a price unreasonably low in view of certain material inside information withheld from the minority. The information concerned plans for a private placement and a public offering of the corporation's shares, both at prices above that offered to the minority. The court held that the purchasers, whether they were called insiders, tippees, or aiders and abettors, were under the same duty of disclosure affecting traditional insiders; hence their failure to make the required disclosures violated Rule 10b-5.⁹³ While the defrauding of minority stockholders by withholding material information is somewhat analogous to the situation in which information about a takeover bid is passed to mutual funds, *Ross* is distinguishable because it involved a close corporation and transactions on a personal level. More importantly, the information was passed to the tippees directly from an inside source.

In *SEC v. Texas Gulf Sulphur Co.*,⁹⁴ since the tippees involved were not made defendants, the court found it unnecessary to decide whether their conduct, in light of their possession of material inside information and the knowledge that it was undisclosed, had violated Rule 10b-5. The court did note, however, that such conduct was as reprehensible as that of the insider source.⁹⁵ The implication in that dictum is that tippees *may* be held liable where they know that the information they possess is nonpublic and that they are acting improperly by using it. While these limitations may be significant in situations where, as here, individual investors were involved, they would provide no defense for an institutional investor that would doubtlessly be charged with full knowledge of the circumstances in which it acted and the likely effects of its action. Its own subjective opinion as to the propriety of its action would be irrelevant. Nevertheless, *Texas Gulf Sulphur* is distinguishable, as was *Ross*, from the typical situation faced by a mutual fund, on the ground that the information again came to the tippees from an inside corporate source.

The peculiar characteristics of the institutional tippee were involved in *Investors Management Co.*⁹⁶ In that case, one investment

⁹² 263 F. Supp. 395 (S.D.N.Y. 1967).

⁹³ *Id.* at 410.

⁹⁴ 401 F.2d 833 (2d Cir.) cert. denied, 394 U.S. 976 (1968).

⁹⁵ *Id.* at 852-53.

⁹⁶ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 (SEC 1971), aff'g [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832 (SEC 1970) (decision of hearing examiner).

management company, six investment advisors and six hedge funds all had sold securities of Douglas Aircraft Co. while possessing inside information received from Merrill Lynch, Pierce, Fenner & Smith, Inc. The latter had had access to Douglas's internal corporate affairs by reason of an underwriting relationship. In holding the tippees liable, the SEC made it clear that the obligation to disclose material inside information prior to dealing in a company's securities extends beyond those who possess such information by reason of traditional corporate relationships.⁹⁷ Three requisites for tippee liability were listed: (1) the information in question must be material and nonpublic; (2) the tippee, whether he receives the information directly or indirectly, must have reason to know that it was nonpublic and that it was obtained improperly by selective revelation or otherwise; and (3) the information must be a factor in the tippee's decision to effect the transaction.⁹⁸

Of these criteria, only the second in any way concerns the relationship of the tippee to the source of the information. The SEC noted that although the case of an *indirect* recipient presents problems of factual proof of the requisite knowledge, the need for the protection afforded by Rule 10b-5 is the same as in situations where the information is possessed by insiders.⁹⁹ In addition, there was a suggestion that tippees engaged in professional securities activities ought to be subjected to a stricter standard because they have both the access to substantial investment funds and the sophistication to appraise and capitalize upon the market effect of the information.¹⁰⁰ The implication of *Investors Management*, for a mutual fund receiving material information is that the fund will be presumed to have constructive knowledge as to whether the information it possesses has been disseminated in a manner making it generally available to investors, and as to the advantage that the information affords over others with whom the fund may deal. Because of this presumption, mutual funds will be unable to rely upon the insulation against liability afforded by the difficulty of proving actual knowledge.

A reexamination of the *Investors Management* and *Texas Gulf Sulphur* criteria for tippee liability reveals only one factor that prevents liability for a fund knowingly utilizing material information in its possession: whether or not the information was "improperly obtained." This factor appears to make the imposition of liability on a tippee totally dependent upon a finding that the information originated with an inside "tipper," in violation of his fiduciary duty to the corporation concerned. *Cady, Roberts, Ross, Texas Gulf Sulphur*, and *Investors Management* all involved information which reached the tippees directly or indirectly from an inside corporate source. Thus,

⁹⁷ Id. at 80,518.

⁹⁸ Id. at 80,519.

⁹⁹ Id. at 80,521.

¹⁰⁰ Id.

where a mutual fund receives information concerning a takeover from a target company seeking the fund's aid in defensive maneuvers, the requisites of liability are present. However, where the fund receives the information from the offeror planning a takeover, the question is more difficult. In this situation, the fund's liability depends on whether the offeror is considered to be an insider, or a tippee (making the fund a second-generation tippee). The cases considering this problem are not numerous.

There is some indication that, in certain situations, a person making a takeover bid will be considered an insider. In *Ward LaFrance Truck Corp.*,¹⁰¹ the Commission held that a corporation which had agreed to purchase a controlling block of stock in an issuer and which had been given access to information not generally available to other stockholders was an insider under Rule 10b-5. The Commission did not comment on the probable status of a tender offeror who made no contact with the target. In *Hughes & Treat*,¹⁰² a violation of Rule 10b-5 was alleged to have been committed by an offeror making market purchases pursuant to a takeover bid after it had been revealed to and approved by the issuer's board of directors, but prior to notification of shareholders. Although the case was resolved by a negotiated settlement, the Commission indicated that there existed a substantial question as to whether the offeror was an insider and whether it had some fiduciary obligation.

The salient aspect of *Ward LaFrance* and *Hughes & Treat* which distinguishes these cases from the typical tender offer situation is that they involved voluntary takeovers—i.e., takeovers to which the target company's management agreed or in which management participated. Where, as in these two cases, management's amenability to the takeover facilitates access to corporate information, or assures the successful consummation of the takeover, the offeror is justifiably considered an insider for purposes of Rule 10b-5. Mutual fund participation in a voluntary takeover situation seems certain to give rise to tippee liability if target company securities are purchased subsequent to management-offeror accord. However, in an involuntary takeover situation, liability of either the offeror or the participating mutual funds seems remote. In *Mills and Williams v. Sarjem Corp.*,¹⁰³ the failure of an offeror syndicate to disclose its plans for immediate sale of the corporate assets was held not to violate Rule 10b-5, since the plan could have been conceived by anyone; thus, the offeror was not considered an insider within the meaning of the rule. Securities transactions, the court indicated, generally involve some degree of speculation, and are usually motivated by a difference of opinion between the purchaser and seller regarding the future prospects of the security involved. Any seller must anticipate that the purchaser has a profit-

¹⁰¹ 13 S.E.C. 373 (1943).

¹⁰² 22 S.E.C. 623 (1946).

¹⁰³ 133 F. Supp. 753 (D.N.J. 1955).

making purpose in mind. Thus the court determined that, in the absence of any fiduciary duty existing by reason of an inside relationship, the purchaser is under no obligation to divulge its plans.¹⁰⁴

In *Mutual Shares Corp. v. Genesco, Inc.*,¹⁰⁵ the plaintiff alleged that in making a tender offer for shares of S.H. Kress and Company the defendant offeror had violated Rule 10b-5 by its failure to disclose, *inter alia*, that Kress's real estate was worth substantially more than the value at which it was carried in the company's financial statements. The court held that the tender offeror, which was a stranger to the corporation, did not violate a duty by its silence since it possessed no information that was not generally available to the public.¹⁰⁶ The court took note of pending federal legislation regarding disclosure in corporate takeovers (the Williams Amendments) and inferred that existing regulation, including Rule 10b-5, did not adequately cover this area.

These cases reveal a reluctance on the part of courts and the SEC to treat an outside offeror as an insider or as one having a fiduciary duty. While it may still be argued that an offeror who possesses no nonpublic information about a target other than his own plans to acquire control *should* be encumbered with a duty by virtue of that knowledge alone, such is not the present state of the law. When the SEC first suggested in the *Cady, Roberts* case that the duties of a fiduciary could be imposed upon persons other than insiders, the Commission required a special relationship which made such a person privy to the *internal affairs* of the corporation.¹⁰⁷ Regardless of the manner in which a takeover bid is construed, it cannot be considered as part of a corporation's internal affairs. In addition, there is language in the *Investors Management* decision which clearly indicates that no liability can attach to a tippee unless (1) the issuer was the source of the informant's knowledge, and (2) the tippee knew or had reason to know that the information was made available by reason of a breach of duty to the corporation not to disclose or use the information for a noncorporate purpose.¹⁰⁸

On balance, it appears that a fund will be subject to liability under Rule 10b-5 only when it purchases shares in a target company and, at the time of purchase, it has received but not disclosed, concrete information regarding an impending tender offer from a corporate insider. Where the fund receives information, albeit material,

¹⁰⁴ Id. at 764.

¹⁰⁵ 384 F.2d 540 (2d Cir. 1967).

¹⁰⁶ Id. at 545. The case also turned, in part, on the fact that the plaintiffs had not tendered shares to the defendant, but rather had purchased shares on plaintiffs' advice, and thus had no standing to sue under Rule 10b-5. Id.

¹⁰⁷ See text at note 91 *supra*.

¹⁰⁸ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. at 80,523-24 (concurring opinion of Commissioner Smith). The Commissioner further argued that the emphasis in such cases should be on policing insiders and their privies rather than on policing the possession of information *per se* in an effort to reduce relative informational advantages in the market, a concept too vague to be applied with any consistency. Id.

about a contemplated takeover bid from an outside offeror, liability is unlikely.¹⁰⁹ Thus the traditional circumstances of fund participation do not seem to pose a serious threat of 10b-5 liability and, to date, no court has imposed such liability on a mutual fund.

At first glance it may seem that this insulation from liability will be detrimental to persons trading in securities who are ignorant of an impending tender offer. However, the Williams Amendments of 1968 were enacted to prevent this result. The Amendments clearly state the disclosure requirements for a tender offer situation. To the extent that Congress has recognized the problems in this area and has enacted remedial legislation to resolve them, disclosure other than that required by statute seems inappropriate. Of course, there may remain a small fraction of investors unprotected by the statutory requirements. There is a point, however, beyond which the philosophy of disclosure is confronted with the realities of the market place; the previous discussion suggested that the circumstances requiring disclosure may be ambiguous. In the final analysis, standards must be established which will insure both that the information received by investors is significant and that disclosure is required only upon the occurrence of a specific and ascertainable event. That the standards set are sometimes somewhat arbitrary is to be expected.

2. Rules 10b-6 and 10b-13

The foregoing discussion has been concerned with potential liability under Rule 10b-5 in situations where a mutual fund purchases target company shares prior to publication of a tender offer. When a mutual fund purchases target company shares *after a public exchange offer has been announced*, Rule 10b-6 becomes significant. Rule 10b-6 makes it unlawful for any person participating directly or indirectly in a distribution of securities to purchase those securities, or any rights to purchase those securities, until after his participation is completed.¹¹⁰ The purpose of Rule 10b-6 is to prevent those persons participating in a distribution of securities from manipulating the market

¹⁰⁹ There are, however, a variety of ways in which a fund might participate that could involve receipt of information from an inside source. Such a situation would exist where a fund is asked by an offeror to purchase its shares in order to maintain the market price for a forthcoming tender offer; or where a fund is asked by the target company to purchase its shares as a defense against a takeover; or where a fund is purchasing target shares to assist an offeror, and either the fund or the offeror has a director in common with the target.

¹¹⁰ Rule 10b-6 provides, in relevant part, that:

(a) It shall constitute a "manipulative device or contrivance" as used in section 10(b) of the act for any person, [who is an underwriter, prospective underwriter, broker, dealer,] or other person who has agreed to participate or is participating in such a distribution, directly or indirectly . . . to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution.

by bidding for those same securities and thereby creating the impression of an active market, which would facilitate their distribution at artificially high prices.¹¹¹ Typically, mutual fund involvement in an exchange offer takes the form of a purchase of target company shares pursuant to an express or implied agreement to tender them to an offeror under the terms of the public exchange offer. The critical questions for the fund are whether its purchase of target company securities is a purchase of the securities to be distributed by the offeror and, if so, whether such purchase constitutes indirect participation in the distribution in violation of Rule 10b-6.

A distribution of securities consists of the entire process by which, in the course of a public offering, a block of securities is dispersed and ultimately comes to rest in the hands of the investing public.¹¹² Rule 10b-6, subsection (b), states that the distribution of a security which is immediately exchangeable for or convertible into another security, or which entitles the holder to receive another security, is considered to be a distribution of that other security within the meaning of the rule.¹¹³ Similarly, the *purchase* of a convertible or exchangeable security must be considered as a purchase of the security received in conversion or exchange.¹¹⁴ When a mutual fund, or any other investor, purchases target company securities during an exchange offer, it acquires the right to receive the offeror's securities. Thus the purchase of target securities is a purchase of the offeror's securities which are being distributed. Such a purchase, even if made for resale, does not itself violate Rule 10b-6. No purchaser would be held to have violated the rule unless it were found to be participating in the distribution.

The difficult problem under Rule 10b-6 is defining the circumstances under which a fund or other investor will be held to have "participated" in the distribution of the securities offered by the company making the takeover bid. Rule 10b-6, subsection (a)(3), refers to, but does not define, the "other participating persons" against whom the prohibitions of the rule are to apply. Reference to Section 2(11) of the Securities Act¹¹⁵ suggests, by analogy, that the key to a fund's status as a participant is whether it has acquired the shares for investment purposes or with a view to "distribution." The SEC has met the difficulty of ascertaining the intention of a purchaser at the time

¹¹¹ SEC v. Scott Taylor & Co., 183 F. Supp. 904, 907 (S.D.N.Y. 1959) (citing L. Loss, Securities Regulation 883-84 (1951)); Miller v. Steinbach, 268 F. Supp. 255, 280 (S.D.N.Y. 1967) (citing 3 L. Loss, Securities Regulation 1596 (2d ed. 1961)).

¹¹² Jaffee & Co., SEC Securities Exchange Act Release No. 8866 (Apr. 20, 1970), [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,805 at 83,858 n.5 (citing Oklahoma-Texas Trust, 2 S.E.C. 764, 769 (1937), aff'd, 100 F.2d 888 (10th Cir. 1939)).

¹¹³ 17 C.F.R. § 240.10b-6(b) (1971).

¹¹⁴ SEC Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1 at 547 (1963).

¹¹⁵ Section 2(11) of the 1933 Act includes in the definition of "underwriter" any person who has purchased securities from an issuer with a view to distribution. 15 U.S.C. § 77(b)(11) (1970).

of acquisition by considering subsequent acts and circumstances in making this factual determination.¹¹⁶ Important factors evidencing the purchaser's intent are the length of the holding period between purchase and resale, the nature of the purchaser's business, and any unforeseeable change in circumstances.¹¹⁷

Since funds do not generally plan to hold the offeror's securities as a prolonged investment, but will either sell their "rights" (target shares) to arbitrage shortly before the expiration of the offer period or exchange the target shares and sell the securities received, they act as a link in a chain of transactions that move the securities being distributed from the issuer into the hands of the public.¹¹⁸ Thus it is submitted that when a fund purchases target shares during an exchange offer and temporarily "warehouses" them on behalf of the offeror, it facilitates the distribution of the offeror's securities and it therefore participates in such distribution within the meaning of Rule 10b-6. The purchases initiate the fund's participation and must, therefore, occur before its participation is completed, thus violating the rule.

Even if "participation" in such a case could not be shown, there is a danger that where a fund purchases the shares pursuant to an agreement with the offeror made during or even prior to the exchange offer, it could be found to be acting as the offeror's agent and thus aiding and abetting a violation of Rule 10b-6 by the offeror. Such a finding would be particularly likely where compensation other than the market price/tender price differential had been agreed upon.¹¹⁹ Although no fund has yet been held liable for such violations, the discussion is not strictly academic. In a number of cases involving takeover bids where violations of Rule 10b-6 were proved or alleged, participating funds have only fortuitously escaped liability. The litigation resulting from the 1969 contest over control of Armour & Co., reported in *Armour & Co. v. General Host Corp.*,¹²⁰ is such a situation. In *Armour*, General Host had made an exchange offer for Armour shares. Armour management opposed the offer and persuaded Greyhound Corp. to make a competing cash tender offer.¹²¹ General Host then solicited purchases of Armour shares by institutional investors, and a number of mutual funds were induced to purchase Armour

¹¹⁶ SEC Securities Act Release No. 5223 (Jan. 11, 1972) (adoption of Rule 144), [Current] CCH Fed. Sec. L. Rep. ¶ 78,847 at 81,053.

¹¹⁷ *Id.* While no particular holding period would be conclusive as to the intention of the purchaser, the opinion of the Commission's General Counsel was that retention for one year, if not contradicted by other evidence, would create a strong inference of a purchase for investment. SEC Securities Act Release No. 1862 (Dec. 14, 1938), 17 C.F.R. § 231.1862 (1971).

¹¹⁸ SEC Securities Act Release No. 5223 (Jan. 11, 1972), [Current] CCH Fed. Sec. L. Rep. ¶ 78,847 at 81,053.

¹¹⁹ See text at notes 26-30 *supra*.

¹²⁰ 296 F. Supp. 470 (S.D.N.Y. 1969).

¹²¹ *Id.* at 472.

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shares for the purpose of tendering them to General Host pursuant to the terms of its exchange offer.¹²²

Armour sought a temporary restraining order and a preliminary injunction enjoining General Host from effecting the exchange. The complaint alleged that a conspiracy existed to gain control of Armour through manipulative, misleading and deceptive practices in violation of Rule 10b-5, and that such purpose was carried out in part through transactions executed in violation of Rule 10b-6.¹²³ Specifically, Armour alleged that Kleiner, Bell, a broker-dealer participating with General Host in the takeover bid, had urged a mutual fund to purchase 150,000 shares of Armour stock in two large block transactions which had been executed by the broker during the effective period of the General Host registration.¹²⁴ These shares were all subsequently tendered to General Host by the fund involved.

The court, relying on the testimony of an officer of the defendant brokerage firm, found that the fund's buy order was unsolicited by the broker and that the transactions were thus exempt from the requirements of Rule 10b-6.¹²⁵ However, after investigating the case in connection with its Institutional Investor Study, the SEC reported that the block purchases were, in fact, made by the fund at the urging of the brokerage firm.¹²⁶ If the court had had the benefit of the SEC's findings to rebut the defendant's testimony, it might well have held that the transactions were nonexempt. The court, however, also noted that substantial legal issues existed as to whether Rule 10b-6(b) applies to the stock of the target as well as to that of the distributor.¹²⁷ In expressing doubt as to this point, the court relied on the fact that the SEC had permitted General Host's registration statement to become effective after Armour had pinpointed its claims of violation and had brought their contentions to the notice of the Commission's Chairman.¹²⁸ The registration statement contained language by which General Host clearly reserved the right to purchase Armour securities outside of the exchange offer after the date of filing but prior to the effective date of the offer.¹²⁹

¹²² See Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2805 (1971) [hereinafter cited as SEC Institutional Investor Study].

¹²³ 296 F. Supp. at 471 & n.1.

¹²⁴ *Id.* at 476; SEC Institutional Investor Study, *supra* note 122, at 2805.

¹²⁵ *Id.* at 476. The exemption noted is found at 17 C.F.R. § 240.10b-6(a)(3)(v) (1971).

¹²⁶ SEC Institutional Investor Study, *supra* note 122, at 2805.

¹²⁷ 296 F. Supp. at 476 & n.18. Rule 10b-6(b) makes the prohibitions with regard to the specific securities being distributed applicable to securities which are immediately exchangeable into those securities or entitle the purchaser to acquire those securities. 17 C.F.R. § 240.10b-6(b) (1971).

¹²⁸ 296 F. Supp. at 473, 475.

¹²⁹ General Host reserves the right in its sole discretion . . . prior to the date the Registration Statement becomes effective, to enter into firm arrangements for

Significantly, the very activity provided for in that registration statement was about to be prohibited under proposed Rule 10b-13, which the SEC claimed was simply a codification of existing interpretations under Rule 10b-6.¹³⁰ The apparent contradiction between the position taken by the SEC Division of Corporate Finance, responsible for examination of registration statements, and that of the Division of Trading and Markets, which proposes new rules, has been viewed critically as revealing serious internal inconsistencies in SEC policy.¹³¹ In any case, serious confusion existed as to the application of Rule 10b-6 to the shares of the target where an exchange offer is used to effect a corporate takeover.

Six months after *Armour*, a somewhat similar case, *Chris-Craft Industries, Inc. v. Bangor Punta Corp.*,¹³² arose in the District Court for the Southern District of New York, presenting an opportunity for clarification of the 10b-6 requirements. Chris-Craft and Bangor Punta were engaged in a fight for control of Piper Aircraft Corp., having made competing exchange offers for outstanding Piper shares.¹³³ Bangor Punta had acquired 120,200 Piper shares in five cash transactions during the time its exchange offer was in registration. Chris-Craft sued to enjoin Bangor Punta, *inter alia*, from voting the shares on the ground that the purchases violated Rule 10b-6.¹³⁴ Although the purchases could not be fitted within any of the explicit exemptions to the rule, Judge Tenney nevertheless found nothing objectionable in the transactions. He concluded that the purchases were clearly not designed to place market pressures on the Piper stock for the purpose of creating an artificially high price, since such an increase in price would make

the acquisition of Armour Common Stock by purchase in the open market at prevailing market prices or through negotiated purchases, or by concluding arrangements for the sale and delivery of securities, including the [General Host] Debentures and Warrants (subject to necessary shareholder approval and approval of counsel as to certain legal matters), to the sellers of any such Armour Common Stocks so acquired.

SEC Registration Statement No. 2-31224 on Form S-1 filed by General Host Corp. on December 30, 1968 at 8, quoted in Lowenfels, Rule 10b-13 and Rule 10b-6, 69 Colum. L. Rev. 1392, 1408 (1969).

¹³⁰ SEC Securities Exchange Act Release No. 8712 (Oct. 8, 1969), [1969-1970 Transfer Binder] CCH Fed. L. Rep. ¶ 77,745 at 83,709.

¹³¹ Lowenfels, *supra* note 129 at 1408. Mr. Lowenfels notes that although the SEC does not approve or disapprove of securities registered with it, nor pass upon the accuracy or adequacy of prospectuses, the relevant language of the General Host prospectus was retained through two amended versions and appeared in the final prospectus without any questions under Rule 10b-6 being raised by the Division of Corporate Finance.

¹³² *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 303 F. Supp. 191 (S.D.N.Y. 1969), *aff'd*, (sub nom.) as to denial of preliminary injunction, *rev'd*, as to alternative holding that securities laws were not violated, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,510 (2d Cir. 1969) (unreported), *aff'd*, 426 F.2d 569 (2d Cir. 1970) (en banc).

¹³³ 426 F.2d at 571.

¹³⁴ 303 F. Supp. at 193.

the Bangor Punta exchange offer less attractive to Piper shareholders.¹³⁶

The Second Circuit Court of Appeals reversed, finding that such purchases of target company securities and the increase in price likely to result could easily mislead small unsophisticated investors to believe "that the price increases result[ed] solely from the bullish effect of the exchange offer on the market . . . [and] . . . not from cash purchases in addition to the offer."¹³⁶ The court concluded that "Prevention of this kind of manipulation seems well within the spirit of Rule 10b-6,"¹³⁷ and held that the Bangor Punta purchases violated the rule.

This resolution, at least for the Second Circuit, of the applicability of Rule 10b-6 to target company shares has significant implications for mutual fund participants in takeover bids. In retrospect, the result in the *Armour* case may be said to be incorrect; the decision turned on a transactional exemption based on testimony later found by the SEC to be inaccurate, and on a doubt in the mind of the district court which the appellate court found to be unjustified. It is not a long judicial step from finding a violation by a broker who urges such a transaction to a finding of aiding and abetting the violation on the part of a fund which knowingly facilitates it. However, the significance of these cases for mutual fund participants in corporate takeovers is not limited to situations involving a middleman. If fund purchases of target company securities at the instigation of a participating broker-dealer violate Rule 10b-6, then, a fortiori, similar purchases pursuant to an agreement with the issuer also violate the rule. Although the fund was not made a defendant in the *Armour* case, if such a situation arises again, a participating fund might find itself facing the inconvenience and expense of defending itself in protracted litigation and the possibility of a costly judgment. However, when such cases arise in the future, Rule 10b-13, which became effective in October, 1969, will be of primary importance.

The adoption of Rule 10b-13¹³⁸ firmly resolved in the negative the question as to whether a tender offeror may legally purchase target company securities outside the terms of its pending offer. Rule 10b-13 prohibits any person making a cash tender or exchange offer from going outside that offer to purchase the desired securities or any securities immediately convertible into or exchangeable for those securities. This prohibition is in effect from the time the offer is publicly announced, or otherwise communicated to holders of the securities to be acquired, until the offer is terminated.¹³⁹ An unfortunate effect of Rule 10b-13 from the point of view of target company shareholders is

¹³⁶ *Id.* at 198.

¹³⁶ 426 F.2d at 577.

¹³⁷ *Id.*

¹³⁸ 17 C.F.R. § 240.10b-13 (1971).

¹³⁹ *Id.* at subsection (a).

that the prohibition of purchases of target shares by the offeror outside the exchange offer prevents the free market appreciation of the target securities that would result from such purchases. Prohibition of purchases prior to the effective date of the offer prevents the offering price from being set higher than it now will be set; prohibition of purchases after the offer becomes effective prevents the offering price from being increased. As a result, the value of the offeror's shares is artificially enhanced, relative to those of the target to be exchanged,¹⁴⁰ and consideration offered to target company shareholders for their shares, in either a cash tender or exchange offer, will be diminished.

In spite of this problem, Rule 10b-13 is presently the law and it applies, as does Rule 10b-6, to transactions made in the context of corporate takeovers. The combined effect of the two rules is (1) to prevent funds which could be found to be participating in a distribution under Rule 10b-6 from purchasing any target shares during a public exchange offer; and (2) to prevent funds which purchase target shares during a cash tender offer, or during a public exchange offer in which they are not participating, from receiving any consideration (cash or securities) greater than that available to the public by the terms of the offer.

Thus, if mutual fund participation in corporate takeovers, effected through tender offers, is to continue on privately negotiated terms, the purchase of target shares by a fund and the subsequent sale to the offeror must take place prior to any public announcement of the offer. Purchases made prior to the inception of the offer period are not prohibited by the rule, although any purchases made within sixty days prior to the announcement of the offer must be disclosed in Schedule 14D to be filed by the offeror.¹⁴¹ While the transfer could also be legally made after the expiration of the offer,¹⁴² this would leave the transaction open to charges that it was effected pursuant to an agreement or understanding reached during the offer period, in violation of Rule 10b-13.¹⁴² By forcing offerors and participating funds to consummate their transactions prior to the offer period, the rules may be expected to produce pre-offer agreements containing inducements such as most-favored-stockholder clauses, profit-sharing clauses, buy-out provisions and others, all designed to compensate the funds for relinquishing their target shares to the offeror prior to the time that the market in those shares may be expected to peak.

C. *Transactions with "Affiliated Persons"*

Another problem arising from the relationship between a takeover offeror and a participating mutual fund is posed by Section 17(d) of

¹⁴⁰ This was well understood by Judge Tenny as his opinion in *Christ-Craft* demonstrates. See text at note 135 *supra*.

¹⁴¹ 17 C.F.R. § 240.14d-101 (1971).

¹⁴² 17 C.F.R. § 240.10b-13(a) (1971).

the Investment Company Act of 1940.¹⁴³ Section 17(d) makes it unlawful for an affiliated person of a registered investment company to effect a transaction in which the investment company is a joint or a joint-and-several participant in contravention of rules prescribed by the SEC. Such rules are to be established for the purpose of preventing injury to fund shareholders arising from participation by the fund on a basis different from, or less advantageous than, that of the affiliated participant.¹⁴⁴ The law appears to be aimed at situations in which affiliated persons, who make or influence the investment decisions of a fund, and who may have a personal financial interest in the securities of a portfolio company, overreach the fund for the benefit of the affiliated person.¹⁴⁵

Rule 17d-1,¹⁴⁶ promulgated by the SEC pursuant to its authority under section 17(d), requires persons affiliated with investment companies to apply for SEC approval before engaging in any joint enterprise or arrangement with such company. Section 2(a)(3) of the Investment Company Act defines an "affiliated person" as including:

1. any person owning or controlling five percent of the fund's outstanding shares;
2. any person whose shares are five percent owned or controlled by the fund;
3. any person otherwise controlling, controlled by, or under common control with the fund;

¹⁴³ The section, in relevant part, provides:

(d) It shall be unlawful for any affiliated person of . . . a registered investment company . . . or any affiliated person of such a person . . . to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person . . . in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant.

15 U.S.C. § 80a-17(d) (1970).

¹⁴⁴ 15 U.S.C. § 80a-17(d) (1970). The final version of the 1940 Act gave the SEC rule-making power to regulate transactions by affiliated persons; the original Senate version of the Act, however, prohibited such transactions entirely. S. 3580 § 17(a)(4), 76th Cong., 3d Sess. (1940).

¹⁴⁵ SEC Investment Company Act Release No. 5128 (Oct. 13, 1967), [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,477 at 82,949.

¹⁴⁶ The rule provides:

(a) No affiliated person of . . . any registered investment company . . . and no affiliated person of such a person . . . acting as principal, shall participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which any such registered company, or a company controlled by such registered company, is a participant, and which is entered into, adopted or modified subsequent to the effective date of this rule, unless an application regarding such joint enterprise, arrangement or profit-sharing plan has been filed with the Commission and had been granted by an order entered prior to the submission of such plan or modification to security holders for approval, or prior to such adoption or modification if not so submitted.

17 C.F.R. § 270.17d-1 (1971).

4. any officer, director, or employee of the fund; and
5. the fund's investment advisor.¹⁴⁷

A "joint enterprise or other arrangement" is, in turn, defined by Rule 17d-1 as "any written or oral plan, contract, authorization or arrangement, or any practice or understanding . . . [in which an investment company and an affiliated person jointly participate or] share in the profits. . . ." ¹⁴⁸

In a takeover situation, the issue is not one of potential liability on the part of the fund, but rather the burden to be imposed on certain offerors who would seek to utilize the fund's resources. This question, of course, has broad significance for the future of fund participation in corporate control contests. The foundations of judicial interpretation regarding section 17(d), however, were not laid in the context of a corporate takeover bid. In *SEC v. Midwest Technical Development Corp.*,¹⁴⁹ directors of a closed-end investment company invested in the securities of ten companies whose securities were also held by the fund. The SEC contended that such investments constituted joint arrangements with affiliated persons and thus required prior SEC approval. The situation was complicated by the fact that the fund's investments provided venture capital to its portfolio companies, many of which were organized, promoted or run by the defendant directors of the fund.

The court noted that the broad language of section 17(d) precluded a narrow interpretation of the terms "joint venture" and "joint enterprise." The court found that all the defendant directors were "affiliated persons" of the fund, and that the facts revealed sufficient collaboration to warrant the finding that a joint enterprise existed. Heavy investments by the fund in certain portfolio securities had been induced by directors who had assisted in organizing the companies, in order to assure the safety of their initial investments. Investments in other portfolio companies made by the affiliated directors followed substantial investments by the fund in those companies, which strengthened the companies' financial structures and reduced the initial investment risk to the directors.

The court concluded, however, that the directors had not schemed to utilize the fund for their personal gain, but were simply ignorant of their duty to avoid a conflict of interests between their duties as directors and their concern for the welfare of their own investments. The disparity between the profits made by the directors and those made by the fund was explained by the court as resulting from the investment limitations imposed on the fund by its stated investment objectives and policy. The court emphasized that there are no pro-

¹⁴⁷ 15 U.S.C. § 80a-2(a)(3) (1970).

¹⁴⁸ 17 C.F.R. § 270.17d-1(c) (1971).

¹⁴⁹ [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,252 (D. Minn. 1963).

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visions in the Investment Company Act which prohibit the purchase of portfolio stocks by an investment company director.

Thus, although the court found that the Act and the rules had been violated, it was sympathetic to the defendants and imposed no judicial sanctions. More significant for mutual funds participating in takeover bids, however, was the court's statement that the case at bar, involving a small investment company and local interlocking directors, was to be distinguished from situations involving directors of large investment funds and nationally traded securities in which a joint venture or enterprise would be extremely difficult to identify. It further appears that the case turned, at least in part, on the court's recognition of the detrimental effect which a transaction by one of the joint participants could have upon the market price of the security involved, and thus upon the value of the shares held by the other participant. The court noted that the fund's sale of a large block of stock in one of its portfolio companies might have shaken the confidence of other investors in its stability, to the detriment of the directors who had substantial holdings in the stock. It is submitted that the same problems arise in the case of securities traded on a national exchange when the "joint venture" involves an investment of millions of dollars by a large mutual fund and a takeover offeror. The scale is larger, but the principles are the same. A sale by the affiliated offeror could have a great impact on the price of the securities sold, to the detriment of the fund. Although the court did not define the requirements for a joint venture, other than to suggest that a strict interpretation of the term would be inappropriate, the case may be read as requiring SEC approval whenever funds and their affiliated persons invest in the same security on a scale creating the potential for stock "manipulation" by one for the benefit of the other.

Apparently the *Midwest* decision engendered a good deal of confusion within the industry. In 1967, the SEC proposed a revision of Rule 17d-1¹⁶⁰ on the ground that, "Under the present Rule, it is in some circumstances unclear whether an application should or should not be filed. . . ."¹⁶¹ In an effort to provide more exact standards as to whether and when a fund and its affiliated person must file an application with respect to certain transactions, the SEC proposed a number of guidelines and exemptions. Under the proposed revision, a fund becomes a joint participant in a transaction involving an affiliated person, and an application is necessary, in situations (1) where either the affiliated person or the fund holds two percent of the outstanding securities of an issuer and the other holds any securities of that same issuer; (2) where two percent of the fund's total net assets are invested in a particular issuer and the fund's affiliated person also holds

¹⁶⁰ SEC Investment Company Act Release No. 5128 (Oct. 13, 1967), [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,477.

¹⁶¹ Id. at 82,949.

securities of that issuer; or (3) where an affiliated person participates in a profit-sharing, bonus or other special remuneration plan provided by the fund.¹⁵² The first two of these guidelines are particularly relevant for funds participating in corporate takeovers. The acquisitions and holdings of all investment companies having the same investment advisor are to be aggregated to compute the two percent tests.¹⁵³

The revision also proposed that persons affiliated with investment companies merely by virtue of the fact that they each hold five percent of a common portfolio company be exempted from the filing requirements.¹⁵⁴ Such a person, the SEC concluded, would not ordinarily be in a position to influence the fund to effect a transaction for his personal advantage, at the expense of the fund, unless he "occupied some additional relationship."¹⁵⁵ Also excluded from filing would be two funds under the same investment advisor, each of which held a significant amount of shares in the same issuer. Although such a situation technically creates a joint transaction, the SEC felt that it was unlikely to result in participation by one fund on a less advantageous basis than the other.¹⁵⁶ Unfortunately, the revised rule, which seems to clarify substantially the requirements of section 17(d), has never been adopted by the Commission.¹⁵⁷ It is difficult to draw any meaningful conclusions from the failure to adopt.

Among the few section 17(d) cases which have directly involved mutual fund participants in takeover bids, the leading judicial statements are found in *General Time Corp. v. American Investors Fund, Inc.*,¹⁵⁸ and related litigation, which resulted from the acquisition by Talley Industries and American Investors Fund of stock in General Time Corp., preparatory to Talley's takeover of that company. Because the litigation was somewhat complicated, a brief explanation of the facts is necessary.¹⁵⁹ In December, 1967, at the instigation of a New York brokerage firm, Talley became interested in General Time as a possible acquisition candidate and purchased 24,000 of the outstanding shares (roughly one percent) at a price of \$23-24 per share. Talley's president then telephoned the president of American Investors

¹⁵² Id. at 82,951.

¹⁵³ Id.

¹⁵⁴ Id. at 82,950.

¹⁵⁵ Id.

¹⁵⁶ There is an apparent inconsistency here between the exemption for funds under common management and the aggregating of shares owned by such funds for purposes of the two percent guideline test.

¹⁵⁷ Although not adopted, the rule has never been withdrawn and presumably retains its status as a proposed rule.

¹⁵⁸ *General Time Corp. v. American Investors Fund, Inc.*, 283 F. Supp. 400 (S.D. N.Y.), aff'd sub nom. on other grounds (*General Time Corp. v. Talley Indus., Inc.*), 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969); see also *SEC v. Talley Indus., Inc.*, 286 F. Supp. 50 (S.D.N.Y.), rev'd with directions, 399 F.2d 396 (2d Cir. 1968), final decree of permanent injunction entered (unreported), aff'd 407 F.2d 65 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969).

¹⁵⁹ See 399 F.2d at 398-99; SEC Institutional Investor Study, *supra* note 122, at 2807.

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Fund (which held nine percent of Talley's voting shares), informed him that Talley had bought stock in a possible merger candidate, and inquired as to whether the fund might also wish to buy some shares to assist Talley in acquiring a decisive interest.

The fund's legal counsel advised that it could purchase some shares if it maintained complete independence in acquiring the stock and made no promises or arrangements as to voting, disposition or otherwise. The fund indicated its interest and Talley revealed the identity of the target. The fund subsequently purchased 210,000 shares (just under ten percent) of General Time at an average price of \$28.49 per share. All purchases were made through Talley's broker in order to avoid competitive bidding for the same shares. Talley continued purchasing for its own account at prices as high as \$42.50, and telephoned American Investors a number of times to report how many shares had been acquired by parties friendly to Talley, including the fund. After General Time had rejected Talley's proposal for a voluntary merger, a plan was formulated to effect the takeover by ousting the incumbent General Time directors through a proxy fight. General Time reached an agreement with Seeburg Corp. regarding a defensive merger, but this plan was abandoned when American Investors and another fund holding General Time stock announced their opposition and their intention to vote against such a merger. By this time, the litigation had begun.

General Time brought suit against Talley and American Investors in the District Court for the Southern District of New York,¹⁰⁰ alleging that they were "affiliated persons" engaged in a "joint enterprise or arrangement" to take over control of General Time, without prior approval of the SEC and thus in violation of Section 17(d) of the Investment Company Act and Rule 17d-1.¹⁰¹ Speaking for the court, Judge Bryan concluded that General Time lacked standing to complain of the violation in question since Congress intended the Investment Company Act to protect *stockholders of investment companies* and not *corporations* whose securities might be acquired by such investment companies.¹⁰² Although on appeal the decision was affirmed on other grounds,¹⁰³ the Second Circuit Court of Appeals in a later case expressed its concurrence with Judge Bryan's determination.¹⁰⁴ This holding is significant in the takeover context because the decision that the target corporation lacks standing removes the possibility of suing under section 17(d) from the target's arsenal of defensive maneuvers.¹⁰⁵

¹⁰⁰ 283 F. Supp. 400 (S.D.N.Y. 1968).

¹⁰¹ Id. at 401.

¹⁰² Id. at 402.

¹⁰³ 403 F.2d 159 (2d Cir. 1968).

¹⁰⁴ In 407 F.2d at 71, the court referred to Judge Bryan's opinion, stating: "While on the appeal from that judgment we did not decide that question . . . we believe the district court's view was sound—indeed, we now think our decision would better have been placed upon that ground."

¹⁰⁵ While at first glance this appears to conflict with the decisions granting standing to the target company where violations of the Williams Act are alleged, this may be ex-

Of course, the target may still attempt to convince the SEC that a violation has occurred, but control of any subsequent legal action is out of the target's hands. In the instant case, General Time was successful in persuading the SEC to take action.

Even before General Time's appeal had been heard, the SEC filed suit against Talley and American Investors for the same violations previously alleged by General Time.¹⁶⁶ Prior to the suit in *SEC v. Talley Industries, Inc.* and just prior to the solicitation of proxies for the General Time annual meeting, Talley, joined by the fund, filed a belated application with the SEC requesting approval of the arrangement between Talley and the fund, or alternatively, a declaration that Rule 17d-1 was not applicable. The SEC found that a joint enterprise had already been carried out, and that there was "no warrant for granting retroactive approval to the transactions effected in such violation of the Act."¹⁶⁷ Nonetheless, Talley proceeded with its plans, winning control of the General Time board at the annual meeting; the margin of victory was attributed to the votes cast by the fund.¹⁶⁸ In its suit, the SEC asked the court to compel both Talley and the fund to withdraw the votes cast by them at the annual meeting.

Although the court found Talley and the fund to be "affiliated persons" within the meaning of the Act by reason of the fund's ownership of nine percent of Talley's stock, it nevertheless dismissed the suit. The court held that neither the fund nor its affiliated person had violated section 17(d). American Investors could not possibly be in violation, stated the court, since the section only prohibits activities of the affiliated person and does not restrict the activities of the fund itself.¹⁶⁹ In respect to the affiliated person, the court held that no violation by Talley had occurred. Rule 17d-1 only regulates enterprises or arrangements in which the fund and its affiliate share or jointly participate in the profits. Since the fund had "no financial interest of any sort in the shares of [General] Time bought by Talley nor any agreement, understanding or commitment of any sort ever to have any such interest,"¹⁷⁰ the section had not been violated. Finally, the court observed that there was no conceivable manner by which the fund could be affected financially by Talley's purchase of the shares.¹⁷¹

plained by the fact that the Williams Act is intended to protect all investors while the Investment Company Act is intended to protect investment company shareholders, or those seeking to become such shareholders.

¹⁶⁶ 286 F. Supp. 50 (S.D.N.Y. 1968).

¹⁶⁷ SEC Investment Company Act Release No. 5358 (Apr. 19, 1968).

¹⁶⁸ SEC Institutional Investor Study, *supra* note 122, at 2810.

¹⁶⁹ 286 F. Supp. at 58.

¹⁷⁰ *Id.*

¹⁷¹ *Id.* Note, however, that the market price of General Time's stock had risen from the \$28.49 average paid by the fund to \$39.00 on the day of the district court decision, *Wall Street Journal*, June 24, 1968, at 26, col. 3, plainly due in no small part to the purchases made by Talley and the underlying purpose of the purchases. Of course, it was upon this expectation that the fund had bought the shares initially.

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On appeal,¹⁷² the Second Circuit found substantial evidence to support the SEC contention that section 17(d) had been violated, and reversed the district court's order dismissing the complaint. The court, finding the crucial issue to be the scope of the phrase *joint or joint and several participant*,¹⁷³ ruled that the district court had construed the language too narrowly. Section 17(d), said the court, must have been intended to reach situations not already covered by section 12(a), which prohibits funds from participating on a joint or joint and several basis in any securities trading account.¹⁷⁴

Judge Friendly indicated that the court will not upset a regulatory agency's interpretation of a statutory term where such interpretation is reasonable, nor will it upset an agency's factual determination where there is substantial evidence to support it.¹⁷⁵ The SEC need only find some element of combination in order to establish a joint enterprise within the meaning of the section. When an investment company and an affiliated person engage in a plan to achieve together a substantial stock interest in another company, it is clearly reasonable to hold this to be a transaction in which the investment company is a joint participant. In the instant case, the fund's purchase, on Talley's recommendation, and the subsequent expenditure by Talley of over \$8,800,000 in making further acquisitions at prices exceeding 150 percent of that paid by the fund, did not, under normal industry practice, leave the fund completely free to act with respect to its own shares.¹⁷⁶ The court noted that, although existing evidence indicated that no participation by the fund on a basis different from or less advantageous than that of Talley had yet occurred, the objective of a court of equity must be to insure that it does not happen in the future. Accordingly, the case was remanded to the district court for formulation of an injunction which would ensure that there could be no future participation by the fund on a basis different from, or less advantageous than, that of Talley.¹⁷⁷

On remand, the district court entered an appropriate decree intended to ensure that Talley obtained no advantages not shared by the fund in any future transactions arising from their joint participation.¹⁷⁸

¹⁷² 399 F.2d 396 (2d Cir. 1968).

¹⁷³ The court held that the term "transaction" as used in § 17(d) was not limited to purchases or sales, but was a nontechnical term meaning, simply, "to prosecute negotiations; to carry on business; to have dealings . . ." *Id.* at 402 (citing Webster's New International Dictionary, 2d ed. at 2688).

¹⁷⁴ *Id.* The section referred to is found at 15 U.S.C. § 80a-12(a) (1970).

¹⁷⁵ 399 F.2d at 403-04.

¹⁷⁶ *Id.* at 404.

¹⁷⁷ *Id.* at 405-06.

¹⁷⁸ The decree provided that as long as Talley was affiliated with the fund, they could engage in no joint transactions without SEC approval. Talley was prohibited from selling any General Time shares on the New York Stock Exchange without giving 3 days advance notice to the fund. If the fund desired to sell, Talley was required to wait 10 days unless the fund completed its sales sooner. Talley could sell its General Time shares only on the New York Stock Exchange or through a merger, tender offer or other arrangement equally available to the fund, or in another manner approved by the SEC and the

General Time appealed from the final decree,¹⁷⁹ but the Second Circuit affirmed, holding that section 17(d) "does not aim to prevent an affiliate and an investment company from jointly acquiring control of another company *simpliciter*; it seeks only to prevent their doing this on a basis wherein the investment company fares worse than the affiliate,"¹⁸⁰ regardless of the possible financial damage to shareholders of the target company.

While the holding of the case may be limited to situations involving a joint plan to acquire securities for the purpose of effecting a change in management control, the case appears to stand for the broader proposition that any collective action by a mutual fund and an affiliated person regarding securities may constitute a transaction requiring SEC approval. Such approval, the court suggested, must be freely given as long as measures have been taken by the participants to ensure that the benefits accruing to the fund as a result of its participation in the transaction are at least equal to those of its affiliated person.

Particularly significant for a mutual fund involved in a takeover bid is the disclosure that would result from the necessary submission of its plan for SEC approval. Even a plan previously judged adequate with regard to a similar transaction would also have to be approved as a matter of course. Thus, while section 17(d) does not make joint action by a fund and an affiliated person unlawful, it does prevent such action from being effected surreptitiously. The effect of disclosure would be to provide advance warning to the target of a forthcoming takeover attempt, permitting it time to prepare its defenses.

Interestingly, although the Second Circuit found that Talley's failure to seek Commission approval constituted a violation, the litigation in the *Talley* case left Talley in control of General Time and subsequently the two companies were merged.¹⁸¹ The court made clear, however, that it found no justification for the drastic relief urged by the SEC—*i.e.*, withdrawal by Talley and the fund of the votes cast at the annual meeting, and an injunction against further voting. That remedy would likely force Talley to liquidate its position in General Time, which might well be detrimental to the very shareholders of the fund which section 17(d) was meant to protect.¹⁸² While the court could have found that shares purchased by Talley without prior approval were illegally acquired and that therefore they must be divested, it did not so find. It is submitted, however, that this approach does not in-

district court. Talley was permitted, however, to nominate General Time directors and solicit proxies for their election, or for a merger or consolidation, provided it did not communicate with the fund regarding these matters. 407 F.2d at 68.

¹⁷⁹ 407 F.2d 65 (2d Cir. 1968).

¹⁸⁰ *Id.* at 71.

¹⁸¹ Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2810 (1971) [hereinafter cited as SEC Institutional Investor Study].

¹⁸² 399 F.2d at 405.

dictate a propensity on the part of the Second Circuit to overlook the violation of the filing requirement and examine whether the abuses which it was designed to prevent had, in fact, occurred. This a fund cannot avoid filing and escape liability simply by entering into a joint enterprise under an agreement similar to the final decree entered in *Talley*. Nor does the court's approach represent a continuing reluctance to force an offending affiliate to dispose of his shares simply because of the potentially damaging affect on the fund. Rather, the failure to impose sanctions on the offender appears to represent the court's concession to the defendant in view of the underdeveloped state of the law. As the Second Circuit noted: "Section 17(d) has been rarely construed . . . [and] . . . [n]o [previously] decided case ha[s] ever applied § 17(d) to a situation like that here."¹⁸³

Given the judicial precedent of the *Talley* case, a future defendant may be expected to know what section 17(a) requires, and failure to file properly for SEC approval will invite a forced disposition under a court injunction leaving the affiliate liable to suit by the fund or its shareholders for any injury suffered as a result of the disposition. In such a situation, the fund could face tremendous pressure to place the affiliate's block of shares with another institutional investor, or to purchase the block itself to avoid the depressing effect that a forced sale would have on the stock price.

It is not yet clear what sanctions should be imposed in situations where no securities have been purchased and only a voting agreement is involved. Additional cases, or further proposed revisions of the SEC rule will be necessary before the permissible bounds of the mutual fund-affiliate relationship, in the context of corporate takeovers, is clarified. In the meantime, it is suggested that the simplest means for participants in a takeover bid to avoid the problems here depicted is to take steps to ensure that those with whom they participate do not meet the definition of an affiliated person, which is clearly set forth in Section 2(a)(3) of the Investment Company Act.

D. Disclosure Under the Williams Act

The final, and perhaps thorniest, problem arising from the relationship between a takeover offeror and a participating mutual fund involves the public disclosures which such a relationship may necessitate. Of course, purchase by a fund of shares in any company sufficient to activate the disclosure provisions of the Exchange Act would necessitate appropriate disclosure by the fund regardless of any relationships with others. If, for example, a mutual fund participating in a takeover bid purchased ten percent of any class of the target's securities, it would be required to file the various "insider" reports detailed under section 16(a)¹⁸⁴ and also to file under section 13(d). However, even when

¹⁸³ Id. at 405-06.

¹⁸⁴ Section 16(a) provides:

Every person who is directly or indirectly the beneficial owner of more than

participating in a takeover bid, an individual fund would not likely seek to acquire as much as ten percent of any portfolio company. This is particularly true in view of the discussion above, regarding the requirements imposed by the Investment Company Act on diversified funds, and the stated policies of these funds.¹⁸⁵ The typical offeror seeking institutional investor assistance is aware of these limitations and is more likely to seek a smaller commitment from a number of institutions rather than relying upon the assistance of a single fund. Nevertheless, a fund's relationships with an offeror and others may require disclosure of its interest in cases where it has not *itself* purchased the shares necessary to trigger the statutory reporting requirements. The purpose of this section is to consider the circumstances giving rise to such a result and the consequences resulting therefrom.

The passage, in July, 1968, of the Williams Act Amendments to Sections 13 and 14 of the Exchange Act was intended to place new controls on corporate takeover bids.¹⁸⁶ Section 13(d)(1), added by the Williams Act, provides, in part, that:

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security . . . is directly or indirectly the beneficial owner of more than 10 [now 5] per centum of such class shall, within ten days after such acquisition [file certain specified information with the SEC, the issuer, and each exchange where the security is traded].¹⁸⁷

10 per centum of any class of equity security [registered under the Act] shall file . . . within ten days after he becomes such beneficial owner . . . a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner.

15 U.S.C. § 78p(a) (1970). Thereafter, such person must report any change in his beneficial ownership within ten days after the end of each calendar month during which a change occurs. *Id.*

¹⁸⁵ See text at pp. 1118-26 *supra*.

¹⁸⁶ 15 U.S.C. §§ 78m(d), (e), and 78n(d)-(f) (Supp. V, 1970), as amended 15 U.S.C. §§ 78m(d), (e), and 78n(d)-(f) (1970).

¹⁸⁷ 15 U.S.C. § 78m(d)(1) (Supp. V, 1970). In addition to certain specified information, the section provides for the filing of "such additional information, as the Commission may by rules and regulations prescribe as necessary and appropriate in the public interest or for the protection of investors." *Id.*

The information required to be filed by § 13(d) and by 17 C.F.R. § 240.13d-1 to 4 (1971) includes the following:

- (1) the name and address of the issuer and the title of the class of securities involved;
- (2) the identity and background of the filer, including his name, business and home address, present occupation and employer, employment record for the previous ten years, and any criminal record;
- (3) the source and amount of funds used to make the purchase;
- (4) the purpose behind the purchase and, if the purpose is to acquire control, a description of any plans the purchaser has to liquidate, merge or sell the assets of the issuer, or to make any other major changes in its business or corporate structure;
- (5) the number of shares of the security beneficially owned and transactions effected in them within the previous sixty days;
- (6) the details of any contracts, arrangements or understandings with any person

Because the legislation is concerned primarily with significant changes in corporate ownership indicating a potential change in control, exemption from the filing requirements is provided in section 13(d)(6)(B) for acquisitions by persons whose total acquisitions within the previous twelve months, when added to the present acquisition, do not exceed two percent of the class of securities acquired.¹⁸⁸ In addition, the SEC may exempt or permit the filing of an abbreviated statement by persons the Commission determines acquired the securities in question for investment purposes and not for the purpose of, or having the effect of, changing or influencing the control of the issuer.¹⁸⁹ Section 14(d) requires that the information specified in section 13(d)(1) be filed by any person making a tender offer for shares sufficient to give him beneficial ownership of more than ten percent of all such shares outstanding.¹⁹⁰ In 1970, sections 13(d) and 14(d) were amended, reducing the level of beneficial ownership requiring disclosure from ten percent to five percent.¹⁹¹

The important issue in regard to the Williams Act reporting requirements is whether the funds' traditional methods of participation are within the ambit of these requirements and, if so, whether the methods can be altered to avoid this result. It is submitted that the resolution of this issue depends to a large extent on the interpretation placed upon the statutory language regarding *group formation* and *acquisition of beneficial ownership*.¹⁹²

To date, only two cases have dealt substantially with these issues: *Bath Industries, Inc. v. Blot*,¹⁹³ and *GAF Corp. v. Milstein*.¹⁹⁴ While both these cases discuss the events giving rise to the reporting requirement, encompassing elements of both group formation and acquisition, *Bath* emphasizes group formation and does not deal directly with the problem of defining an acquisition; *Milstein*, on the other hand, deals

with respect to the securities of the issuer;

(7) where a tender offer is involved, the names of all persons employed to make solicitations or recommendations to security holders; and

(8) copies of all solicitations or advertising materials to be used in connection with a tender offer.

¹⁸⁸ 15 U.S.C. § 78m(d)(6)(B) (1970).

¹⁸⁹ 15 U.S.C. §§ 78m(d)(5), 78m(d)(6)(D) (1970).

¹⁹⁰ 15 U.S.C. § 78n(d) (1970).

¹⁹¹ 15 U.S.C. §§ 78m(d), 78n(d) (Supp. V. 1970), as amended 15 U.S.C. §§ 78m(d), 78n(d) (1970). The reduction appears to have been prompted by a large number of instances in which just under 10% of an issuer's securities were acquired prior to a tender offer in order to avoid the reporting requirements. See S. Rep. No. 1125, 91st Cong., 2d Sess. 3 (1970). Since the cases discussed herein were brought while the 10% limit was still in effect, the significance of the holdings in these cases will be discussed with reference to the 10% figure. All other references are to the statute as amended.

¹⁹² This formulation of the issues was suggested in Comment, "Acquisitions" and "Groups" Under Section 13(d) of the Securities Exchange Act of 1934, 13 B.C. Ind. & Com. L. Rev. 149 (1971).

¹⁹³ 427 F.2d 97 (7th Cir. 1970), aff'g 305 F. Supp. 526 (E.D. Wis. 1969), rehearing denied (July 17, 1970).

¹⁹⁴ [Current] CCH Fed. Sec. L. Rep. ¶ 93,300 (2d Cir.), aff'g in part, rev'g in part, 324 F. Supp. 1062 (S.D.N.Y. 1971).

primarily with the acquisition concept and never directly confronts the definition of a group. These decisions vividly illustrate the ambiguities inherent in the statutory language.

The disclosure requirements of section 13 are directed at *persons who are beneficial owners* of the requisite shares. Beneficial ownership has been broadly defined by the SEC in its administration of section 16. In a release restating and clarifying the term as it relates to securities held by family members, the SEC maintained that a person may be regarded as the beneficial owner of securities held in the name of another, if by reason of any contract, understanding, relationship, agreement or other arrangement, he obtains benefits substantially equivalent to those of ownership.¹⁹⁵ Such benefits include use of the income derived from the securities, and the ability to exercise a controlling influence over the purchase, sale or voting of the securities.¹⁹⁶ Thus in a family context, a person is presumed to be the beneficial owner of securities held by members of the family living under the same roof.

The concept of beneficial ownership embodied in the Williams Act is significantly broader than the section 16 definition. Sections 13(d)(3) and 14(d)(2) provide:

When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for the purposes of this subsection.¹⁹⁷

Thus, in the case of such joint ventures, the securities owned by each group member will be aggregated to determine whether the group is the beneficial owner of sufficient shares to trigger the reporting requirements of section 13(d)(1). The House Report on the Williams Act explains:

This provision [section 13(d)(3)] would prevent a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns more than 10 [now 5] percent of the securities. . . . This provision is designed to obtain full disclosure of the identity of *any person or group* obtaining the benefits of ownership of securities by reason of any contract, understanding, relationship, agreement or other arrangement.¹⁹⁸

¹⁹⁵ SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966), 2 CCH Fed. Sec. L. Rep. ¶ 26,030 and ¶ 26,031.

¹⁹⁶ *Id.*

¹⁹⁷ 15 U.S.C. § 78m(d)(3) (1970).

¹⁹⁸ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 8-9 (1968) (emphasis added). Although the value of certain portions of the legislative history contained in this report have been hotly debated, 13 B.C. Ind. & Com. L. Rev. supra note 192, at 164, there is little doubt that the legislature intended to accomplish the result described in the excerpt quoted above. A previous proposal by the SEC to include persons acting as a group for the

Thus, if a mutual fund becomes a member of such a group and the group is subsequently required to file under section 13(d)(1), the fund will be required to provide information for Schedule 13D regardless of the size of its individual holdings. Note B to Schedule 13D clearly states that when the schedule is filed by a group, the required information must be supplied for each member and, if the member is a corporation, for each officer, director or controlling stockholder of that corporation.¹⁹⁹ In addition, amendments to the statement must be filed whenever any material change occurs in the facts disclosed.²⁰⁰

If it is assumed *arguendo* that the existence of a group whose members beneficially own an aggregate of five percent of a corporation's stock has been established, the critical question becomes whether the formation of the group is an acquisition of beneficial ownership sufficient to activate the disclosure requirement. This question was first raised in *Bath Industries, Inc. v. Blot*.²⁰¹ The case involved a contest for control of Bath. Blot, a substantial stockholder and a director of Bath, desired to replace the chief executive officer and move the offices of Bath from Milwaukee, Wisconsin to New York City. Madison Fund, Inc., a closed-end investment company, was also named as a defendant.²⁰²

The trial court found that Edward Merkle, as President of Madison Fund, Blot and two other defendants "undertook a deliberate, conscious plan to pool their voting interests in Bath stock and to acquire additional shares of Bath stock, and to obtain the support and votes of other large shareholders of Bath, all to the end that they could force the resignation of [the president] or force the Directors of Bath to elect a new chief executive officer of their choosing and move the offices of Bath to New York City."²⁰³ Although none of the individuals who were part of the alleged group owned ten percent of the outstanding shares of Bath, the sum of their individual interests approximated fifty percent. The court discussed at length the formation of the group and concluded that the group had violated section 13(d) by failing to file Schedule 13D within ten days after the group had *agreed to act*

purpose of acquiring, holding, disposing or voting securities in the definition of "person" contained in Section 3(a)(9) of the Exchange Act was not adopted. SEC Exchange Act Release No. 6435 (Dec. 12, 1960), [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,730; SEC Securities Exchange Act Release No. 6487 (Mar. 9, 1961), [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,752. In the Williams Act this language was specifically included. In addition, Senator Williams, the sponsor of the legislation, stated that the purpose of § 13(d)(3) is "to successfully close the loophole that now exists which allows a syndicate, where no member owns more than 10 percent, to escape the reporting requirements of the . . . Act." 113 Cong. Rec. 856 (1967).

¹⁹⁹ 17 C.F.R. § 240.13d-101 Note B (1971).

²⁰⁰ 15 U.S.C. § 78m(d)(2) (1970); 17 C.F.R. § 240.13d-2 (1971).

²⁰¹ 305 F. Supp. 526 (E.D. Wis. 1969), *aff'd*, 427 F.2d 97 (7th Cir. 1970), rehearing denied (July 17, 1970).

²⁰² 305 F. Supp. at 530. Although Merkle and Madison Fund were both dismissed by stipulation in the trial court, 427 F.2d at 103, the case remains as an important guide to mutual fund conduct under the Williams Act provisions.

²⁰³ *Id.* at 531.

together.²⁰⁴ An injunction was granted enjoining the defendants from any further accumulation of Bath stock, or carrying out the plan to acquire control, until the court determined that the filing requirements had been properly met.²⁰⁵

On appeal,²⁰⁶ the defendants contended that the statute was not meant to reach concerted action by existing stockholders agreeing to act together but not purchasing additional shares. The Court of Appeals for the Seventh Circuit agreed in part with the defendants' contention, but affirmed the district court's decision after clarifying the necessary elements giving rise to a filing requirement. Informal discussions among existing shareholders concerning inadequate management performance, or even agreements to take over management control, are *not* reportable events, stated the court, even if the shareholders involved hold ten percent or more of a corporation's stock. However, once shareholders possessing the requisite interest "agree to act in concert to acquire additional shares, [disclosure is required]."²⁰⁷

In the court's opinion, the formation of the Blot group for the purpose of acquiring additional shares was itself a reportable event. Since none of the defendants individually owned ten percent of Bath's stock, the court implicitly held that, at the time of the group's formation, the group, as a separate entity or "person," had acquired a beneficial interest in the securities held by its members; this acquisition by the group triggered the disclosure requirements of section 13(d)(1).

While the decision in *Bath* implied that group formation was an acquisition of beneficial ownership reportable under section 13(d), the Second Circuit Court of Appeals in *GAF Corp. v. Milstein*²⁰⁸ directly confronted the issue and reached the same result. *Milstein* involved an attempt by minority stockholders, all members of the same family, to gain control of GAF. Although the defendants held a total of 10.25 percent of GAF convertible preferred stock, none of them individually owned ten percent, nor had purchased any preferred stock since section 13(d) became effective on July 29, 1968. The District Court for the Southern District of New York, per Pollack, J., interpreted section 13(d) more narrowly than the Seventh Circuit had, reasoning that no resort to the legislative history was necessary since "the specific statutory language is clear and compels the construction that the reportable event is the acquisition of the requisite amount of shares and not the mere formation of a group with a view to control."²⁰⁹

GAF argued that a constructive conveyance of the shares from the individual to the group occurs when the group is formed, and constitutes the acquisition of beneficial ownership necessary to bring the

²⁰⁴ Id. at 538.

²⁰⁵ Id. at 539.

²⁰⁶ 427 F.2d 97 (7th Cir. 1970).

²⁰⁷ Id.

²⁰⁸ 324 F. Supp. 1062 (S.D.N.Y. 1971), aff'd in part, rev'd in part, [Current] CCH Fed. Sec. L. Rep. ¶ 93,300 (2d Cir. 1971).

²⁰⁹ 324 F. Supp. 1062, 1067 (S.D.N.Y. 1971).

group under the filing requirements of section 13(d).²¹⁰ The court, however, rejected this argument and all other theories of group acquisition of beneficial ownership in the securities held by group members:

There is simply no statutory authority for saying that . . . a group must report when it makes no purchases at all.

Nowhere does the statute say that the formation of a group with a view to gaining control but without making any purchases of securities, triggers the filing requirement. That result cannot be achieved by attributing ownership of the members to the group, without any other purchase.²¹¹

The Second Circuit Court of Appeals disagreed with these conclusions and reversed the decision of the district court.²¹² Taking a broad view of the acquisition of beneficial ownership in the group context, the court held that when individuals collectively owning more than ten percent of a company's securities *agree to act in concert*, this agreement creates a group under section 13(d)(3) and triggers the reporting requirements under section 13(d)(1).²¹³ Conceptually, it appears that the agreement creates the group and the group, at the moment of its formation, acquires a beneficial interest in the members' securities by reason of the agreement. The acquisition of such beneficial ownership imposes a duty to file under section 13(d)(1) and *no acquisition of shares or agreement to acquire additional shares is necessary*.²¹⁴ The court argued that such an interpretation was necessary in order to effectuate the legislative purpose behind full disclosure of "*potential changes* in control resulting from a new aggregation of stockholdings."²¹⁵ The formation of a group whose members together own over ten percent of an outstanding class of an issuer's securities certainly poses as great a threat to the corporate structure as an individual who purchases the identical amount in one transaction. "It can hardly be questioned," stated the court, "that a group holding sufficient shares can effect a takeover without purchasing a single additional share of stock."²¹⁶

Thus the *Milstein* decision requires disclosure within ten days of the formation of a group, as defined in section 13(d)(3), where the aggregated holdings of the individual members exceeds five percent.²¹⁷ Since initiation of any takeover bid would generally be fruitless unless the dissident forces controlled substantially more than five percent, the critical question for a mutual fund considering participation in

²¹⁰ Id. at 1066.

²¹¹ Id. at 1068. *Accord*, *Ozark Airlines, Inc. v. Cox*, 326 F. Supp. 1113 (E.D. Mo. 1971).

²¹² [Current] CCH Fed. Sec. L. Rep. ¶ 93,300 (2d Cir. 1971).

²¹³ Id. at 91,654-55.

²¹⁴ Id. at 91,655.

²¹⁵ Id. (emphasis in original).

²¹⁶ Id.

²¹⁷ See also 119 U. Pa. L. Rev. 863, 872 (1971); 13 B.C. Ind. & Com. L. Rev. 168.

such a takeover is whether it will be deemed a member of a section 13(d)(3) group. The SEC recognized this to be the crucial factor, observing in its Institutional Investor Study, published after the *Bath* decision but before *Milstein*, that:

Institutions frequently hold and manage large amounts of a company's shares, but do not themselves have beneficial ownership of such shares. The limitation of disclosure to beneficial ownership means that the holdings of a complex of institutions or accounts under common management by a single financial manager are not aggregated in determining whether there must be any disclosure, *except to the extent that the complex constitutes a group of persons within the meaning of Sections 13(d) or 14(d).*²¹⁸

Under the broad statutory language, two or more persons *acting together for the purpose of acquiring, holding, or disposing of securities* constitute a "group" within the meaning of the section. The district court in *Bath* tried to express the definition more simply as a "pooling of interests" with respect to particular securities. It then found that the defendants' agreement to vote in concert constituted such a pooling, making them a group.²¹⁹ The Seventh Circuit took pains to express its disagreement with this definition. It noted that stockholders must be permitted the latitude to discuss corporate affairs, evaluate management performance and band together to influence corporate policy or control without fear of the arbitrary restraints imposed by disclosure. The court indicated that only when they agree to acquire additional shares should their activities come within the purview of the statute, because it is only then that the abuses which the statute was designed to prevent may occur.

The court found this interpretation to be consistent with its review of the legislative history of the Williams Act, which indicated that the overriding purpose of Congress in enacting the legislation was to protect investors by requiring disclosure when substantial shareholders or management *undertake to acquire* shares in a corporation for the purpose of solidifying their own position in a contest involving corporate control.²²⁰ The court noted the evidentiary problems involved in showing that an agreement *to acquire additional shares* existed, apart from the unlikely execution of a formal agreement, but held that when any agreement was shown, a subsequent purchase by a group member would give rise to a rebuttable presumption that the purchase "was made pursuant to an agreement of the group as of that date to acquire shares in furtherance of its objectives."²²¹ By invoking its interpreta-

²¹⁸ SEC Institutional Investor Study, *supra* note 181, at xxvii (Letter of Transmittal of March 10, 1971, from the SEC to the Congress) (emphasis added).

²¹⁹ 305 F. Supp. at 537.

²²⁰ 427 F.2d at 109.

²²¹ *Id.* at 110. Thus, if the total shares held by the group exceeds 10%, then any purchase that evidences formation of a group, even if less than 2%, will trigger the re-

tion of the legislative purpose and insisting upon a market purchase of shares to evidence the agreement, the Seventh Circuit effectively read the language "holding, or disposing" out of the statute. Such a result is inconsistent with methods of statutory interpretation established by the United States Supreme Court, which has stated that "[t]here is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes."²²²

The Seventh Circuit's holding that the acquisition had occurred at the time the group agreed to act together *to acquire additional shares*, rather than simply when it agreed *to act together*, as the district court held, is particularly significant. It allows an undisclosed major shift in corporate voting power to occur where previously independent shareholders pool their shares to form a power block in furtherance of a common purpose, but make no agreement to acquire nor actually do acquire additional shares. Thus, where a number of institutional investors, including mutual funds, participate in a takeover bid, failure to show that some arrangement existed among them and that, subsequent to making that arrangement, purchases were made by at least one of them, would make proof of a violation of section 13(d) a practical impossibility.²²³

In *Milstein*, the Second Circuit eliminated *Bath's* requirement of a subsequent purchase in assessing group formation. After considering the legislative history, the court determined that the purpose behind section 13(d) was to make shareholders and investors generally aware of *potential changes* in a corporation's management, by requiring disclosure of pertinent information from persons who have acquired a substantial interest, or have substantially increased their interest, in a company's securities within a relatively short period of time.²²⁴ In light of this history, the court concluded that the purpose of section 13(d)(3) was to prevent a group of persons, collectively owning more than ten percent of a company's securities and agreeing to act together with respect to those securities, from avoiding the disclosure requirements of the Act merely because no one individual owns ten percent. From this premise, it follows that an agreement to act together on the part of individuals collectively owning more than five percent of a company's securities both creates a group under section 13(d)(3) and triggers the reporting requirements under section 13(d)(1).

porting requirements, since upon its creation the group acquired a beneficial interest in the securities of its members.

²²² *United States v. Amer. Trucking Ass'n Inc.*, 310 U.S. 534, 543 (1940). See also *Browder v. United States*, 312 U.S. 338, 355 (1941); *Addison v. Holly Hill Fruit Products, Inc.*, 322 U.S. 607, 617-18 (1944); and *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 420 (1968).

²²³ Evidence other than a market purchase would be necessary to show that the agreement contemplated further acquisitions; such evidence would, no doubt, be difficult to obtain.

²²⁴ [Current] CCH Fed. Sec. L. Rep. at 91,654.

By eliminating the requirement of a subsequent purchase, the Second Circuit removed the only specific, ascertainable event which could serve as evidence that an agreement, and thus a group, existed. While the statutory language "holding and disposing" compels this result, it raises the problem against which the district court warned: the inherent difficulty of ascertaining if and when an agreement was entered into and a group formed. The circuit court did not consider this obstacle insurmountable and noted that a plaintiff would have to carry its burden of proof by a fair preponderance of the evidence in order to prevail on the merits.²²⁵

Clearly, this burden will not be easily met. In the case of a group acting to acquire or dispose of securities, the actual purchase or sale of those securities by individuals may furnish, as the *Bath* court suggested, a rebuttable presumption or at least an inference that such actions were taken pursuant to an agreement. This is particularly true under circumstances involving the use of the same broker, an exchange of information about holdings in a target company, or simply where large block transactions are made at approximately the same time by persons known to be in frequent communication. Such a presumption would not be useful, however, where persons making no purchases are sought to be included in a group where purchases have been made by others.

The case of the group *acting to hold* securities is somewhat more difficult. Both the *Bath* and *Milstein* decisions recognize that stockholders must be free to discuss corporate affairs, express concurrence with one another on issues of company policy, and vote their shares as they see fit. If shareholders are exposed to filing and reporting requirements, and possible litigation, merely because of their interaction with other shareholders, it will signal the end of the last vestiges of stockholder sovereignty.

One further problem arises with regard to agreements to hold securities for the purpose of voting to effect a change in control: if a shareholder must register as part of a group acting to hold securities at the time he agrees to vote to effect such a change, is he precluded by such filing from changing his mind at a later time? Certainly the voting rights incident to his ownership afford him the opportunity to change his allegiance right up to the moment of voting, which obviously leaves no time to amend his filing. If he does change his vote, shareholders and other investors who relied on the information in his filing may be misled. This problem may be particularly significant in a contest for control among forces which are each receiving the support of mutual funds and other institutions.

The 1967 proxy battle for control of MGM is a case in point. At the time of the contest, fourteen mutual funds and two closed-end investment companies held 1,423,000 MGM shares, or more than

²²⁵ [Current] CCH Fed. Sec. L. Rep. at 91,656.

twenty-five percent of the 5,043,000 shares outstanding.²²⁶ By contrast, the dissident group, led by an MGM director, controlled directly 13.6 percent of the stock and the twelve director candidates proposed by management personally controlled only 5.5 percent of the stock.²²⁷ The annual stockholders' meeting was preceded by an eleven week battle, during which both sides sought the votes controlled by the funds. Six of the funds chose to side with the dissidents, ensuring a close contest. In the final vote, management prevailed, 2,573,000 to 1,882,000, a margin of 691,000 votes.²²⁸ Significantly, the Fidelity Group, which held in its various funds 404,000 MGM shares, or eight percent of the outstanding MGM stock, decided at the last minute to support the management slate rather than the dissidents, as they had previously indicated. If Fidelity had voted on the other side, the dissidents would have prevailed by 117,000 votes, effecting a change in corporate control. In a situation such as this, any disclosures made in advance of the vote, if changeable, would be highly misleading to investors and, if not changeable, would prevent the free exercise of the fund's voting rights. There is no apparent solution to this dilemma.

To date, many other problems under the Williams Act remain unsolved by the cases. As the Second Circuit noted in *Milstein*, "the statute before us is anything but a model of clarity. . . ."²²⁹ The decisions are contradictory and confusing, and may be distinguished on any number of individual facts. They offer no guidelines for the great variety of ways in which mutual fund participation in takeover bids may occur. Violations of the law carry criminal sanctions²³⁰ and create possible civil liability as well.²³¹ Yet it is virtually impossible in many situations for a mutual fund, or an individual, to know when one has become a member of a group or that one is required to file. The question remaining is how a particular mutual fund manager who is mindful of his legal responsibilities but who, recognizing his duty to his shareholders, is unwilling to sacrifice potentially profitable investment opportunities, can come to a meaningful resolution of the issues in a particular case.

It is submitted that, inevitably, the answer lies with the SEC. The Commission must apply its knowledge of the abuses which Congress

²²⁶ Louis, *The Mutual Funds Have the Votes*, *Fortune*, May, 1967 at 150.

²²⁷ *Wall Street Journal*, Jan. 18, 1967, at 26, col. 4.

²²⁸ *Id.*

²²⁹ [Current] CCH Fed. Sec. L. Rep. at 91,654.

²³⁰ Securities Exchange Act, § 32(a), 15 U.S.C. § 78ff(a) (1970).

²³¹ Although the Exchange Act does not expressly provide for private civil remedies, the courts have consistently implied such remedies from the prohibitions of Sections 17(a), 10(b) and others. See *Thiele v. Shields*, 131 F. Supp. 416, 419 (S.D.N.Y. 1955); *Ross v. Licht*, 263 F. Supp. 395, 398 (S.D.N.Y. 1967) (both citing cases); and *Petit v. American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963). The cases indicate that liability may be imposed upon a party not only for direct injury caused by it, but may also be imposed when it assists in or has knowledge of improper activities by other "group" members, or simply by reason of its participation in a group-caused injury.

had sought to reach, and the problems of an overly broad sweep, to carve out exemptions and guidelines to accomplish the legislative purpose. Only one proposal has thus far come to light.²³² Its author argues from the premise that the Williams Act was designed to reveal shifts in beneficial ownership of securities which may portend a change in corporate control (and thus the value of a corporation's securities). The relevant benefits of ownership are those having control implications—*i.e.*, those which confer the ability to exercise a controlling influence over the purchase, sale or voting of securities. A number of individuals would thus be considered a "group" only when the facts of a case indicate that they have obtained incidents of ownership which will enable them to benefit from those activities that the Williams Act intended to be disclosed. The specific tests proposed are as follows: A section 13(d)(3) group is formed (1) for the purpose of holding securities where its constituents have made a firm commitment and the group has the ability to determine how the securities are voted, or (2) for the purpose of acquiring or disposing of securities where the members of the group have received the benefits of market speculation in securities.²³³

It is submitted that some problems exist with this proposal. One unanswered question concerns the formality of the agreement necessary in order to create a firm commitment. Will anything short of an enforceable contract suffice? Moreover, when a takeover bid is in the offing, *all shareholders of the target company* benefit by the speculative purchases of group participants to the extent that they share in the price rise in proportion to their stockholdings. Certainly some sort of collective action is necessary to find that a group exists and to place certain individuals in it. On the other hand, it is not yet clear whether one must actually own securities in order to become part of a group and thus subject to the filing requirements. Nevertheless, this proposal is a necessary start which points the SEC in the right direction.

E. *The Regulated Target and Problems of Control*

When a takeover bid involves a target company subject to federal regulatory statutes other than the securities laws, special problems may arise for participating mutual funds. The federal laws which regulate companies engaged in providing transportation, communication or public utility services contain provisions that are activated whenever any person or group acquires, even temporarily, an interest in a regulated company large enough to represent "control."²³⁴ Since, by definition, a takeover bid involves an attempt to seize control, these provisions are

²³² 13 B.C. Ind. & Com. L. Rev. at 149.

²³³ *Id.* at 174. The author justifies the imposition of stricter standards for groups acting to acquire or dispose of securities than for groups acting to hold on the ground that the voting of securities is intrinsic to the right of ownership, while the ability to purchase and sell securities is a "speculative incident of ownership." *Id.*

²³⁴ The relationship of these statutes to institutional investors was suggested in Enstam and Kamen, *Control and the Institutional Investor*, 23 Bus. Lawyer 289 (1968).

relevant to the conduct of the offeror. If the concepts of group action articulated in the cases arising under the Williams Act²³⁵ are extended outside the disclosure context, the control provisions of these regulatory statutes may also be important for mutual fund participants. There is frequently a time lag between the acquisition of shares by a group of investors cooperating with an offeror, and the transfer, by tender or sale, of those shares to the offeror. To the extent that a group is formed which may be viewed as having acquired voting control over the shares held or acquired by its members by reason of an agreement to purchase or vote those securities, the future action of the group may be subject to the special control provisions of the federal regulatory laws.

If it is assumed that group treatment is possible, the critical question for participants in takeover bids centers upon the word "control": how large an interest may be aggregated before a control position is achieved? It has been generally recognized since long before 1933 that practical control of a corporation does not require ownership of fifty-one percent of its voting securities—or anything near that amount.²³⁶ The term control is used in both the Securities Act of 1933 and Securities Exchange Act of 1934, but it is defined in neither. Under each statute, the SEC has issued regulations which define control in almost identical terms:

The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.²³⁷

The standard here is somewhat flexible, and depends upon the particular characteristics of the company involved and the circumstances of each case.²³⁸

The definition of control included in the Investment Company Act is somewhat broader:

"Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.²³⁹

Although the Public Utility Holding Company Act, Civil Aeronautics Act and Interstate Commerce Act each contain their own definitions

²³⁵ See text at pp. 1153-60 *supra*.

²³⁶ 2 L. Loss, *Securities Regulation* 770 (1961 ed.).

²³⁷ 17 C.F.R. § 230.405(f) (1971) (1933 Act); 17 C.F.R. § 240.12b-2(f) (1971) (1934 Act).

²³⁸ *Rochester Telephone Corp. v. United States*, 307 U.S. 125, 145-46 (1939).

²³⁹ 15 U.S.C. § 80a-2(a)(9) (1970). "Controlling influence" has been held to be something less than "control." *H.M. Byllesby & Co.*, 6 S.E.C. 639, 651 (1940). See also *Koppers United Co. v. SEC*, 138 F.2d 577, 581 (D.C. Cir. 1943).

of control,²⁴⁰ the SEC has found decisions under one act with respect to questions of control useful in cases brought under other statutes, and deserving of "substantial weight."²⁴¹

Most of the SEC control cases which have gone to court have arisen under the Holding Company Act.²⁴² The emphasis in those cases has been on "controlling influence" which the SEC and the courts have stated means something less in the way of influence over management and policies than control, and that latent power²⁴³ or susceptibility to domination²⁴⁴ is sufficient to establish a "controlling influence." The figure most frequently emerging as a measure of control appears to be ten percent²⁴⁵ but, as has been noted, this figure may vary with the circumstances of a particular case. Control, of course, exists wholly apart from the fact whether or not it is exercised, and in most of the statutes cited above, it is the acquisition of a controlling interest that constitutes a violation.

Where control or a controlling influence has been established, the specific provisions of the federal statute under which a target is regulated become relevant. The Federal Communications Act prohibits any person who directly or indirectly controls a person engaged in a telephone or telegraph business, or a radio transmitting, receiving or equipment company, from acquiring control of any other such person where there may be anticompetitive effects.²⁴⁶ In addition, an FCC rule effectively prohibits mutual funds from owning in excess of three percent of more than seven television stations of which five are VHF stations.²⁴⁷ Examples of problems created by this rule for funds participating in takeover bids are indeed available.

In 1966, Banque de Paris des Pays-Bas made a tender offer for shares of Columbia Pictures Corp. The bank was seeking only twenty percent of the 1,970,000 shares outstanding, but it received over 680,000, or about thirty-five percent. The executive vice president of the bank, who was a director of Madison Fund, arranged for Madison

²⁴⁰ 15 U.S.C. § 79b(a)(7)(A) (1970) (Public Utility Holding Company Act); 49 U.S.C. § 1383 (1970) (Civil Aeronautics Act); and 49 U.S.C. § 1(3)(b) (1970) (Interstate Commerce Act).

²⁴¹ *The M.A. Hanna Co.*, 10 S.E.C. 581, 589 n.13 (1941); *The Chicago Corp.*, 28 S.E.C. 463, 468 n.8 (1948).

²⁴² 2 L. Loss, *Securities Regulation* 774 (1961 ed.).

²⁴³ *Koppers United Co. v. SEC*, 183 F.2d 577, 580-81 (D.C. Cir. 1943), and cases cited therein.

²⁴⁴ *American Gas & Electric Co. v. SEC*, 134 F.2d 633, 643 n.22 (D.C. Cir.) (citing cases), cert. denied, 319 U.S. 763 (1943).

²⁴⁵ See Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 399 (1962).

²⁴⁶ 47 U.S.C. § 314 (1970).

²⁴⁷ 47 C.F.R. § 73.636(a)(2) and Notes 4 & 5 (1971) state that no license will be granted to any applicant 1% or more of whose stock is owned by a shareholder having a direct or indirect interest in more than 7 television stations of which more than 5 are VHF. If the shareholder is an investment company, the relevant percentage of ownership is 3%. Holdings of investment companies under common management are aggregated for purposes of determining the percentage of ownership.

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to take 100,000 of the surplus shares. Dreyfus Fund took an additional 190,000 of the surplus shares. When the two funds later pooled their votes with the bank, and with other individuals holding 350,000 shares, in an effort to gain a majority of the seats on the Columbia board, Columbia sued. It challenged the right of the funds to own Columbia stock based on the FCC rule cited above. Dreyfus and Madison each held in their portfolios more than one percent of Metromedia, which owned four VHF stations, prior to buying the shares of Columbia, which also owned four VHF stations. Madison also owned more than one percent of Wometco, which owned three VHF stations.

The suit was settled and the arguments were never heard in court, but the lessons for mutual funds are clear: (1) the fund's inventory of broadcasting stocks must be checked prior to the making of any purchase of broadcasting company securities, whether in the context of a takeover bid or not; violation of the rule could result in a forced divestiture of the shares held by the fund, at unfavorable market prices; (2) the holdings of the *offeror* must also be checked by a fund before participating in a takeover involving a target engaged in broadcasting or owning voting securities of a broadcasting company; the offeror's inability to complete his intended offer because of a statutory control provision or similar administrative regulation may leave the fund with an investment which is fundamentally unsound, apart from the prospect of a takeover bid.

The Public Utility Holding Company Act prohibits any person from purchasing securities in a public utility if he does or will thereafter own or control five percent of the voting stock of such utility plus five percent of the voting stock of another public utility, or of a public utility holding company. In addition, a company itself becomes a public utility holding company if it owns or controls ten percent of the voting securities of a public utility or ten percent of the voting securities of another company that owns or controls ten percent of the voting securities of a public utility.²⁴⁸ If a mutual fund were classified as a holding company, having unconsciously achieved that status as a result of its participation in a control contest, it would be subjected to SEC holding company regulations. Since public utility holding companies may not issue any securities, or acquire securities in other companies without SEC approval,²⁴⁹ the fund again might be forced to divest its interest in the utility, at depressed prices. The Civil Aeronautics Act prohibits the acquisition of control over any air carrier, a common carrier, or a company engaged in another phase of aeronautics.²⁵⁰ Therefore, before purchasing shares of any target subject to this Act, a fund should check on its holdings of airlines and other companies engaged in aeronautics.

The Interstate Commerce Act makes it unlawful, except by approval of the ICC "to accomplish or effectuate, or to participate in

²⁴⁸ 15 U.S.C. § 79b(a)(7)(A) (1970).

²⁴⁹ 15 U.S.C. §§ 79f(a), 79i(a)(1) (1970).

²⁵⁰ 49 U.S.C. § 1378(a)(5), (6) (1970).

accomplishing or effectuating, the control or management in a common interest of any two or more carriers, however such result is attained, whether directly or indirectly, by use of common directors, officers, or stockholders, a holding or *investment company or companies*, a voting trust or trusts, or in any other manner whatsoever."²⁵¹ The statute's definition of a carrier is broad, including common carriers, private carriers and companies that do no carrying at all.²⁵² Once again, care must be exercised when a fund participates in a takeover bid involving a company subject to this act, in order to avoid the same problems which could arise under the acts described above. Problems could also arise under the antitrust laws if a fund had a controlling interest in two competing companies,²⁵³ or had a director in common with a competitor of a company in which the fund held a controlling interest.²⁵⁴

Where a mutual fund purchases securities of regulated companies purely for investment purposes, it is unlikely that any question under the statutory provisions discussed herein would be raised. However, where a fund acquires shares of such a company, or agrees to vote shares already owned, in the context of a takeover bid, a different situation is presented. There appear to be no reported decisions on this point. It is submitted, however, that an unwilling target company determined to resist a takeover bid might seize upon the opportunity to litigate the issues involved. Such a case might turn on the technicalities of the statutory language or upon the court's judgment of the effect of the takeover on the public interest. Here, a decision against the offeror enjoining his offer might be as detrimental to the fund as an adverse decision in a direct suit. By reducing the marketability of the shares and their investment potential, an adverse decision would predictably result in heavy investment losses for the fund.

III. TAKEOVER BIDS AND MUTUAL FUNDS: A VALUE JUDGMENT

In order to determine the manner in which mutual funds should be permitted to exercise their power in influencing contested transfers of corporate control, or whether fund participation should be permitted at all, the economic and social value of such contests must first be assessed. Available empirical data bearing on this determination is inconclusive. In a study of all cash tender and exchange offers made in the period

²⁵¹ 49 U.S.C. § 5(4) (1970) (emphasis added).

²⁵² 49 U.S.C. § 4(3) (1970). Included in the definition are railroads, pipe line companies, express companies, sleeping car companies, motor carriers, and water carriers. "Motor carrier" includes all companies carrying passengers or property in interstate commerce by motor vehicle, whether on a contract basis or as a common carrier. 49 U.S.C. §§ 303(a)(14), (15) (1970). "Water carrier" includes common and contract carriers moving persons or goods by water in interstate or foreign commerce, or anyone who furnishes a vessel for compensation, under a lease, charter, or other arrangement, to a noncarrier to be used to transport his own property. 49 U.S.C. §§ 902(c)-(e) (1970).

²⁵³ 15 U.S.C. § 18 (1970) (Clayton Act).

²⁵⁴ *United States v. Sears, Roebuck & Co.*, 165 F. Supp. 356, 357 (S.D.N.Y. 1958).

from 1956 to 1967, researchers concluded that it is "impossible to state that tender offers lead to corporate reform of previously unprofitable and vulnerable firms."²⁵⁵ On the other hand, there is no empirical support for the view that takeover bids represent attempts by disreputable persons to obtain control of established companies for the purpose of "milking" them, liquidating them or using their assets for further acquisitions.²⁵⁶ It is suggested that the purpose of most takeovers is to enable a company seeking rapid growth or diversification to expand where it can no longer do so internally.

If it is assumed that there exists a relationship between management efficiency and skill and corporate earnings that is reflected in the market price of a company's stock, a corporation which is poorly managed will tend to be underpriced in relation to its potential value. A control contest may result in a better allocation of economic resources by giving new management a chance to improve the target's performance record, or where attack is successfully resisted, by sparking corporate reform. Incumbent management does not, by reason of its incumbency, have a monopoly on the ability to run its business; moreover, there is no basis for assuming that the company would not perform as well or better under different management.

Perhaps in recognition of the inconclusiveness of the data as to the value of corporate takeovers, Congress passed the Williams Act as a means of protecting investors when a takeover was in the offing but, significantly, took a neutral position with regard to the control contest itself.²⁵⁷ In view of this congressional mandate, a difficult question is raised as to whether the legal framework surrounding takeover bids should differentiate between financial institutions, particularly mutual funds, and other investor/shareholders in recognition of the practical and economic differences in their respective abilities to influence such contests.

A number of theories concerning the manner in which funds should exercise their power in takeover contests have been advanced and vehemently supported. The three principal theories may be briefly summarized as follows:

- (1) The power of mutual funds arises from the cumulative investments of small investors, and a duty therefore arises to use this power to advance the interests of all small investors. Mutual funds should exert an influence on the management of

²⁵⁵ Austin and Fishman, *The Tender Takeover*, 4 *Mergers & Acquisitions*, no. 3 at 4, 23 (1969). The study was based upon such data as the rate of return and dividend payout ratios of target companies before and after a takeover bid. See also Hayes and Taussig, *Tactics of Cash Takeover Bids*, 45 *Harv. Bus. Rev.*, no. 2 at 135 (1967).

²⁵⁶ See *What Further Changes Are Needed?*, 25 *Bus. Lawyer* 871, 873 (1969-70).

²⁵⁷ "[E]xtreme care [was taken] . . . to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders without unduly impeding cash takeover bids. Every effort has been made to avoid tipping the balance of regulatory burden in favor of management or . . . the offeror." 113 *Cong. Rec.* 856 (1969) (remarks of Senator Williams).

their portfolio companies or others consistent with this duty. When it has knowledge of a takeover bid, a fund should give portfolio company shareholders and other small investors the benefit of the fund's sophisticated analysis through the mechanism of full disclosure. A fund must not be allowed to use its superior knowledge or financial power to benefit at the expense of the small investor.²⁵⁸ This position, in its essence, espouses a theory of stockholder representative democracy supplanting or augmenting representation by elected directors.

(2) Since the fund manager is not the true owner of the portfolio securities and only holds the voting power fortuitously, funds should be deprived of all voting rights.²⁵⁹ This theory is directed more toward proxy contests than to tender offers, but represents an interesting variance from theory number (1).

(3) A fund's primary (and perhaps sole) obligation is to its own shareholders. When it learns of a potentially profitable situation where, by exercising its influence, it could realize substantial gains for its shareholders, it has a duty to do so. There is no duty on the fund to consider the desirability of a transfer of control from the standpoint of the business and the structure of the companies involved.²⁶⁰

The SEC subscribes to the first of these theories. In 1940, when the Investment Company Act was under consideration for the first time, the SEC articulated its position as follows:

Investment companies may serve the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested. Throughout the course of the existence of such industrial corporations, various problems are presented to their stockholders which require a degree of knowledge of financial and management practices not possessed by the average stockholder. Investment companies by virtue of their research facilities and specialized personnel are not only in a position to adequately appraise these situations but also have the financial means to make their support or opposition effective. These investment companies can perform the function of sophisticated investors, disassociated from the management of their portfolio companies. They can appraise the activities of the management critically and expertly,

²⁵⁸ Baum and Stiles, *The Silent Partners: Institutional Investors and Corporate Control* (1965).

²⁵⁹ Louis, *supra* note 226, at 150.

²⁶⁰ *Id.*

²⁶¹ Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 310 (1966).

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and in that manner not only serve their own interests but the interest of the other public stockholders.²⁶¹

The Investment Company Act which emerged imposed no restrictions on the capacity of investment companies to control the enterprises in which they invest. As late as 1966, the SEC indicated that it was not its intention, nor that of Congress, to restrict investment by mutual funds in their portfolio companies.²⁶² In fact, no regulatory measure prior to 1968 specifically contemplated the facilitation or discouragement of corporate takeover bids, or the permissible role of mutual funds in such bids. However, the actions of mutual funds in a substantial number of contested takeovers in which they participated in the late sixties indicated that they did not necessarily subscribe to the SEC theory, and invited congressional re-examination. The result was the Williams Act Amendments to the Securities Exchange Act, enacted in 1968, and later amended in 1970.²⁶³

As originally conceived, the Williams Act was designed to protect established companies from corporate "raiders";²⁶⁴ however, when enacted, the Act was framed as a means of protecting individual investors from being overreached by others who are aware of impending or potential changes in management control.²⁶⁵ The device chosen to accomplish this objective was that which is relied upon throughout the securities laws—full disclosure; in this case, disclosure of significant shifts in corporate ownership, or impending tender offers was required. It is submitted that this approach has done more to further the purpose of the Williams bill as originally introduced—*i.e.*, the protection of incumbent corporate management, than to protect the uninformed investor. While the philosophical underpinning of the legislation may have changed, the substance of it remained substantially the same and may be relied upon to produce the results originally sought.

A consideration of the investors involved in a takeover bid and the protection provided them by the Williams Act supports the above argument. In a takeover contest, involving mutual fund participants, there are basically three kinds of investors involved—target company shareholders, offeror shareholders and mutual fund shareholders. Each of these shareholders has little concern for his corporation as a business entity. He is primarily concerned with the price of the stock

²⁶² *Id.* at 307.

²⁶³ See notes 186 & 191 *supra*.

²⁶⁴ "In recent years we have seen proud old companies reduced to corporate shells after white-collar pirates have seized control with funds from sources . . . unknown in many cases, then sold or traded away the best assets, later to split up the loot among themselves." 111 Cong. Rec. 28,257 (1965) (remarks of Senator Williams). Other scholars of legislative history have noted that there is some evidence that the purpose of the Williams Act, at least as originally contemplated, was not as stated—to provide additional protection for investors—but to provide protection for management. Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 37-38 (1967) (statement of Professor Stanley Kaplan).

²⁶⁵ 113 Cong. Rec. 855 (1967).

and the dividends paid. He has no interest in management except to the extent that it can increase the value of his shares at a satisfactory rate. The shareholders of the offeror may only be injured financially if the company sustains heavy losses due to expenditures for an unsuccessful takeover bid, or if a successful takeover proves to be ill-advised. Full disclosure offers them no protection in either case and may contribute to their injury by making defeat more likely.

As for the target company shareholder, the maneuvering of each side in a control contest may leave him somewhat confused. Unless he is an unusually sophisticated investor, he is neither in a position to assess the relative merit of the offeror management as against incumbent management, nor to estimate the probability of a successful bid, access to the information filed in Schedule 13D notwithstanding. His actions would more likely hinder than help the group he favored. That is, if he believed a takeover would greatly improve corporate performance, he would retain his shares to profit by the enhanced value he expected new management to create, thus making it more difficult for the offeror to gain the requisite shares to achieve control; if he preferred the present management and were uncertain about the future under the offeror, his fear of a takeover might prompt him to terminate his ownership by selling or tendering his shares, thus increasing the likelihood of a successful tender.²⁰⁶

Since takeover bids are usually made at a ten to twenty percent premium over the current price, to insure acquisition of a controlling interest, the target company stockholder is almost always able to divest his ownership at a premium. When institutions such as mutual funds enter the market to purchase target shares, he may benefit from a further increase in price. In fact, the best protection the target shareholder has is reliance upon the natural market forces, and transactions by sophisticated investors, to value his securities at a price that adequately reflects the likelihood and effect of a takeover bid. To the extent that federal securities laws and SEC rules provide management with an early warning system (Rule 13d-1), prevent offeror purchases outside the tender offer (Rule 10b-13), or otherwise discourage takeover bids by diminishing their chances for success, shareholders are deprived of this opportunity to realize natural market appreciation in the value of their shares. In short, the fortunes of the target company shareholder who sells his shares to a mutual fund that is accumulating stock for later tender to an unknown offeror ought not to be compared with the position of that investor if he had full knowledge of the impending takeover bid, but rather with his position if such a takeover bid was effectively prevented by federal regulation.

As far as mutual fund shareholders are concerned, the net asset value of their shares is likely to increase by reason of any cash profit realized by the fund upon tender of the target shares to the offeror, or

²⁰⁶ Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L.F. 269, 295-96 (1969).

their sale in the open market; any resulting loss is merely incident to the risk the shareholder assumed in selecting a particular fund and placing his faith in the judgment of its adviser.²⁸⁷ The only protection required here is a mechanism that will prevent fund managers from securing personal benefits in control contests at the expense of the fund. Disclosure of purchases by the takeover group is not particularly helpful in this regard. Rather, the fiduciary duty of the fund manager might be supplemented by a rule directed specifically to his actions in takeover contests, possibly carrying criminal sanctions.

The regulatory provisions regarding control contests presently in effect are, in fact, most valuable to the management of potential takeover targets. The advance warning of a forthcoming tender bid provided by a filing under section 13(d) affords the time needed to plan and execute the defensive maneuvers necessary to a successful resistance.²⁸⁸ Public disclosure of the specific information contained in a completed Schedule 13D permits management to pressure the sources of the opposition's funds to withdraw financial assistance, identify group participants and probe for weaknesses in the alliance in order to divide it, and publicly attack the plans of the new group for the target while revealing no plans of its own.²⁸⁹ The motivating factor in formulating a defense is most likely to be the self-interest of management, whether or not it coincides with the interests of target company shareholders.

²⁸⁷ Where an exchange offer is involved, the fund may sell its shares for cash just prior to the expiration of the offer period in order to avoid the risks associated with holding the offeror's securities following the exchange. Such shares are purchased by arbitrageurs who typically purchase target shares while simultaneously selling short securities of the offeror, subsequently covering the short sale by exercising the exchange privilege. One authority estimates that 60-90% of shares tendered in a control contest are tendered by arbitrageurs. *Newsweek*, Dec. 16, 1968, at 86.

²⁸⁸ Target company management may arrange for a competing offer from a company friendly to the target, or otherwise seek to place substantial amounts of its outstanding stock in friendly hands. The corporate charter and by-laws may be amended to provide for an expanded board of directors with staggered terms, election by non-cumulative voting procedures, and an increase in the percentage of shareholder votes necessary to approve a merger.

Any action which will raise the market price of the target's stock, such as a competing transfer bid, an increase in the dividends or a stock split, can make a takeover more expensive for the offeror. Where an exchange offer is made, target company management may solicit sales of the offeror's shares to drive the price down, necessitating an increase in the exchange ratio.

Some targets have gone so far as to enter into contractual restrictions with friendly creditors which would be activated by a change in management, or acquired another company in the same business as the offeror to create potential antitrust problems. *W. Carey, Corporate Devices Used to Insulate Management from Attack*, 25 *Bus. Lawyer* 837. See also *Institutional Investor Study*, Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2838 (1971) [hereinafter cited as *SEC Institutional Investor Study*]. Hearings on S. 336 and S. 3431 Before the Subcomm. on Securities of the Comm. on Banking and Currency, 91st Cong., 2d Sess. 133 (1970) (in one example, Boston & Maine R.R. covenanted that a change in management control would be a default on outstanding bonds; in another, B.F. Goodrich agreed that all bank loans would mature in the event of a change of management).

²⁸⁹ See note 187 *supra*.

In contrast to the foregoing discussion, the SEC appears to believe that the Williams Act does not go far enough in regulating institutional investor participation in takeover bids. In its 1971 Institutional Investor Study, the SEC concluded that a need existed for additional regulation to deal with misuse of undisclosed information concerning a corporate takeover, which the Commission considered to be an area not properly covered by either the Williams Act or Rule 10b-5.²⁷⁰ It noted that any new rules should distinguish between persons who receive information for a legitimate purpose related to a proposed takeover, and those who are given a "tip" for some other purpose.²⁷¹ The SEC did not suggest what a legitimate purpose might be nor did it indicate whether facilitation of the takeover by purchase and later tender of target shares would be legitimately related to the takeover. Nor did the SEC support its finding with any data on the number of takeovers attempted since the passage of the amendments to the Williams Act in 1970.

The SEC further indicated that any new rules must also distinguish between persons who are part of the group attempting the takeover, and who thus may communicate among themselves and purchase shares of the target subject to the requirements of the Williams Act, and those who are not part of the group but who are given the information for other purposes.²⁷² If, however, there is a way for one to receive the information about a forthcoming takeover, purchase target company shares, and *not* become part of a section 13(d)(3) group, the courts have not yet recognized it.²⁷³ In its Study, the SEC observed that the Williams Act requires no disclosure of a takeover bid until after acquisition of five percent of target company shares, thus recognizing the fact that a requirement of public disclosure as soon as a takeover bid is contemplated would be likely to abort the takeover.²⁷⁴ It is submitted that under the developing judicial interpretation of section 13(d)(3) relating to group action in takeover bids, the five percent triggering level will have the same undesirable effect.

CONCLUSION

The wide scattering of ownership in large U.S. corporations has resulted in the separation of ownership from corporate control. Management, owning little or no stock in its company, perpetuates its control through the use of the proxy machinery. Faced with the almost impossible task of influencing corporate behavior, most dissatisfied shareholders do not try to muster support to force a change; they simply sell their shares. The takeover bid jeopardizes retention of management control through the proxy system. In an economic sense, the market for corporate control is perhaps the most important device left for

²⁷⁰ SEC Institutional Investor Study *supra* note 268, at xxxii.

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ See text at pp. 1153-60 *supra*.

²⁷⁴ SEC Institutional Investor Study, *supra* note 268, at xxxii.

achieving an identity of interests between shareholders and management, or at least for making management more responsive to corporate shareholders.

It is submitted that a reappraisal of the full disclosure philosophy, particularly with respect to its application in corporate takeover bids, is long overdue. A law which insures that shareholders may become better informed does not automatically benefit them. Full disclosure is still only a means, not an end in itself. Its applicability to corporate takeover bids should face empirical testing and economic analysis. Political and judicial intervention into essentially private corporate affairs requires a stronger foundation than the perpetuation of past practice and preconceived notions of fairness.

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