

REGULATION 13D AND THE REGULATORY PROCESS

JONATHAN R. MACEY*
JEFFRY M. NETTER**

INTRODUCTION

Pursuant to its authority under the Securities Exchange Act of 1934,¹ the Securities and Exchange Commission (SEC) has promulgated Schedule 13D,² which imposes certain disclosure requirements on persons within ten days of the date that they acquire more than five percent of the beneficial ownership of a public company.³ As this article goes to press Congress is on the verge of reducing the threshold acquisition percentage perhaps to two percent and shortening the window from ten days to two or even one day. As such, it seems an appropriate time to evaluate the welfare effects of these disclosure requirements.

Item 4⁴ of Schedule 13D requires that five percent purchasers of a company's stock disclose their reasons for buying the shares and any plans or proposals they have with respect to the target. The disclosure requirements of the Williams Act are controversial among those commentators applying economic analysis to legal issues because the rules appear to force inefficient wealth transfers from shareholders of bidding firms to shareholders of target firms.⁵ All sides of the debate, however,

* Professor of Law, Cornell University.

** Senior Financial Economist, Office of the Chief Economist, U.S. Securities and Exchange Commission. We would like to thank Dale Oesterle and Annette Poulsen for their valuable comments and helpful suggestions. The Securities and Exchange Commission as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed here are those of the authors and do not necessarily reflect the views of the Commission or of the author's colleagues on the Staff of the Commission.

1. Securities Exchange Act § 1, 15 U.S.C. § 78a (1982).

2. Securities Exchange Act, Rule 13-d, Schedule 13D, 17 C.F.R. 240.13d-1, 240.13d-7 (1986).

3. Securities Exchange Act § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1982).

4. Securities Exchange Act, Schedule 13D, Item 4, 17 C.F.R. 240. Schedule 13D-101, Item 4 (1986).

5. For an earlier analysis of the disclosure requirements from a property rights perspective, see Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 13-14 (1978) ("the disclosure requirements of the Williams Act . . . dilute the value of the property right in privately produced information"). For a particularly critical perspective, see Carney, *Toward a More Perfect Market for Corporate Control*, 9 DEL J. CORP. L. 593, 597-605 (1984).

generally presume that the disclosure requirements in fact cause bidders to provide shareholders with new and useful information about bidders' intentions.⁶

This Article explores the economic and incentive effects of these disclosure requirements. After a brief introduction into the specifics of Item 4, the Article examines the effects of Item 4 under the prevailing assumption that these disclosure requirements actually provide target shareholders with new and useful information about the bidding firm's plans. We observe that under this assumption there are potentially large costs to society from the mandated disclosures. To the extent that bidders must turn over to target shareholders the fruits of their research and disclose their insights as to the true value of the target firm, such bidders lose not only their incentive to undertake such research but also their incentive to acquire the skills necessary to locate undervalued firms. Put another way, Schedule 13D and Item 4 disclosure requirements cause an absolute loss of wealth by reducing bidders' incentives to make wealth enhancing takeover bids in the first place.

Section II of the Article explores the assumption that Item 4 conveys any information of value to shareholders. We find support for the proposition that the Item 4 disclosure requirements are at least partially redundant in the sense that the information disclosed is already incorporated in the target firm's share price by the time disclosures are made. Building on this analysis, our Article examines the likely effects of Schedule 13D under the assumption that the information disclosed in Item 4 is, in fact, redundant.

In Section III we conclude that, to the extent it provides new information to the market, Item 4 will deter beneficial transactions. On the other hand, to the extent that Item 4 disclosures are redundant, they are wasteful, and they exacerbate the agency cost problems facing target firm shareholders because they provide incumbent management with a private right of action to use against hostile bidders in corporate control contests.⁷ And, if Item 4 is redundant, then the Schedule 13D filing require-

6. See Fischel, *supra* note 5, at 13 (describing the disclosure provisions as the "most objectionable feature of the Williams Act").

7. It is not clear why target firms have standing to sue for violations of § 13(d) because arguably, only shareholders are harmed by violations of the statute. Congress did not create an express private right of action, and § 13, in contrast to § 14, does not create an express right of action. Nonetheless, courts have held that both shareholders and targets have standing to sue to enjoin violations of § 13(d). *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972). The Supreme Court, in *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975), held that

ments—irrespective of the information contained in the filings—themselves deter beneficial tender offers. Our analysis calls into question the desirability of the extensive legislation affecting the market for corporate control that deters tender offers and provides incumbent management with additional tools for resisting hostile tender offers. In our view, management has sufficient devices, and more than sufficient incentives, to mount resistance on its own. It is the bidders and not the targets who may be in need of any proffered regulatory assistance.⁸

I. THE LEGISLATIVE HISTORY AND MECHANICS OF 13D

A. *Legislative History*

In 1968, the Williams Act added section 13(d) to the Securities Exchange Act of 1934.⁹ The Williams Act was proposed and adopted against the background of a changing market for corporate control, characterized by a huge surge in the number of takeovers, particularly in the form of cash tender offers.¹⁰ In 1966, the year that Senator Williams first proposed amending the Securities Exchange Act to require substantial disclosure, one hundred cash tender offers had been reported to the SEC. These offers represented a twelvefold increase in only six years.¹¹ Williams and others were skeptical that investors had enough information about these tender offers to make prudent and profitable decisions. They saw required disclosure prior to any cash tender offers as a means for insuring that investors had the information necessary to evaluate a proposed offer.¹² Williams recognized, however, that requiring disclosure for cash tender offers only would still leave investors unprotected in the event that a bid for corporate control was made via the proxy battle. Therefore, Williams designed the statutory scheme to require disclosure

injunctive relief is available for target firm shareholders, although the Court applied the traditional rule of injunctions that requires plaintiffs to have suffered irreparable harm in order to prevail in the lawsuit.

8. See Easterbrook and Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (describing conflict of interest between shareholders and managers of firms that are subjects of takeover attempts).

9. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, *amending* Securities Exchange Act § 13, 15 U.S.C. § 78m (1982).

10. S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967).

11. *Id.*

12. H.R. REP. NO. 1711, 90th Cong., 2d Sess. 3, *reprinted in* [1968] U.S. CODE CONG. & ADMIN. NEWS 2811; 111 CONG. REC. 28,259 (1965) (remarks of Senator Williams); Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149 (1966).

about rapid, large-scale accumulations of stock by one investor or a single group of investors. This ostensibly was done to offer complete assurance that investors would have adequate information about block purchases of their stock, regardless of the takeover method employed.

The Act, as originally introduced in the Eighty-Ninth Congress,¹³ proposed to amend sections 10 and 16(a) of the Exchange Act to require advance disclosure both of acquisitions beyond a trigger percentage of the beneficial ownership of a company and of any cash tender offers.¹⁴ Senator Williams, acknowledging that certain investors might acquire large percentages of shares with no intention of using these blocks to effect a change of control of the corporation, included two exceptions to the advance disclosure requirements. First, if the acquisition, together with all other acquisitions in the preceding twelve months, would not exceed two percent of a class of securities, then no disclosure would be required.¹⁵ Second, the SEC would have the authority to grant exceptions if the purchaser could satisfy the SEC that the acquisition was made purely for investment reasons and would not "in any way change or influence the ultimate control of the corporation."¹⁶

Congress did not adopt this original statutory scheme. Rather, Williams was forced to reintroduce the legislation in the following Congress¹⁷ and to compromise one of its key features. Instead of requiring advance disclosure in both situations, the revised legislation required advance disclosure in the case of the cash tender offer, but not in the case of rapid, large-scale acquisitions.¹⁸

This compromise of requiring advance disclosures only in the case of cash tender offers grew out of criticisms made by the SEC. The SEC took the position that requiring advance notice of a large acquisition

13. S. 2731, 89th Cong., 1st Sess. (1965).

14. S. 2731 would have amended § 10, 15 U.S.C. § 78(i)(1964) to require a notice to be sent to the issuer and a statement filed with the Commission twenty days prior to either acquisition of beneficial ownership of more than five percent of any class of equity securities registered under the Exchange Act or the making of a cash tender offer which, if successful, would result in ownership of more than five percent of such securities; it would have amended § 16(a), 15 U.S.C. § 78p(a)(1964), to require ongoing disclosure for officers, directors and beneficial owners once they acquired five percent of a class of equity securities of a registered issuer. *See* 112 CONG. REC. 19,003 (1966) (Memorandum of SEC in remarks of Senator Williams.) [hereinafter SEC Memorandum.]

15. 111 CONG. REC. 28,259 (1965) (remarks of Senator Williams).

16. *Id.*

17. S. 510, 90th Cong., 1st Sess. (1967).

18. *See* 113 CONG. REC. 854-57 (1967) (remarks of Senator Williams); S. REP. NO. 550, 90th Cong., 1st Sess. 7-11 (1967).

would not be a sound disclosure policy because it would be impossible in some situations and misleading in others.¹⁹ The situations the SEC identified as those that would make compliance impossible were those in which the acquisition was involuntary, such as acquisition by inheritance. The situations identified as misleading were those in which a purchaser filed a disclosure statement, but then changed his or her mind about the acquisition.²⁰ In the later circumstance, investors might pursue the wrong investment strategy because the market might have already reflected the anticipated gain or loss in the stock's price from the effects of the transfer.

The bill that Williams finally ushered through the Senate Committee on Banking and Commerce in the 90th Congress²¹ reflected the SEC's criticisms and incorporated their suggestions thereby radically altering the structure of the legislation as originally authored by Williams. The new bill proposed to amend sections 13 and 14 of the Securities Exchange Commission Act of 1934, rather than sections 10 and 16(a).²² It established the trigger percentage for disclosure at ten percent instead of five percent of beneficial ownership of any class of equity securities.²³ Moreover, advance disclosure, the centerpiece of Williams' original proposal, was completely written out of this new bill. Disclosure for acquisitions of more than ten percent of the beneficial ownership was required within ten days *after* the acquisition.²⁴ Disclosure for cash tender offers that, if successful, would result in the purchaser owning more than ten percent of the beneficial ownership was required *simultaneously* with the offer being made public.²⁵ Congress adopted this bill, now known as the Williams Act.²⁶

B. *The Mechanics*

In its current manifestation, section 13(d) requires a person who acquires more than five percent of the stock of a publicly traded company to prepare a statement containing such information as the SEC prescribes

19. SEC Memorandum, 112 CONG. REC. 19,003, 19,004 (1966).

20. *Id.*

21. S. 510, 90th Cong., 1st Sess. (1967).

22. See S. REP. NO. 550, 90th Cong., 1st Sess. 4 (1967); SEC memorandum, 112 CONG. REC. 19,003, 19,006 (1966).

23. See S. REP. NO. 550, 90th Cong., 1st Sess. 4 (1967).

24. *Id.* at 7.

25. *Id.* at 9-11.

26. See *supra* note 8.

as "necessary or appropriate in the public interest or for the protection of investors."²⁷ The information required is specified in the form of Schedule 13D.²⁸ The acquiror files the statement with the SEC, and the SEC sends it to the issuer and to the exchanges where the security is traded.²⁹

The statute requires the purchaser to disclose his identity and background, the source of the funds used to make the acquisition, and any plans or proposals to make major changes in the "business or corporate structure" of the target firm if the purpose of the purchases is to acquire control.³⁰ Williams envisioned such extensive disclosure as the only method by which "corporations, their shareholders and potential investors could adequately evaluate a tender offer or the possible effects of a change in substantial shareholders."³¹ Without this disclosure, he argued, the Act would fail to achieve its stated purposes: providing the public "with adequate information on which to base intelligent investment decisions, thereby enhancing public confidence in the Nation's securities markets and encouraging healthy growth and development of those markets."³²

Item 4 of the Schedule 13D (the form filed to comply with section 13(d) and Rule 13d) goes a bit beyond the requirements of the statute, adding that the purchaser "state the purpose or purposes of the acquisition of securities" and "describe any plans or proposals which the reporting persons may have which relate to or would result in certain" enumerated types of changes in the management, composition, operation and policies of the issuer.³³

In addition to initial intent filing, 13D investors must file amendments to the original Item 4 in the event that there is "any *material change* in the facts set forth in prior filings" (emphasis added). In general, "material" means that a reasonable investor would find the change important in formulating investment plans—that is, it is a change having direct implications for the market valuation of the firm's shares.

In a nutshell then, a person who buys a greater than five percent interest in a company must make significant disclosures about why he made

27. Securities Exchange Act, § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1982). The percentage figure was reduced from ten percent to five percent in 1970.

28. Securities Exchange Act, Rule 13d-1, 17 C.F.R. § 240.13d-101 (1986).

29. Securities Exchange Act, § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1982).

30. *Id.* at § 13(d)(1)(c); 15 U.S.C. § 78(d)(1)(c).

31. 111 CONG. REC. 28,259 (1965) (remarks of Senator Williams).

32. S. REP. NO. 550, 90th Cong., 1st Sess. 1 (1967).

33. *See supra* note 4.

the purchase. Interestingly, not only the SEC but management of the target firm has standing to sue the acquiror of its stock for filing a Schedule 13D that does not truthfully indicate its plans at the time of the filing.³⁴ The disclosures actually made by bidders in Item 4 filings can generally be classified into four broad groups:

1) acquisition for investment purposes only; 2) acquisition for investment purposes with reservation of right to increase or decrease holdings as conditions change; 3) acquisition for investment purposes with a possibility of seeking control at a later date; and 4) acquisition for control purposes.

Rule 13d, therefore, requires purchasers of stock whose holdings rise above a threshold level to reveal certain information about their plans.³⁵ However, purchasers sued for filing a 13D, Item 4 that does not truthfully reveal their plans at the time of the filing do appear to face what appear to be draconian remedies. When a court finds a violation of Rule 13d-1, it usually orders a corrective disclosure and may enjoin the purchase of more stock or further actions until the Schedule 13D, Item 4 filing is amended.³⁶ In a few cases, the court has gone beyond corrective disclosure and ordered rescission and/or a permanent injunction.

These may not always be relatively minor remedies because in the world of tender offers a delay of only a few days resulting from an injunction is very costly and often fatal to a bid. Thus, a purchaser of five percent of the stock in a company who is contemplating a later tender offer for that company has a strong incentive to reveal his plans in the 13D, Item 4. A bidder who does not reveal his plans for a tender offer faces the prospect of litigation if the bid is opposed by incumbent management.

II. THEORETICAL AND EMPIRICAL CONSIDERATIONS

A. *The Costs and Benefits of Schedule 13D, Item 4, Assuming Non-Redundancy*

While both the SEC and the courts have continued to require full disclosure of all 13(d) information, there are reasons to question the benefits of disclosing all the information required in a 13(d) filing. One of the

34. See *GAF Corporation v. Milsten*, 453 F.2d 709, 720-21 (2d Cir. 1971); *Robinson & Mahoney, Schedule 13D: Wild Card in the Takeover Deck*, 27 BUS. LAW. 1107 (1972).

35. See R. CLARK, *CORPORATE LAW* 548, n.9 (1986).

36. See, e.g., *Kirsch Co. v. Bliss and Laughlin Industries, Inc.*, 425 F. Supp. 488 (W.D. Mich. 1980) (court ordered corrective disclosure and enjoined further purchase of stock until 30 days after the correction was made).

prime examples of potentially harmful disclosure is Item 4, requiring disclosure of the purpose behind all five percent stock acquisitions. Presumably Congress and the SEC continue to require this disclosure because they believe the information is valuable and non-redundant to investors. We will consider information to be redundant if it has already been incorporated into the price of the stock of the firm to which it pertains at the time of its release. In this section, we will assume that information disclosed under Item 4 is non-redundant and discuss the benefits and costs of Item 4 disclosure requirements to see if they are justified. In the following section we will again examine the costs and benefits of Item 4 and Schedule 13D, presuming the information in item 4 is redundant.

1. Benefits of Item 4 Assuming Non-Redundancy

One all-encompassing argument in support of the position that Item 4 is useful to shareholders is that the capital markets themselves somehow are "entitled" to all available information about those firms whose stock is publicly traded. Even Boyd Jefferies, who later pled guilty to two felony counts of securities law violations—including a 13D violation, said in an SEC Roundtable Discussion that the marketplace is entitled to information, "good, bad or indifferent."³⁷ Presumably those who subscribe to this view are of the opinion that the information required in Item 4 should be disclosed because it will lead to more efficient investor decisions regarding capital allocation. In turn, these more efficient investor decisions will insure that capital flows to the highest valued users.

One can also argue that the absence of the Item 4 information, on the plans of large blockholders, could increase the likelihood of fraud in securities transactions. Darby and Karni, in their classic article, argued that incomplete information on the part of a consumer about a good's qualities creates favorable conditions for fraud by a seller.³⁸ They showed that individual sellers of certain kinds of goods have incentives to engage in fraud, leading to an equilibrium with a non-optimal allocation of resources.³⁹ This, too, may lend support to the case for requiring disclosure of Item 4 information.

A staunch supporter of Item 4 disclosure might even argue that this

37. Boyd L. Jefferies, S.E.C. Roundtable Market Rumors and Trading Halts, (February 19, 1986).

38. Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67 (1973).

39. *Id.* at 70.

information should be disclosed because information is a public good. For example, Professors Coffee and Easterbrook and Fischel present a case for a federal scheme of regulation that mandates the disclosure of certain types of information.⁴⁰ They identify factors that would lead self-interested firms to not release the socially optimal amounts of information. In general the Easterbrook and Fischel arguments are grounded in the public good and externality aspects of the economic theory of information.

A public good is one for which it is costly to exclude those who have not paid for the good from consuming it. A fireworks display is an example of a public good produced. Free riding by people who consume a public good but decline to pay for it, can prevent the producer of a public good from appropriating all the benefits from its production and sale. The resulting reduction in incentives to provide the good can lead to a provision of less than the socially optimal level of the public good. Commentators such as Coffee, Easterbrook and Fishel argue, in the case of information such as that mandated in the federal security disclosure regulations, that if the developer of information cannot appropriate all the benefits from the information he discovered, he will engage in less research. As a consequence, not enough information will reach the market. That is, in the absence of mandated disclosure, investment analysts who study security investments might not develop the beneficial information because others could appropriate the research. Not all those who listen to E.F. Hutton, ("When E.F. Hutton talks, people listen,") are paying for the information developed by E.F. Hutton. Federal disclosure regulations can alleviate this problem, it is argued, by requiring the release of certain information.⁴¹

While the above arguments appear to support the position that Item 4 disclosure can be beneficial, we argue that a closer examination reveals

40. See Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984). Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investor*, 70 VA. L. REV. 669, 680-87 (1984).

41. Non-excludibility is only one characteristic of a public good. A pure public good also has the property that one person's consumption will not reduce the consumption of the good by another consumer. A good example of a pure public good is national defense. Whether a person pays for defense or not, he receives the benefits of an existing defense force. An individual's consumption of defense presumably does not reduce the amount of defense available for others. The problem with public goods is that their characteristics lead a market system to provide too little of the good, because no individual has the incentive to purchase the optimal amount of the good. He will just wait for others to purchase the good. Therefore, an optimal solution may require a government to tax to raise the funds for the good.

that these benefits may be virtually non-existent and that the mandated disclosure in Item 4 may also create substantial costs. All three of these arguments are severely flawed in the case of Item 4 and a strong case can be made that the disclosure requirements of Item 4 should be eliminated.

The public good argument in favor of mandated disclosure is inapplicable as applied to the disclosures required in Item 4 because its mandated disclosure increases rather than reduces free-riding. Markets fail to provide enough output of public goods because free-riding reduces incentives to produce the goods. However, unlike disclosure requirements that require firms to release firm-specific information that can be used by investors, Schedule 13D, Item 4 requires investors to release information they have already developed about other firms. Therefore, in the case of Item 4, free-riding is caused by the mandated disclosure. It transforms information developed by an acquiror *into* a public good. Other investors can free-ride on the research done by the filer who must reveal his plans.

The effect of this disclosure is to reduce the incentives for investors to make the type of investments that must be disclosed. The information of value is the bidder's plans. The probability of the information never coming into existence *increases* if bidders must disclose the information before realizing its full profit potential. In the absence of mandated disclosure, the bidder's plans quickly will become known to the public through the bidder's actions. Thus, without mandated disclosure there is no public good problem because the economic benefits from the bidder's information (for example, a tender offer at a price greater than the market price) will be realized even if the information is not disclosed in advance to the market. The effects of requiring disclosure are purely distributive. In fact, as we discuss below, beneficial tender offers may not occur if bidders are forced to disclose their plans.

In addition, Easterbrook and Fischel, while making a case for mandated federal disclosure, were careful to point out, "we have not constructed a compelling case for regulation of any sort, let alone for the particular regulations the SEC uses."⁴² Easterbrook and Fischel did not attempt to justify regulations, such as Item 4, that impose duties on the purchasers of stock to reveal information. The related argument, that 13D statements provide notice to competing bidders and thus begin a competitive bidding process, is similarly flawed. While auctions may be

42. Easterbrook & Fischel, *supra* note 40, at 714.

beneficial to target firm shareholders, firms should not be compelled to conduct an auction for the sale of their own assets any more than they should be forbidden to do so.⁴³

The argument about the possible increase in the incidence of fraud is equally misguided. A large literature has discussed how market factors constrain opportunistic behavior of which fraud is an example.⁴⁴ For example, Darby and Karni⁴⁵ illustrated market mechanisms that deal with the fraud problem. More importantly for our discussion, concerns about fraud arise when the *seller* has special knowledge that is unknown to the buyer at the time of purchase. We believe there is no analogous problem when the *buyer*, who has developed some information about the seller's product, exchanges a known commodity, such as cash, for the product. Presumably, the seller could have developed this information but didn't, and the buyer (the filer of the Schedule 13D, Item 4) should be able to keep his information confidential. This is unlike the usual case, covered by legal theories of fraud, where the seller has special knowledge that can be used to defraud a buyer because there may have been no chance for the buyer to develop the information.⁴⁶

It is informative that the common law has never imposed a duty to reveal information analogous to the disclosure requirements imposed by 13D, Item 4 on individuals who buy more than five percent of the stock in a company. Fraud is the analogous tort. In certain circumstances sellers, not buyers, must reveal information about the product that is being sold,⁴⁷ but even sellers are not usually required to provide information about future plans.⁴⁸ Parties who have been damaged by a false statement may also have a contract remedy for breach of warranty. But the existence of warranties never imposes any enforceable affirmative dis-

43. Haddock, Macey and McChesney, *Resistance to Tender Offers and Optimal Property Rights in Assets*, 73 VA. L. REV. 701 (1987).

44. See *supra* note 38.

45. See, e.g., Klein, Crawford & Alchain, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POLIT. ECON. 615 (1981).

46. There is an analogy that perhaps can be drawn to insider trading. An insider such as a majority shareholder or a member of the board cannot buy stock from others if he has material inside information not publically available. Of course, this is still very different from requiring all those who purchase more than five percent of stock to reveal their purposes and plans for the stock.

47. See the discussion of fraud in W. KEETON, PROSSER & KEETON ON TORTS 740 (5th ed. 1984).

48. *Id.* at 762.

closure requirements on buyers.⁴⁹

Proponents of 13D disclosure also defend such disclosure on the ground that it provides accuracy to otherwise speculative positions in stock. This argument neglects the fact that whatever inaccuracy exists in the share price of a target firm reflects valuable information that can only be discovered at considerable cost. Requiring premature disclosure of this information deprives bidding firms of any incentive to gather this information in the first place. Thus mandatory disclosure ultimately results in less accurate share prices for target firms as fewer bidders engage in the search process that uncovers such information.

Finally, even if there are benefits from the disclosure mandated in Item 4, these benefits must be balanced against the costs. There are efficiency reasons for keeping information confidential in certain situations. We believe that hostile takeovers present one such situation. The takeover process facilitates the movement of corporate resources to their highest valued users. The process requires bidders to engage in a costly search for information about potential targets.⁵⁰ Requiring bidders to disclose this information before they have realized its full value through purchases of a target firm's stock will lead to suboptimal search levels by bidders.

2. *Costs of Item 4 if it Provides Non-Redundant Information*

While the theoretical support for the existence of benefits from Item 4 disclosure is limited, the theoretical arguments that these disclosure provisions impose potentially high costs on all shareholders are highly persuasive. Forcing potential bidders to disclose their motives for buying shares and their plans for increasing the value of the target firm decreases the likelihood that such value-increasing activities will occur. This is a classic example of the free-rider problem. Specifically, this disclosure can deter beneficial tender offers by reducing the gains to bidders from takeovers.

Empirical evidence strongly indicates that takeovers benefit target-firm

49. *Id.* at 675. A buyer may find it in his interest to reveal plans for a product. But the only duty that can arise in this situation is an implied warranty of fitness for a particular purpose which is given by the seller.

50. See Fischel, *supra* note 5, at 16. For a discussion of the costs involved in identifying potential targets, see Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1981).

shareholders and society as a whole.⁵¹ Grossman and Hart, among others, have shown that if socially desirable takeovers are to exist, bidders must be compensated for the costs of investigating and acquiring potential targets.⁵² Grossman and Hart demonstrated that value maximizing shareholders, who are aware of the fact that their firm is worth more in the hands of an outside bidder, will not tender unless they are paid a price at least equal to the value of the firm to the acquiror.⁵³ They based their conclusion on the assumption that each shareholder is small enough that his tendering decision will not affect the outcome of the tender offer.⁵⁴ Their results hold even though accepting a lower bid would benefit target shareholders as a group. The only way around this free-rider problem is to let the raider exclude shareholders from completely sharing in the benefits of the takeover. Therefore, mandated disclosure laws can have dramatic effects on the probability of takeovers occurring and succeeding. Strict mandated disclosure laws decrease the threat of takeover bids by reducing appropriable benefits to bidders.

The above analysis applies with equal force in the case of a raider or pirate who plans to loot the target firm by converting its assets to his own personal use at the expense of non-tendering shareholders. In principle, full disclosure rules provide shareholders with information about the looter's intentions. But, just as full disclosure may prevent higher valuing users from acquiring control, it may (absent other constraints) facilitate the acquisition of control by looters. Shareholders who receive an announcement that leads them to conclude a bidder is a looter unquestionably will be strongly inclined to sell out at the firm's current market price in order to avoid the danger of other shareholders selling out and being left with a minority position in a firm controlled by looters. This will drive the price of the firm's shares down and make it less costly for a looter to obtain control. Of course, the process also works in reverse. As Professor Loss has succinctly put it, "one result of full disclosure may well be: the better the reputation and attainment of the offeror, the

51. See Gregg Jurell, James Brickley, and Jeffrey Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," *Journ. of Economic Perspectives* Forthcoming (1987) for an excellent summary. Takeovers not only improve efficiency by replacing inefficient management but also by increasing the incentives of all managements to be efficient to escape hostile takeovers.

52. Grossman & Hart, *The Allocational Role of Takeover Bids in Situations of Asymmetric Information*, 36 *J. FIN.* 253 (1981).

53. Grossman & Hart, *Disclosure Law and Takeover Bids*, 35 *J. FIN.* 323 (1980).

54. *Id.* at 327.

higher the price he will have to pay.”⁵⁵

This reasoning applies not only to looters but also to management teams that are perceived as inferior to incumbent management. Disclosure rules give these bidders an edge over bidders representing management teams perceived as being superior to incumbent management. Shareholders will have incentives to sell their shares (lowering share price) if an inferior management team is in a position to obtain control in order to avoid future capital losses from the expected poor performance of the new management. On the other hand, shareholders will hold their shares, hoping their value will increase, if a new highly qualified management team may take over. Thus, it will be very costly for the new better management to obtain control. Ironically, if shareholders behave rationally, under the current disclosure regime new, poor management teams can prevail in tender offer battles and strong, competent management teams may be met with defeat.

Second, logic dictates that, if potential bidders are forced to disclose their plans, the bidders are less likely to make an offer in the first place. The problem is that the earlier a buyer's plans are disclosed, the greater the likelihood he will lose the bid because management can enact changes that diminish his probability of success. For example, incumbent managements have implemented corporate restructuring policies as defensive tactics in control contests. Frequently, these restructurings mimic the policies initiated by bidders in the control contests. While the beneficial policies that the bidder proposed are implemented in the restructurings that occur, aggregate shareholder wealth declines because bidders, unable to appropriate the gains, have less incentive to research targets in the first place. In addition, third parties, using the information discovered by initial buyers can come in and outbid initial purchases due to the lower costs incurred by the third parties. While the initial bidder may be able to sell his foothold in the target at a profit under either scenario, often this potential trading profit may not adequately compensate the first bidder for his research costs. The possibility of not fully recouping research costs must diminish the number of bids made.⁵⁶ This reduction in the likelihood of tender offers occurring can result in a significant loss to investors.

Jarrell and Bradley found empirical support for these arguments in

55. L. Loss, *FUNDAMENTALS OF SECURITIES REGULATION* 580 (1983).

56. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 *STAN. L. REV.* 1 (1982).

their study of the effects of the Williams Act and state regulation of tender offers.⁵⁷ They argued that these regulations, which force increased disclosure and delay the execution of tender offers, have diluted acquiring firms' property rights in information. These regulations have caused an increase in the premiums paid in tender offers, which redistributed the gains from acquirors to target firm shareholders.⁵⁸ Because acquirors receive a smaller share of the gains from takeovers, Jarrell and Bradley argued, the regulations have reduced the number of takeovers and reduced the social gains from takeovers. Furthermore, the gains to bidders have been declining over this time. This evidence provides strong support for the hypothesis that mandated disclosure deters socially beneficial investments in research and beneficial takeovers.

A final problem, related to the previous one, is that, because requiring disclosure of Item 4 reduces the likelihood of tender offers, potential bidders will not monitor management's performance to the same extent as they would otherwise. This decreased level of monitoring can allow management to continue policies detrimental to the firm's shareholders.⁵⁹ The sources of agency costs and the effect of the market for corporate control in controlling those costs have been well documented. Mandated disclosure of Item 4, by reducing the incidence of takeovers, permits, and perhaps encourages suboptimal performance by managers. The higher level of agency costs permitted by Item 4 can result in lower stock trading prices of potential targets.

In sum, it appears to us that there are potentially high costs and potentially small benefits from the disclosure mandated in 13D, Item 4. We base this analysis on the assumption that Item 4 provides non-redundant information. In fact, as shown below, some of the information contained in Item 4 may be redundant given the other disclosure requirements of Schedule 13D. In the next section we examine the stock-price evidence on the information contained in Schedule 13D's and discuss other costs associated with its requirements.

57. Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980).

58. While the premiums paid to target shareholders are higher, they receive fewer bids. Jarrell and Bradley argued that the net effect has been a loss for target shareholders.

59. See Easterbrook & Fischel, *supra* note 8.

III. REDUNDANCY AND THE COSTS AND BENEFITS OF ITEM 4

A. *Empirical Evidence—At Least in the Case of Corporate Raiders, Item 4 Disclosure May be Largely Redundant*

The efficient capital market hypothesis posits that stock prices of public companies at any given time “fully reflect” all publicly available information about the firm. The efficient capital market hypothesis is widely accepted; as Professor Jensen has observed, “[t]here is no other proposition in economics which has more empirical evidence supporting it than the efficient market hypothesis.”⁶⁰ In the case of 13D disclosures, the efficient market hypothesis can be used to draw conclusions about the importance of disclosures by examining the magnitude of stock movements at the time of the disclosures. If, after disclosure, the stock price of the firm to which the disclosure pertains does not change, it is reasonable to infer that the disclosure contained no new material information.

Our analysis of the stock price evidence on 13D filings suggests that, in certain situations, the important distinction between control and passive block formation is made largely by the market without the help of Item 4 disclosures. The evidence suggests that the market can reach conclusions, based solely on its knowledge of the identity of the block purchaser about whether such a purchaser’s 13D investment is a prelude to an attempt to gain control of the target firm. The purchaser’s identity is an important bit of information because active blockholder-investors such as arbitrageurs develop bonded reputations that the market uses in predicting the ultimate outcome of investment decisions. In addition, certain other investors develop particularized expertise in decoding the signals contained in the purchases of others. When the market learns the identity of certain filers, the available stock price evidence suggests that the additional disclosure contained in the Item 4 disclosure documents adds little information.

Table 1 summarizes several studies examining the stock price reaction to 13D filings, grouping the data on the alternate bases of intent (control or passive) and identity (raider or non-raider).⁶¹ The data indicates that for well known corporate “raiders” intent and identity have similar stock

60. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95 (1978).

61. The stock price evidence discussed here is based on a calculation of abnormal returns (also called excess returns or net of market returns). An abnormal return is the change in the stock price of a firm that cannot be explained by changes in market conditions. Thus, the price change is due to firm-specific events. Cumulative abnormal returns (CARs) are abnormal returns summed over some period. A further discussion of this technique is presented later in the Article.

price effects, averaged over large samples of 13D filings, when control intent is compared to "raider" identity, and passive intent is compared to "non-raider" identity.

Mikkelson and Ruback provided information on the stock price reaction to 13D filings, classified by the information contained in Item 4.⁶² They found that the valuation effects of 13D filings, in cases not associated with an outstanding takeover, depended on the investor's intent. (Their results are listed in the Stated Intent columns in Table 1.) Mikkelson and Ruback calculated the abnormal returns in the two-day window around the initial announcement of the filings. The highest returns, an increase of 7.74%, occurred when the filer mentioned the possibility of a takeover in the Item 4. By contrast, the abnormal returns were only 3.24% if the investor reported the purchase was for investment purposes only. These results indicate that the market obtains valuable information from the filings of 13D's—information that is related to the intent of the investor.

Another issue is the ability of the market to infer intent from the disclosure of the filer's identity, thus reducing the importance of the specific information in Item 4. Holderness and Sheehan performed a more direct test of the effects of the identity of the investor in 13D filings on the price of a target stock.⁶³ (These results are reported in the Identity of Filer column in Table 1.) Poulsen supported their results by subsequent research.⁶⁴ Holderness and Sheehan found that for six individuals, all of whom are commonly described as corporate "raiders", net of market stock prices increased 5.9% in the ten-day period preceding the first public announcement of the acquisition, while for a control sample of other investors the net of market stock prices increased only 3.4%.⁶⁵ Most

62. Mikkelson & Ruback, *An Empirical Analysis of the Interfirm Equity Process*, 14 J. FIN. ECON. 523, 535 (1985).

63. Holderness & Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555, 567 (1985). The six investors Holderness and Sheehan studied were Icahn, Jacobs, Lindner, Murdock, Posner, and Bludhorn. They chose these six individuals because all are publicly viewed as raiders.

64. A. Poulsen, *Market Reaction to Corporate Raiders as Individuals*, (Office of the Chief Economist, Securities and Exchange Commission, Working Paper, 1984).

65. Holderness and Sheehan found that on the day of the first public announcement of stockholding the abnormal returns in target firms was 1.8% for the raiders' targets and .4% for the other targets, a significant difference. Poulsen found a 6.10% abnormal return for raiders' targets in the day (-20) to day (1) window around the filings of three raiders. The abnormal returns were even higher for Posner and Icahn in the Poulsen sample. See Poulsen, *supra* note 64.

importantly, Holderness and Sheehan found these differences (5.9% to 3.4%) to be statistically significant.

A comparison of the Mikkelson and Ruback and Holderness and Sheehan stock-price evidence is revealing. The evidence suggests that, while the intention of an investor is valuable information to the market, that intent may be inferred from the revelation of the identity of the investor, particularly if the investor is a well-known raider. The 13D filings revealing a possible control intent in Item 4 have a similar impact on stock prices as do the filings of raiders (7.74% to 5.9%), while passive intent and non-raiders' filings also have similar stock-price effects (3.24% to 3.4%).

One must be careful in drawing too strong a conclusion about the comparison of the effects of identity and intent based solely on a comparison of these studies. Mikkelson and Ruback and Holderness and Sheehan did not calculate abnormal returns for the same exact windows and the studies used different samples of filers. In addition, Holderness and Sheehan did not control for the intent stated in their sample of 13D's, and Mikkelson and Ruback did not control for the identity of the investors. Thus, the differential stock-price effects that Holderness and Sheehan found for raiders may occur because raiders state a control intent in their Item 4's more often than other filers. On the other hand, stock-price increases that Mikkelson and Ruback attributed to a control intent stated in Item 4 may in fact be derived by the market simply from the identity of the filers. Definite conclusions on the importance of Item 4, given the identity of the filer, will require further empirical work.

At least in the case of one very well-known raider—Victor Posner—we do have direct evidence that the market can infer a probable control intention from identity alone. Holderness and Sheehan found that the filing of a 13D by Victor Posner is associated with a 7.0% abnormal return earned by holders of targets' stock. However, our own examination of nineteen of Posner's actual initial 13D filings revealed no cases in which the Item 4 indicates that the acquisition was part of a plan to seek control of the company.⁶⁶ In every case, the 13D filing stated that the acquisition was for investment purposes and reserved the right to increase or decrease holdings as conditions change. "Control" was never mentioned.⁶⁷ Therefore, at least for Posner's filings, the evidence indicates

66. Poulsen found the cumulative abnormal return in the window day (-10) to day (0) was 7.3% for the stock prices of these 19 firms. See Poulsen, *supra* note 64.

67. We also found that Icahn's initial 13D's rarely contained an intention to seek control.

that the market forms its judgments about control intention from his identity, not from its judgments about control identity, and not from the Item 4.⁶⁸

In sum, the authors believe there is evidence supporting the hypothesis that stated intent in 13D's may be redundant in that it provides the market with no new information beyond that which can be gleaned from knowledge of the identity of the filers. There is an important caveat to these results. This empirical evidence is based on the actions of well-known raiders. Their reputation conveys valuable information. The market may not be able to predict as easily the intent of a less well-known purchaser simply from his identity. Thus, there may be significant benefits to some investors from the revelations in the Item 4 filed by an unknown investor. Of course, such purchasers will develop reputations that allow the market to predict the ultimate outcome of those acquisitions if the benefits to the market of acquiring the expertise to make these predictions come to outweigh the costs. And the ability of market professionals to discern the intentions of a purchaser from knowledge of his identity should not be underestimated.

In sum, we believe there is evidence that Item 4 is at least partially redundant. The problem is that there are costs to Item 4 even when it provides no new information. In the next section we discuss some observed costs related to Item 4 disclosure. We show the effect of target management's suits may be to reduce target shareholder wealth. In addition, because Item 4 may make a tender offer more difficult to implement, this requirement may actually deter significant stock purchases by potential bidders.

B. Costs and Benefits of Item 4 Assuming At Least Partial Redundancy

Assuming that at least in some cases Item 4 may provide no information not revealed by disclosure of a bidder's identity, where does that leave our argument on the costs and benefits of 13D, Item 4? Most importantly, when Item 4 provides no additional information, our preceding analysis is still valid with respect to 13D's in general because those

However, his initial filings still were associated with a price increase that indicated the market expected a control contest (7.2% abnormal return in the Holderness and Sheehan study, 12.7% abnormal return in the Poulsen study).

68. An examination of the eventual outcomes of these 19 cases revealed that Posner eventually made a tender offer in four cases, and obtained control or a seat on the board in three of these firms.

filings require disclosure of the bidder's identity as well as his plans. That is, if the market can infer the bidder's plans from his identity, then all our arguments about the distinctive effects of Item 4 filings still apply to 13D filings, although the harm comes not from disclosure of the bidder's plans, but from disclosure of his identity. Where disclosure of a bidder's identity reveals the nature of his plans, inefficiencies result because investors can not appropriate all the benefits of their research. As such, the resulting costs, discussed earlier, of deterred tender offers and reduced checks on incumbent management will result where disclosure of identity provides target shareholders with useful information.

1. *Item 4 as a Defensive Device*

Ignoring those deterrence effects caused by the disclosure mandated in Schedule 13D, costs to the Item 4 requirement still exist even if the information it provides is redundant. Obviously, where Item 4 is purely redundant, it is of no value to investors. But it is not possible to conclude that when Item 4 is redundant it can do no harm. In addition to the substantial direct costs of preparing the disclosure documents, we believe the disclosure mandated in Item 4 causes inefficiencies because it gives entrenched management an additional weapon to use against hostile bidders.

This Article will not digress into the arguments for and against the ability of management to use defensive tactics in general. We wish to start our analysis, however, from two well-established premises. First, while target shareholders may benefit from resistance, resistance to takeovers should not be mandated. Second, to the extent that defensive tactics benefit shareholders, incumbent management, who presumably wish to keep their jobs, are perfectly capable of presenting their shareholders' interests to the extent that resistance to a hostile bid is called for. In short, the danger is of too much resistance, not too little.⁶⁹

At first glance, it is difficult to see precisely how target management might use the 13D disclosure requirement to further entrench itself. The

69. See Haddock, Macey and McChesney, *supra* note 43. There is a large literature analyzing empirically the effects of defensive tactics by incumbent management. See, e.g., Jarrell & Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, J. FIN. ECON. (forthcoming) (authors demonstrated that some antitakeover amendments reduce target shareholders' wealth). But see Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J. L. & ECON. 151 (1985) (defensive tactics may increase shareholders' wealth).

direct costs that the disclosure requirements impose on raiders, such as hiring lawyers to prepare Schedule 13D reports, appear trivial compared to the total cost of launching a tender offer. Further, if the information is redundant, it seems unlikely that it can benefit incumbent management.

The Item 4 disclosure requirements constitute a device used by target management to entrench itself because it gives recalcitrant target management additional grist for the lawsuit mill. As previously discussed, Schedule 13D requires purchasers of five percent of a corporation's common stock to disclose their intent (plans) with respect to the target corporation. In addition, five-percent purchasers must amend their 13D filings in the event there is any material change in the facts set forth in prior filings. In our view, the vagueness inherent in defining intent provides target management with the ability to obtain preliminary injunctions and temporary restraining orders under Item 4 auspices. This may be just one of the actions filed by target management in its defense, but it is a relatively inexpensive weapon, and it has an imprimatur of legitimacy lacking in other defensive tactics.

2. Overview of the Item 4 Cases

In order to examine the possibility that Item 4 can be used as a defensive tactic, we developed a virtually exhaustive set of reported cases in which the 13D investor was sued over alleged violations of Item 4 disclosure. In these cases the 13D, Item 4 claim was usually one of several allegations in the suits. We examined the nature of the target management's allegations, and the holding of the court in order to determine management's motivations in bringing the lawsuit and as well as the effects of these suits on share prices. (Table 2 presents a summary of case allegations and court holdings.)

First, note that forty-seven cases is a small percentage of total Item 4 filings. During 1983 alone the SEC received approximately 1700 Schedule 13Ds and about 3700 amendments to Schedule 13Ds. This relatively small number of suits suggests that there is something exceptional about these actions. A review of the data reveals that the suits typically arise in the context of a hostile takeover or a perceived threat of a takeover. This is logical, considering the remedies that are available under the law. When a violation is found, the courts commonly order corrective disclosure and an injunction preventing further purchases until a corrected

amendment is filed.⁷⁰ The most severe remedy—disvestiture of stock that is held and a permanent injunction barring further purchases—has been granted by the courts in a few cases for deliberate violations.⁷¹ Clearly, remedies of this type are most useful as a way of combatting a hostile tender offer. However, even a temporary injunction can be a valuable delaying tactic as part of a defensive strategy.⁷²

Table 2 contains a summary of the allegations and holdings of the cases.⁷³ It is difficult to quantify and aggregate legal cases because they often turn on subtle fact differences. However, this summary provides insights into the form of these actions. In twenty-five cases, target management alleged that the bidder did not reveal his control purpose in his disclosure documents. In eleven cases, the plaintiff alleged that there was an insufficient statement of intent. Nine cases alleged a failure to disclose plans to merge or liquidate the firm. Three actions were based on the allegation of the existence of an undisclosed plan to extort an excessive price in a subsequent share repurchase (seek greenmail). In almost every case, the target firm was clearly concerned with a potential control battle. This suggests that target management teams file these actions as a defensive mechanism against perceived threats to their control.

Table 2 also contains a summary of the outcomes of the litigation. It reports the holdings of the highest court that reached a decision in each case. When the court issued a preliminary injunction or remanded the case for a new trial, and no further action on the case was reported, the eventual result presumably was an out-of-court settlement or an end to the takeover attempt or both.

In twenty-nine cases, we classified the defendant as the winner. That is, the court either found the bidder's disclosure to be adequate and refused to issue an injunction or it reversed an earlier injunction and dismissed the action. Note that calling the defendant the winner is somewhat misleading in this context. If the primary purpose of the target's management is to delay a potential tender offer or takeover attempt, the target might win the war by losing the battle if the litigation involves sufficient delay.

70. See, e.g., *General Aircraft Corp. v. Lampert*, 556 F.2d 90 (1st Cir. 1977).

71. *General Steel Industries, Inc. v. Walco National Corp.*, [1981-1982] Sec.L.Rep. (CCH) ¶ 98,402 (E.D. Mo., Nov. 24, 1981).

72. See Jarrell, *supra* note 69. Jarrell found that management-induced delay in a tender offer can increase the premium paid to targets.

73. Note the similarity between some of the classifications (for example, insufficient statement of intent and control purpose not revealed).

We classified the plaintiff as the winner in eighteen cases in our sample. In five cases, the court issued an injunction until trial and, in two cases, remanded for a new trial. In four cases, the court issued an injunction on further purchases and/or proxy solicitations until some period (usually thirty days) after corrective disclosure was filed. In one case, the court issued a permanent injunction. Finally, in three actions, the court ordered some sort of rescission.

Given the considerable carrying costs (interest costs, exposure to market moves exacerbated by large and undiversifiable holdings) to the 13D investor, and given the critical role played by timing in a successful control bid, such remedies can impose enormous costs on the bidding firm. Such costs can be large enough to result in disadvantageous settlements or withdrawal of the bid. And the prospects of defensive litigation may deter initial bids in the first place. The costs to bidders are illustrated, in the extreme, by the cases in which the court forced a complete or partial rescission of the entire foothold 13D acquisition. But even if a relatively mild form of discipline, such as corrective disclosure plus injunction (four cases), is imposed on the defendant, there may be considerable delay-related costs (such as a thirty-day purchase restriction after corrective disclosure is filed).

In short, we believe the evidence demonstrates that the 13D, Item 4 requirement can be a defensive tactic, not only as a delaying device but also as a signal that target management will resist the bidder. Defendants win a significant proportion of the cases (twenty-nine of forty-seven, or sixty-one percent). These figures could mean that in many of the cases the bidder never contemplated anything more than an investment in the target's stock or that a false Item 4 claim is difficult to prove. However, in either case, Item 4 serves as a source of litigation. It is an additional defensive tactic provided by the federal government that incumbent management does not need and target firm shareholders cannot avoid.

IV. ITEM 4: A COASIAN PERSPECTIVE

In essence, those who defend the mandatory disclosure system make a contractarian argument. They argue that shareholders of target firms would mandate disclosure of the kind required in Schedule 13D, but are somehow at a disadvantage vis-à-vis purchasers that prevents them bargaining effectively with purchasers. The legislative history of the statute supports this view of the theoretical underpinnings of the disclosure requirements. Congressional proponents of the statute claimed that one of

the primary goals of the Williams Act was to place public investors "on an equal footing" with acquirors.⁷⁴ Interestingly, no one has ever explained why target firms could not themselves provide incentives for bidders to disclose the information required by the Williams Act if such disclosure would benefit shareholders. If shareholders of potential target firms find such information of value, they could make appropriate adjustments in their firms' articles of incorporation that would require the disclosure. Alternatively, they would seek to list their shares on stock exchanges that required bidders to make such disclosures. If such adjustments to firms' articles of incorporation prove to be too costly or too difficult to make, we believe the law should respond by facilitating these adjustments—not by mandating disclosure for all firms. Indeed, we believe the only plausible explanation for the nonexistence of such firm-created disclosure requirements before the passage of the Williams Act is that shareholders do not value them.

Certainly managers have incentives to make hostile takeovers as difficult as possible in order to retain their jobs. Thus, the absence of these prohibitions cannot be attributed to the divergence of interests between shareholders and managers. In other words, if disclosures by bidders were beneficial to shareholders, target firms would require such disclosures, and they did not and do not.

In our view, the reason that shareholders would not make such demands on bidders is that it is not in the interest of these shareholders to do so. Hostile bids present target shareholders with a variety of problems, all of which are effectively handled by intrafirm contracts or stock exchange rules. For example, coordination problems among target shareholders are a much more severe problem for target shareholders than lack of disclosure by potential bidders.⁷⁵ It is well-known that a two-tier bid can place target shareholders in a "prisoners' dilemma" that leaves them subject to coercive and exploitive treatment by bidders (or by targets in a self-tender), yet the law does nothing to protect shareholders from this dilemma.⁷⁶ Indeed, as discussed above, the Williams Act may exacerbate the problems of coordination among target shareholders by providing them with an incentive to tender in the face of unattractive

74. See Fischel, *supra* note 5, at 10.

75. See Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 *YALE L.J.* 13 (1985).

76. *Id.* See also Carney, *supra* note 5, at 598-600.

offers, while prompting them to refuse to tender in the face of attractive offers.

Our point here is that it is noteworthy that, prior to enactment of the Williams Act, shareholders themselves did not indicate they were disadvantaged by a lack of disclosure by bidding firms. Indeed, we believe the absence of any attempt by target firms to mandate disclosures similar to those required by the Williams Act, through intrafirm agreements, provides strong evidence of the limited value of these disclosure requirements to target shareholders.

Target-firm shareholders derive tremendous benefits from an unfettered market for corporate control. Widely dispersed shareholders are ineffective monitors of the activities of the managers of the firms in which they own shares. Such shareholders place a high value on the monitoring that is done by potential acquirors. However, this monitoring will not occur unless these potential acquirors are given adequate incentives to engage in the costly search necessary to locate undervalued firms. Therefore, target shareholders have a strong incentive to encourage such search. And, while it has been well established that target shareholders may want their management to engage in resistance to takeovers (following in the Easterbrook and Fischel tradition, the term resistance here refers to any action that makes takeovers more costly), mandatory disclosure of the bidding firm's acquisition plans is not the sort of resistance that target-firm shareholders would choose for themselves.

The literature on takeovers identifies several categories of defensive tactics that can be beneficial to target-firm shareholders. The first category includes those tactics identified by Professors Gilson and Bebchuk in their well-known exchange with Professors Easterbrook and Fischel.⁷⁷ Gilson and Bebchuk pointed out that target-firm shareholders often will be better off if their managers use defensive tactics to produce a subsequent higher bid for their shares, through the creation of an auction market. They argued that, while such resistance may decrease the number of bids for targets, the resulting higher price for targets will offset these losses to target shareholders. The disclosure mandated by the Williams Act in Item 4 does not further the objectives envisioned by Bebchuk and Gilson. The disclosure provisions do nothing to "buy time" for the crea-

77. See Bebchuk, *Comment: The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers: Reply and Extension*, 35 STAN. L. REV. 73 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

tion of an auction market for the target firm.⁷⁸ If disclosure attracts additional bidders, this is because these bidders are able to free-ride on the research of the initial bidder. *Ex ante* this free-riding will only decrease the probability of an initial bid being made, it will not enhance the quality of the auction market.⁷⁹

Next, as Carney and Oesterle argued,⁸⁰ defensive tactics can benefit target-firm shareholders by solving some of the game theoretic problems associated with the two-tiered bid. As explained above, however, the disclosure provisions evaluated here exacerbate rather than mitigate these problems by providing shareholders with a perverse set of incentives in the decision to tender.

Finally, Haddock, Macey and McChesney⁸¹ suggested that defensive tactics provide an incentive for target firms to invest in ways that make themselves attractive to potential bidders. Their theory is that resistance enables target firms to reap the full value of their investment in the firm. Firms can and should set their own levels of resistance based on their own personalized decisions about how much monitoring by outside firms they deem to be appropriate.

Implicit in these discussions of the value of defensive tactics is the notion that both parties, targets as well as bidders, bring value to corporate control transactions; and both parties should be protected from having the investments they have made in the firm expropriated by outside bidders without compensation. The disclosure provisions of Item 4 and Schedule 13D specifically and the Williams Act in general are antithetical to the basic economic model of the takeover process because they force bidders to turn over to targets the fruits of their search for information about targets.

Simply put, target-firm shareholders are the real losers of the Williams Act disclosure provisions discussed here. By removing bidders' incen-

78. The cause of action given by Item 4 can be used to buy time, as we discussed earlier. However, it is ridiculous to think that Item 4 can be justified on the grounds that it bestows this "right" on target-firm management.

79. Greenmail is an example of a defensive tactic that can facilitate the creation of an auction market without causing a free-rider problem. See Macey & McChesney, *supra* note 75.

80. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341; Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985).

81. Haddock, Macey & McChesney, *Resistance to Tender Offers and Optimal Property Rights in Assets*, *supra* note 43.

tives to search, the disclosure provisions lower the probability that target-firm shareholders will enjoy the gains from trade that can come from hostile takeovers.⁸²

Indeed, regardless of the source of the bidders' information, if that information is not already reflected in the target firm's share price, there will be gains from trade, *i.e.* gains for both bidders and targets, if bidders can trade on the basis of that information without disclosing it. Where disclosure is required there will be fewer mutually beneficial bargains between bidders and targets at the margin, although they will not disappear entirely. And, unlike other defensive tactics, the reduction in offers brought about by required disclosure will not bring a concomitant increase in the premium to targets because any increased premium will not flow to those who have brought increased value to the transaction.

In sum, in our view the old adage that the securities laws' disclosure requirements are justified because they place target-firm shareholders on an equal footing with bidders is misguided for two reasons. First, if target-firm shareholders desired to be placed on an equal footing with bidders, they could arrange this themselves by drafting the appropriate intrafirm agreement. Second, where privately negotiated defensive tactics benefit target-firm shareholders, they do so because they apportion the gains from trade in a takeover on the basis of the relative contributions of the parties. We argue that the rules regarding mandatory disclosure of proprietary bidder information are in stark contrast with this model in that they require the party who has created a valuable asset—information—to turn over this asset to others.

V. THE SOURCES OF MANDATORY DISCLOSURE RULES

Thus far we have made the case that the federal rules requiring mandatory disclosure of a bidder's plans regarding its purchase of a substantial block of another firm's shares do not benefit the group they ostensibly were designed to benefit. If we are correct in our theoretical and empirical analysis, one must conjecture about why the rules were developed and why they have exhibited such excellent survival properties over time. In the absence of a plausible public-interest explanation, we believe the evidence strongly supports the hypothesis that the mandatory disclo-

82. Society as a whole also loses when combinations that would improve efficiency never take place or are delayed. See Easterbrook & Jarrell, *Do Targets Gain From Defeating Tender Offers?* 59 N.Y.U. L. REV. 277, 281 (1984).

sure components of the federal takeover laws are designed to benefit one or more discrete interest groups rather than the public at large. As Henry Manne,⁸³ George Benston,⁸⁴ and Frank Easterbrook and Dan Fischel⁸⁵ have pointed out, law and accounting firms and investment bankers are clear beneficiaries of mandatory disclosure rules, and such groups "would suffer windfall losses if the regulations were repealed."⁸⁶ Some commentators have also pointed to the SEC's interest in having regulations to implement and enforce.⁸⁷

In addition to these groups, as Roberta Romano recently has demonstrated in the context of state anti-takeover statutes, the incumbent managements of firms that have a high probability of being displaced in a takeover have a strong incentive to press for the enactment of laws impeding the takeover process.⁸⁸ Indeed, Professor Romano observed that states often pass anti-takeover statutes "at the behest of the local business community, and quite frequently, one concerned firm."⁸⁹

It appears likely to us that narrow interest-group concerns also motivated the legislative process that produced the disclosure rules. On the basis of the data presented here, the relevant interest groups include not only the incumbent management of firms that are likely takeover targets but also the lawyers, investment bankers and accountants who enjoy increased demand for their services as a result of the disclosure rules. We base this conclusion on the fact that much of the information contained

83. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION 23, 31-40 (H. Manne & E. Solomon eds. 1974).

84. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (H. Manne ed. 1969).

85. Easterbrook & Fischel, *supra* note 40 at 671.

86. *Id.*

87. Sappideen, *Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United Kingdom, United States and Australia*, 8 J. COMP. BUS. & CAP. MARKET L. 281 (1986) summarizes H. Kripke's arguments in THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 317 (1979):

Because the SEC is dominated "by lawyers to the exclusion of economic thinkers", it "shows a tendency to treat disclosure as a moral issue" rather than a pragmatic one. *Id.* at 18. For this reason, Kripke notes, there has been a marked tendency for the SEC to adopt voluminous and detailed regulations with little regard for their impact upon the regulated. The SEC has also overstretched its actual powers and is obsessed with punishment. He questions whether the elaborate mandatory disclosure requirements continue to be necessary in the face of natural forces within the capital markets (which protect sophisticated investors) and the efficient markets theory (which protects unsophisticated investors).

88. Romano, *The Political Economy of Takeover Statutes* 73 VA. L. REV. 111 (1987).

89. *Id.* A good example is the Ohio antitakeover law passed to aid Goodyear in its battle against Goldsmith. See Office of the Chief Economist, Securities and Exchange Commission, "Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers." May 18, 1987.

in the lengthy disclosure documents required by the Williams Act is made redundant by the efficiency of the market.

VI. CONCLUSION

It would be remarkable if social product could be increased by weakening the well-defined property rights of target-firm shareholders that existed before the mandatory disclosure provisions of the Williams Act. This Article has provided an empirical and theoretical analysis of the centerpiece of the disclosure rules applied to takeovers, which require that purchasers reveal their future plans regarding the firms whose shares they are acquiring.

We have concluded that if Item 4 provides useful information, it is harmful because it deters beneficial takeovers. The deterrence comes from several sources. Potential bidders have less incentive to engage in costly research of potential targets because the bidders cannot appropriate all the benefits of their research. Further, target shareholders are given the perverse incentive to tender to undesirable bidders and not tender to quality bidders. Thus, it may be easier for a looter or other undesirable bidder to take over a firm than a bidder who could improve the firm's operations.

We also present evidence that suggests that, in certain cases, the information revealed in Item 4 is redundant. In many cases, the market can infer the plans of the bidder from his identity. However, if Item 4 is redundant, the Schedule 13D filing itself deters beneficial takeovers. We suggest that the private right of action granted to target management based on an allegedly false Item 4 serves as a weapon against a hostile bidder. Schedule 13D and Item 4 merely exacerbate the well-known agency accompanying the separation of ownership and management within the large corporate enterprise.

Based on the foregoing analysis, we believe Congress could benefit investors by amending the Williams Act to remove the requirements imposed on block purchasers to disclose their plans regarding the target firm. Unfortunately, the political reality is that such an amendment of disclosure regulations will become more rather than less restrictive.

As we have seen, so long as the bidder is required to disclose his identity, the market may receive all of the information that Item 4 requires purchasers to disclose. As such, the requirement that a bidder disclose his identity also involves a deprivation of a valuable property right be-

longing to the bidding firm. This deprivation is a cost to shareholders of both potential targets and potential bidders. The main beneficiaries of the rules are incumbent management teams and the lawyers, accountants and investment bankers who have a comparative advantage in dealing with and providing the complex regulatory apparatus.

TABLE 1:
ABNORMAL RETURNS TO TARGET FIRMS IN REACTION
TO 13D FILINGS CLASSIFIED BY INTENT IN ITEM 4 OR
IDENTITY OF FILER

<u>STATED INTENT IN</u>		<u>IDENTITY OF FILER</u>		
<u>ITEM 4</u>				
<u>Control</u>	<u>Passive</u>	<u>Raider</u>	<u>Non-Raider</u>	<u>Posner</u>
7.74%	3.24%	5.9%	3.4%	7.0%
(12.8)*	(12.3)*	(5.2)*	(3.8)*	(3.8)*

t-statistics are in parentheses, *denotes significant at the 99% level.

Sources: Results on stated intent are from Mikkelson & Ruback, *supra* note 61, and are based upon 26 "control" cases and 106 "passive" cases. Results on identity are from Holderness and Sheehan, "Raiders or Saviors? The Evidence on Six Controversial Investors," 14 J. FIN. ECON. 523 (1985). The latter results are supported by A. Poulsen, "Market Reaction to "Corporate Raiders", Working Paper, Office of the Chief Economist, Securities and Exchange Commission, 1984.

TABLE 2:
ALLEGATIONS AND HOLDINGS IN CASES WITH ALLEGED
FALSE SCHEDULE 13D ITEM 4 FILINGS

<u>Primary Allegation</u>	<u>Number*</u>
Insufficient or Misstatement Statement of Intent, Purpose, or Plans	11
Control Purpose Not Revealed	25
Failure to Disclose Plans to Liquidate, Merge, or Sell Assets	9
Undisclosed Plan to Extort Excessive Price for Share Repurchase	3
Other	1
 <u>Holdings and Remedies</u>	 <u>Number</u>
Defendant Wins	29
Plaintiff Wins	18
Injunction until Trial	5
New Trial	2
Corrective Disclosure + Injunction	4
Permanent Injunction	1
Rescission or Offer of Rescission	3
Defense Motion to Dismiss Denied	2
Correct 13D	1

* includes two cases counted in each of two categories of allegations

