

12. Mesa Petroleum Company (C)

T. Boone Pickens, Jr., chairman of Mesa Petroleum, didn't seem to agree with the way major companies in America were being run.

"People talk about fiefdoms in the Middle East, in these Arab countries. What do you think you have in these chief executive offices in these companies in the United States? I mean they've got everything in their command. I do. Hell, I could order this airplane down and load it up with girls and go to Las Vegas," commented Pickens. . . . "But you've got to have discipline to run it like it should be run, and it should be run for the stockholders," continued Pickens. "These people are caught up in their empire. Look at a guy like Lee [Gulf's CEO]. Where do you think a guy like Lee can get another job for \$800,000 a year? He's not articulate. He's not knowledgeable. Hell, he's about as attractive as yesterday's toast."¹

Certain of Pickens' contemporaries had definite opinions on his takeover ploys and his claims to be working in the shareholders' interests.

"He's only after the almighty buck, he's nothing but a pirate," said G. C. Richardson, formerly of Cities Service.²

This case was written by Mark Rich and Francis C. Stiff, research assistants, and Robert R. Gardner, associate director of the Maguire Oil and Gas Institute, under the direction of Professor M. Edgar Barrett, director of the same institute. It is designed to serve as the basis for class discussion and is not intended to illustrate either effective or ineffective handling of an administrative situation.

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¹"Playing for Keeps," *Westward Magazine*, *Dallas Times Herald*, March 25, 1984.

²"High Times for T. Boone Pickens," *Time*, March 4, 1985, pp. 52-64.

"My only objection to Pickens is the aura he tries to create when he says he is for the small shareholder. That's just a lot of crap," remarked Harold Hammer, head of Gulf Oil's defense effort.³

Senator Howard Metzenbaum (D-Ohio) commented, "Pickens makes a crusade out of what he is doing because he can make a lot of money."⁴

Pickens' critics regularly hurled invectives, calling him a raider, a greenmailer, and a waster of corporate assets. These criticisms, however, rarely came from Mesa Petroleum's shareholders and partners.

PETROLEUM INDUSTRY IN THE EARLY 1980s

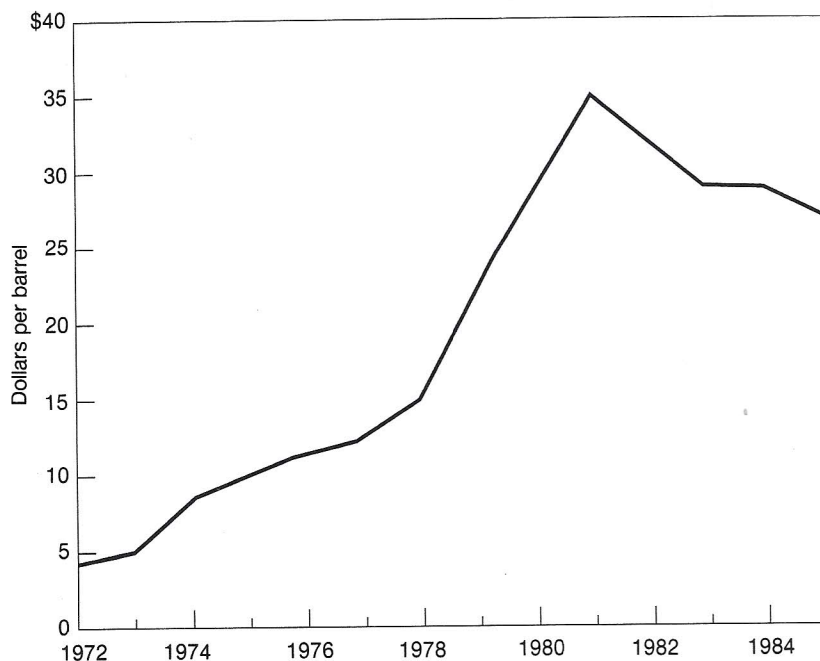
The oil and gas industry entered the 1980s riding a boom of at least a half dozen years of immense prosperity. The boom quickly, and surprisingly to many, turned sour in late 1981. By 1982, the industry found itself heading into a severe recession. Oil and gas firms in 1985 were still deeply mired in this recession and showed few signs of a near-term recovery.

The Boom. After the OPEC oil embargo in 1973, world crude oil prices rose steadily through the 70s, peaking at \$35 per barrel in 1981 (Exhibit 1). Expectations by many in the industry were for crude prices to reach \$60-\$100 per barrel in the next decade.

As the "boom" fever spread, investors poured literally billions of dollars into oil and gas deals. Oil company stock prices became "hot" plays as their prices pushed upward. Oil and gas syndicates also became popular among investors seeking tax benefits and earnings potential. Bankers competed fiercely to loan money for both oil and gas production and oil field equipment.

³Ibid.

⁴Ibid.

EXHIBIT 1 Refiner Acquisition Price per Barrel of Crude

Source: "Big Oil Starts Thinking Smaller," *The New York Times*, March 17, 1985, p. 1, sec. 3.

Within the industry itself, drilling activity began to rise dramatically as exploration and production companies spent the dollars flowing in from increased production revenues and from new investors. Increased activity by established drilling contractors was complemented by a substantial number of new drilling companies attracted by the profits to be earned. According to *Reeds Rig Census*, there were 3,100 rigs capable of drilling to 3,000 feet or better in operation as of December 1979. By December 1981, the same count had grown to 4,800 rigs. The number of working rigs at the peak of demand was 4,530 at the end of 1981. At that time new rigs were coming on-line at the rate of 2.5 rigs per day.⁵

As drilling activity increased, so did the demand for oil field equipment. Prices on rigs, pipe, and related products moved up sharply. Increasing costs, rather than

discouraging drilling, seemed only to add to the frenzy, as investors and bankers viewed the oil field equipment industry as another "hot" play.

The Bust. Meanwhile, in the face of the boom, demand for refined products was slowing. Gasoline consumption was down due to the switch to more fuel-efficient cars (average mpg had risen from 13.2 in 1973 to 24.6 in 1982), and reduced driving in general (down 10% between 1978 and 1982).⁶ The combined effects led to a decrease in gasoline consumption by 1 million barrels per day between 1978 and 1983.⁷

In addition to gasoline, the demand for middle distillates was also down. In the industrial and utility sectors,

⁵*Reeds Rig Census*.

⁶"Energy," *Forbes*, January 2, 1984, p. 74.

⁷*Ibid.*

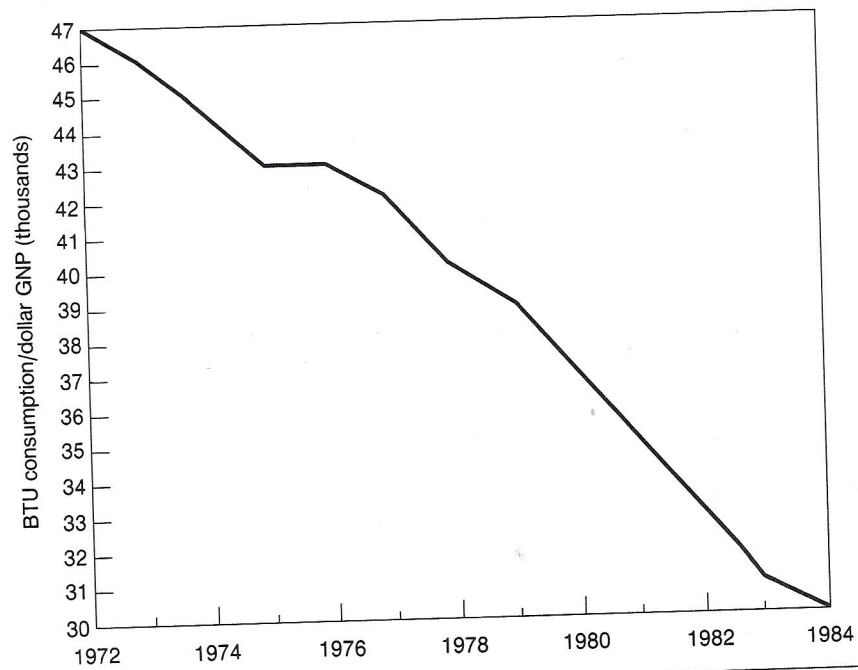
a massive effort was paying off falling steadily industries led steel industry the pulp and paper period.⁸ Contr by industrial u began in 1981

While dem continuing at reached a peak per day (bopd) high levels.⁹

⁸"Scorecard i nal, July 5, 198

⁹"Energy," p

EXHIBIT 2 Oil Use per Dollar of GNP



Source: "Big Oil Starts Thinking Smaller," *The New York Times*, March 17, 1985, p. 1, sec. 3.

a massive effort at conservation and fuel substitution was paying off. Oil consumption per dollar of GNP was falling steadily throughout this period (Exhibit 2). Heavy industries led this trend, with oil consumption in the steel industry down 80% from 1979-84 and oil use by the pulp and paper industry falling 50% during the same period.⁸ Contributing to the decrease in oil consumption by industrial users was the economic recession that also began in 1981.

While demand was falling, production had been continuing at a record pace. OPEC countries had reached a peak in production of 32 million barrels of oil per day (bopd) in 1979 and were still producing at very high levels.⁹

The turn from boom to bust in the industry became apparent on the order books of drilling contractors by late 1981. Land-based contractors were booked solid through the end of the year, but had little or no backlog of orders for 1982. By April of 1983, the number of rigs in operation had fallen to 1,807.¹⁰

At the same time, investors began to cool toward oil and gas plays. A major factor was the Income Tax Reform Act of 1981. This act reduced the top tax bracket from 70% to 50%, thus reducing the value of immediate tax reductions and, hence, the appeal of many drilling ventures.

Decreased demand for oil ultimately led to falling prices. As E&P companies had borrowed heavily to finance their operations, the fall in prices placed these

⁸"Scorecard for the OPEC Meeting," *The Wall Street Journal*, July 5, 1985, p. 6.

⁹"Energy," p. 75.

¹⁰"Oilfield Drillers and Services," *Forbes*, January 2, 1984, p. 84.

companies in a severe cash bind. With a loss of revenues due to falling prices, and a decline in investor interest in oil and gas plays, hundreds of operating companies were forced into bankruptcy.

The refining and marketing segment of the industry was also hard hit. The fall in demand left the industry with significant overcapacity. Competition at the gas pump combined with already low refinery utilization rates led to very poor profitability throughout the refining and marketing industry. Despite closure of more than a hundred refineries, the industry in 1985 was still saddled with overcapacity and thus, poor profitability (Exhibit 3).

Outlook. The near-term outlook for the oil industry as of 1985 was not encouraging. With the control of much of the world's oil production in the hands of foreign-exchange-hungry governments, the prospect of reducing the oversupply of oil through production cuts appeared unlikely. OPEC's production had fallen to 16 million bopd and many members of the cartel were either cheating on their production quotas or selling oil below set prices.¹¹ Saudi Arabia, in turn, threatened cheating OPEC countries with a price war that could flood world markets with oil and drive prices below \$20 per barrel.¹²

Analysts did not look to demand increases to bolster prices, even with a strong economy. Said Raymond Mason, Charter Co. president,

Even if the economy keeps expanding, pressures will continue to push oil prices down.¹³

Fred Singer, of George Mason University, remarked,

Consumption in the transportation sector may increase slightly if gasoline prices fall; for other sectors, gas and coal prices will adjust downward and provide competition. The big item in demand (short run) may be inventories; will oil stocks be built up at \$24 (per barrel of oil)? I don't think so.¹⁴

¹¹"Scorecard for the OPEC Meeting."

¹²Ibid.

¹³"Energy," p. 74.

¹⁴"Scorecard for the OPEC Meeting."

Boone Pickens summed up the outlook for the industry as follows:

Of all the wells that have been drilled in the world, 80 percent of them have been drilled in the Lower Forty-eight. . . . So, while you've got a limited number of good prospects in the U.S., you still have more rigs running than the rest of the world does. You also have natural gas markets that are weak, and oil markets that are uncertain. That's a very sobering set of fundamentals the industry is facing.¹⁵

Adding to the dilemma of many major oil companies was the current trend in the financial markets of low valuation of conglomerates. Many major oil companies found themselves "undervalued" by the market, both because of the poor outlook of the oil industry and because of Wall Street's current disenchantment with multibusiness firms.¹⁶

Development of spot markets for both crude and refined products was a new addition to the industry in the 1980s. This new feature served to establish a world market for oil and refined products, and reduced some of the advantages of integration in the oil industry. The long-term effects of this addition were still unclear.

MESA PETROLEUM COMPANY: 1981-1985¹⁷

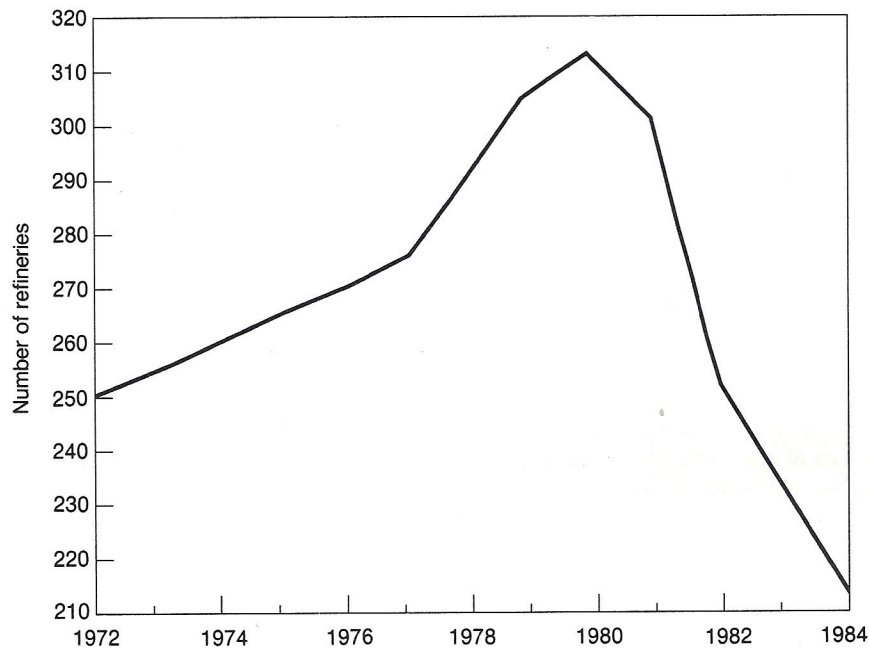
By early 1981, Mesa was a reasonably good-sized oil and gas exploration company. Based in Amarillo, Texas, it had reported revenues in 1980 of \$200 million and net income of \$95 million. Mesa was primarily a domestic E&P firm with approximately 90% of its revenues generated by its exploration and production operations. Its oil and gas reserves in 1980 were estimated at 25 million barrels of oil and 858 billion cubic feet (bcf) of

¹⁵"Interview: T. Boone Pickens, Wildcats on Wall Street," *Planning Review*, July 1985, p. 6.

¹⁶"Splitting Up," *Business Week*, July 1, 1985, p. 50.

¹⁷For background data on the firm from its inception until 1980, see *Mesa Petroleum Company (A)* and *(B)*, [not included in this publication].

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EXHIBIT 3 Number of U.S. Refineries*

*Many of the refinery closures illustrated here were the result of the Reagan administration's elimination of entitlement cross-subsidies in 1981. The majority of these closed refineries were small, "teakettle" operations.

Source: "Big Oil Starts Thinking Smaller," *The New York Times*, March 17, 1985, p. 1, sec. 3.

gas, with production of 3 million barrels of oil and 106 bcf of gas during the year.

Mesa's finding costs had risen fairly dramatically since 1979. According to *Petroleum Outlook*, it cost Mesa \$15.06 to find a barrel of oil in the United States in 1981. By comparison, Mesa's finding costs were \$13.80 a barrel in 1980 and \$5.43 a barrel in 1979.¹⁸

Though Mesa had exhibited a healthy earnings growth rate through 1981, this was partially a function of the firm's accounting practices. A 1979 FASB ruling had allowed the capitalization of certain interest costs related to developing properties. Since 1979, Mesa had been

capitalizing an increasing percentage of its interest costs. In 1979, Mesa had capitalized \$6.2 million, or 11% of its interest costs. By 1981, the firm was capitalizing \$70 million, or 70%. Had that interest been expensed, 1981 earnings would have been reduced by some \$38 million.¹⁹

Mesa's capital expenditures during the early 80s peaked in 1981 (during the industry boom) and thereafter declined steadily. Expenditures in 1985 were projected to be \$85 million. Recent reductions in capital spending were due in part to the general slowdown in the industry and in part to a change in strategy at Mesa. Sid

¹⁸"A Nicely Coppered Bet," *Forbes*, July 5, 1982, p. 40.

¹⁹*Ibid.*

Tassin, assistant to Mesa's financial Vice President David Batchelder, recalled when the initiative to change strategy began:

Pickens said it wasn't enough to just hunker down like a bunch of groundhogs; get rid of a little fat; accept a little less cash flow, lower reserves and less net income, and next winter come out of the hole. . . . He said it was time to take a fresh look at our own business.²⁰

The "fresh look" that Pickens took resulted in a change in strategy and a restructuring of Mesa's operations. The changes included reducing the work force by one third, selling overseas interests, halting the issue of company cars, and holding exploration costs at less than \$10 per barrel.²¹ Early in 1984, Mesa reduced the number of its vice presidents from 10 to 3. Mesa's employees in 1985 averaged 36 years of age, with all of Pickens' closest advisers being below 35 years of age.²²

Despite Mesa's leaner operations, the firm continued to perform well. Oil and gas revenues rose steadily through the 80s, reaching record levels. Total assets and shareholder's equity of the company, after a fall in 1982, grew strongly through 1984. The net amount of Mesa's debt also declined from 1982 to 1984 by about \$60 million. In addition, Mesa was able to remain at or above the industry average (excluding acquisitions) of replacement percentage (Table 1).²³ Including acquisitions, the replacement percentage was higher in later years. Mesa also continued to introduce innovations into its operations. Examples of these included running wells by wind chargers and reducing obsolete inventory by trading with other companies.²⁴ Exhibits 4-6 summarize Mesa's recent financial and operating history.

Mesa continued its policy of spinning off oil and gas properties into tax shelters for its shareholders. In 1982, Mesa transferred a 90% net overriding interest in 10 offshore, partially developed properties into the Mesa Offshore Royalty Trust. The trust was somewhat unique

²⁰"Mesa's Style Is Lean and Unorthodox," *Los Angeles Times*, April 22, 1985.

²¹Ibid.

²²Ibid.

²³Replacement percentage is the amount of new reserves discovered divided by the amount of production in the period. It should be noted that Mesa tended to book its reserves just

TABLE 1 Reserve Replacement Percentage

Year	Percent of Mesa Replaced (excluding acquisitions)	Percent of Industry Replaced (excluding acquisitions)
1980	145%	80%
1981	154	87
1982	117	70
1983	80	81
1984	65	64

Source: "Mesa's Style Is Lean and Unorthodox," *Los Angeles Times*, April 22, 1985.

TABLE 2 Mesa's Capital Expenditures

Year	Amount (millions)
1980	\$397
1981	420
1982	332
1983	223
1984	105
1985	85 est.

Source: "Mesa's Style Is Lean and Unorthodox," *Los Angeles Times*, April 22, 1985.

in that the properties transferred were only *partially* developed and would require significant expenditures to complete development. The development expenditures meant that no distributions from the trust would take place in 1983, and only a minimal distribution was likely in 1984.

before they were brought into production. Therefore, reserve increases shown in a given year in the 1980s could, in fact, reflect discoveries made in the mid- to late-1970s.

²⁴"Mesa's Style Is Lean and Unorthodox."

Citing a lack of economically drillable prospects, Pickens, during this period, diverted a portion of Mesa's resources away from oil and into other opportunities. One activity was the purchase of undervalued reserves from other oil companies. Generally, this meant attempt-

ing to take over companies with assets valued below appraised value. The details of Mesa's ventures in this area, specifically the attempted takeovers of Cities Service, General American Oil, Superior Oil, Gulf Oil, Phillips Petroleum, and Unocal, are presented in the

EXHIBIT 4

MESA PETROLEUM COMPANY
Income Statement
Years Ended December 31
(\$ in thousands)

	1984	1983	1982
Revenues:			
Natural gas	\$ 279,317	\$262,620	\$264,776
Oil and condensate	115,807	112,618	96,342
Natural gas liquids	14,829	13,084	13,766
Other	3,536	2,812	1,497
	<u>413,489</u>	<u>391,134</u>	<u>376,381</u>
Costs and expenses:			
Lease operating	51,628	48,850	50,353
General and administrative	21,476	20,235	19,440
Production, federal excise and other taxes	30,516	26,472	29,798
Depreciation, depletion and amortization	155,137	137,070	124,226
	<u>258,757</u>	<u>232,627</u>	<u>223,817</u>
Operating income	<u>154,732</u>	<u>158,507</u>	<u>152,564</u>
Other income (expense):			
Gain on sale of securities and assets	403,549	89,221	63,967
Interest income	87,748	19,524	23,942
Interest expense, net of amounts capitalized	(184,192)	(77,513)	(40,299)
Dividend income	22,403	10,108	4,943
Other	(8,649)	(102)	(9,613)
	<u>320,859</u>	<u>41,238</u>	<u>42,940</u>
Income before income taxes	475,591	199,745	195,504
Provision for income taxes	(205,407)	(73,835)	(65,600)
Net income	270,184	125,910	129,904
Preferred stock dividends	(16,333)	(11,019)	(13,959)
Net income available for common shares	<u>\$ 253,851</u>	<u>\$114,891</u>	<u>\$115,945</u>
Net income per common share	<u>\$ 3.75</u>	<u>\$ 1.72</u>	<u>\$ 1.72</u>
Weighted-average shares outstanding	<u>67,657</u>	<u>66,987</u>	<u>67,462</u>

Source: Mesa Petroleum Company, Annual Reports.

MESA PETROLEUM COMPANY
Balance Sheet
as of December 31
(\$ in thousands)

	1984	1983
Assets		
Current assets:		
Cash and short-term investments	\$ 550,946	\$ 22,722
Accounts and notes receivable	136,926	126,630
Marketable securities	338,507	—
Inventories	12,524	31,644
Prepaid expenses and other	18,325	2,885
Total current assets	<u>1,057,228</u>	<u>183,881</u>
Long-term receivables:		
Secured installment note	796,007	—
Term royalty	185,273	222,232
Other	22,274	22,248
	<u>1,003,554</u>	<u>244,480</u>
Marketable securities	<u>249,051</u>	<u>637,220</u>
Property, plant and equipment (using full cost accounting):		
Oil and gas properties, wells and equipment	2,191,833	1,599,888
Oil and gas properties not yet evaluated	45,582	64,074
Transportation, office and other properties	53,896	54,425
	<u>2,291,311</u>	<u>1,718,387</u>
Less—Accumulated depreciation, depletion and amortization	664,116	491,706
	<u>1,627,195</u>	<u>1,226,681</u>
Deferred charges and other assets	18,923	13,383
	<u>\$3,955,951</u>	<u>\$2,305,645</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Current maturities on long-term debt	\$ 27,670	\$ 54,745
Revolving credit debt repaid in 1985	350,000	—
Accounts payable	58,561	80,375
Accrued liabilities:		
Interest	21,935	17,619
Other	8,790	5,217
Total current liabilities	<u>466,956</u>	<u>157,956</u>
Long-term debt, net	<u>1,625,009</u>	<u>1,248,878</u>
Subordinated variable rate notes	500,000	—
Deferred revenue and other	115,478	42,532
Deferred income taxes	<u>422,914</u>	<u>227,774</u>
Contingencies		
7% redeemable preferred stock	<u>84,000</u>	<u>126,000</u>
Stockholders' equity:		
Common stock, \$1 par value; authorized 100,000,000 shares; outstanding 66,959,000 and 66,904,000 shares, respectively	66,959	66,904
Capital surplus	163,412	162,852
Reinvested earnings	530,500	290,032
Unrealized loss on marketable securities	(19,277)	(17,283)
Total stockholders' equity	<u>741,594</u>	<u>502,505</u>
Total liabilities and stockholders' equity	<u>\$3,955,951</u>	<u>\$2,305,645</u>

Source: Mesa Petroleum Company, Annual Reports.

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EXHIBIT 6

MESA PETROLEUM COMPANY
Statement of Changes in Financial Position
Years Ended December 31
(\$ in thousands)

	1984	1983	1982
Funds provided by operations:			
Net income	\$ 270,184	\$ 125,910	\$ 129,904
Depreciation, depletion and amortization	155,137	137,070	124,226
Deferred income taxes	194,971	66,753	59,432
Gain on sale of securities and assets	(403,549)	(89,221)	(63,967)
Interest capitalized	(7,263)	(10,831)	(57,323)
Unrealized foreign exchange loss	11,298	1,659	10,255
Funds provided by operations	<u>220,778</u>	<u>231,340</u>	<u>202,527</u>
Other funds provided:			
Proceeds from sale of securities and assets, net	1,099,451	284,383	330,839
Marketable securities classified as current assets	338,507	—	—
Increase in deferred revenue and other liabilities	72,946	23,121	—
Other	(4,627)	5,525	(7,003)
Other funds provided	<u>1,506,277</u>	<u>313,029</u>	<u>323,836</u>
Funds provided by (utilized in) financing:			
Long-term borrowings	1,789,470	631,544	305,864
Issuance of subordinated notes	500,000	—	—
Retirements of long-term debt	(1,386,909)	(104,765)	(430,832)
Decrease (increase) in long-term receivables	(770,372)	25,044	(6,002)
Redemption of preferred stock	(42,000)	(42,000)	(42,000)
Funds provided by (utilized in) financing	<u>90,189</u>	<u>509,823</u>	<u>(172,970)</u>
Funds utilized:			
Capital expenditures—			
Purchase of Mesa Royalty Trust units	507,068	—	—
Oil and gas properties and other, net	109,278	235,989	314,495
Purchases of marketable securities	606,835	801,192	62,225
Cash dividends	29,716	24,385	27,315
	<u>1,252,897</u>	<u>1,061,566</u>	<u>404,035</u>
Resulting in an increase (decrease) in working capital of	<u>\$ 564,347</u>	<u>\$ (7,374)</u>	<u>\$ (50,642)</u>
Changes in working capital:			
Cash and short-term investments	\$ 528,224	\$ 8,603	\$ (978)
Accounts and notes receivable	10,296	(10,609)	(60,572)
Marketable securities	338,507	—	—
Inventories, prepaid expenses and other	(3,680)	(26,644)	(5,455)
Current maturities on long-term debt	27,075	(20,730)	3,698
Revolving credit debt repaid in 1985	(350,000)	—	—
Accounts payable and accrued liabilities	13,925	42,006	12,665
	<u>\$ 564,347</u>	<u>\$ (7,374)</u>	<u>\$ (50,642)</u>

Source: Mesa Petroleum Company, Annual Reports.

following sections. Although a great deal of Mesa's net income was attributable to these activities, Mesa's oil and gas operations also remained relatively profitable during the 1981 to 1984 period.

MESA'S ATTEMPTED ACQUISITIONS AND MERGERS: 1982 AND 1983

In early 1982, Pickens offered his assessment of the market for oil and gas securities, an appraisal that foreshadowed a series of mergers and attempted mergers that he would initiate over the next two years. Stated Pickens,

The company remains committed to the replacement and enhancement of its reserves, the depletable assets of the shareholders. . . . Oil and gas assets are currently undervalued in the security markets. . . . [Mesa] will actively evaluate and pursue opportunities to enhance its shareholders' investment through acquisitions and financial innovations.²⁵

Cities Service Co. Pickens did not delay in moving actively and aggressively to capitalize upon apparent opportunities. In May of 1982, Pickens lined up partners to help finance a tender offer for 51% of Cities Service Co. at \$45 per share. The stock of Cities Service, the nation's 20th largest oil company, was then selling at approximately \$35 per share. Cities Service was a much larger company than Mesa, with 1981 revenues of \$8.56 billion versus Mesa's \$407.7 million.

Learning of the proposed offer, Cities Service's management surprised Wall Street by making a preemptive offer of \$17 per share for 51% of Mesa's 73.8 million outstanding shares. Mesa responded by offering \$50 per share for 51% of Cities' 80.7 million shares outstanding. Pickens made the offer to Cities Service's board as a proposed "friendly" merger. Explaining his reason for wanting to merge with Cities Service, Pickens voiced a theme he would return to often, "We had a feeling we needed to do something about our invest-

²⁵Mesa Petroleum Company 1981 Annual Report, p. 5.

TABLE 3 Gains on Takeover Attempts (in millions, pre-tax gain)

Supron (1982)	\$ 22.3
Cities Service (1982)	31.5
General American Oil (1983)	43.6
Superior Oil (1983)	31.6
Gulf Oil (1984)	760.0
Phillips Petroleum (1985)	89.0
Unocal (1985)	83.0*
Total	\$1,061.0

*Estimated after-tax gain from *The Wall Street Journal*, July 3, 1985.

Source: "High Times for T. Boone Pickens," *Time Magazine*, March 4, 1985, p. 55.

ment, because Cities Service management was depleting the company's reserves and not replacing them."²⁶

Many industry analysts felt there was good reason to take Mesa's offer seriously despite the disparity in the companies' sizes. As one executive stated, "This man is definitely who Cities fears most. He is a cool and calculating gambler, the arch stereotype of the West Texas poker player."²⁷ Pickens' uncanny financial abilities had earned the respect of much of the investment community. "He has made a lot of people a lot of money by doing what he says he is going to do," said a Houston-based analyst. "I suspect that 99 percent of the world loves Boone Pickens."²⁸

When Cities' board did not respond to his merger offer, Pickens made a tender offer directly to the shareholders. The offer was for 12.1 million shares at \$45 per share. Pickens' apparent objective was to strengthen his bargaining position by proving that Cities' shareholders were eager to sell.

On June 8, after rejecting Mesa's offer, Cities' board made its second offer—a "friendly" bid to purchase all

²⁶"Cities Service Heats up Battle with Mesa via Fraud Suit, Legal Pressure on a Bank," *The Wall Street Journal*, June 3, 1982.

²⁷"The Man Cities Service Fears," *Dallas Times Herald*, June 6, 1982, p. 2.

²⁸"Mesa's Founder Takes on Big Foe," *The New York Times*, June 7, 1982, p. D-1.

of Mesa for \$21 per share. This offer was, in turn, rejected by Mesa's board.

During the following week, Mesa and Cities were each tendered approximately 45% of the other's shares.

Attempting to thwart Cities Service's takeover, Mesa's board voted for two antitakeover measures. The first measure was a "super-majority" provision, requiring a 75% shareholder vote to approve a change in the control of Mesa. The second measure removed from Mesa's bylaws a provision that gave anyone holding at least one third of the shares the right to convene a special shareholders meeting.

On June 17, Gulf Oil Corp. announced a \$63 per share bid for Cities Service, a total purchase price of \$5 billion. Gulf's chairman, James E. Lee, acknowledged that the large jump in bidding (from Mesa's \$45-a-share offer to Gulf's \$63-a-share offer) was designed to prevent a bidding contest with any other potential suitors.

Three-way negotiations involving Mesa, Cities, and Gulf ensued, eventually resulting in Mesa selling its 4.1 million shares of Cities back to Cities for \$55 a share. As part of the peace agreement, Mesa agreed that for a period of five years it would not purchase Cities stock or seek to influence the affairs of Cities. The total pre-tax gain to Mesa was said to exceed \$30 million.

With Mesa out of the way, the road seemed to be paved for Gulf to proceed with its bid for Cities. The potential for antitrust objections still threatened to derail the acquisition, however. [Cities Service ultimately merged with Occidental Petroleum in a \$4.05 billion transaction.]

Just days after accepting the Gulf deal, Pickens made it clear he was not through dealing in the securities market. "We've got to come up with some other deals, because this industry is in for some rough sledding. . . . As long as the costs of finding oil and gas reserves stay high, 1982 will be a shakeout year in this industry, especially if companies keep depleting their reserves."²⁹

General American Oil (GAO). In an effort to take control of Dallas-based General American Oil Co. of Texas, Mesa, in December of 1982, offered \$40 a share

for a majority of GAO's stock. GAO was primarily an exploration and production firm operating in Canada, the United States, the Gulf of Mexico and the North Sea. Mesa and GAO were roughly of equal size in terms of reserves and undeveloped acreage.

Mesa had purchased 7.5% of GAO's stock in 1976. Subsequently, Mesa issued debentures exchangeable for most of the GAO shares it had accumulated.³⁰

In a surprise reaction to Mesa's hostile bid, GAO made a \$50-a-share offer for nearly a third of its own outstanding shares. The strategy behind the move appeared to center on GAO management's control of a large block of its shares held in a foundation and two trusts set up by GAO's late founder. Should a third of GAO's shares be repurchased and retired, the management-controlled block of shares which remained would constitute a clear majority.

At the proration deadline several days later, Mesa's hostile tender offer for control of GAO was heavily oversubscribed.

In a move similar to the ending of the Cities Service deal, Phillips Petroleum Co. stepped in and purchased GAO for \$1.14 billion. As a part of the deal, Mesa dropped its hostile bid; in return, GAO paid Mesa \$15 million for tender offer expenses. Mesa further agreed not to purchase GAO securities for five years.

Mesa's pre-tax gain on its holdings of GAO stock amounted to \$43.6 million.

Superior Oil Co. In early March, 1983, Pickens spoke in Dallas. "You've got to replace your reserves or you are liquidating the assets," said Pickens. "We have to replace those reserves because we're on record for five years now saying that if we have back-to-back years of down reserves we'll sell out."³¹

Within a week, Mesa's latest play for oil became public. On March 14, the financial press announced that Mesa had purchased 2.5 million shares (or nearly 2%) of Superior Oil Co., the nation's largest independent oil company. Like Cities Service, Superior was a much larger company than Mesa. In 1982, Superior earned \$223.4 million on revenues of \$2.04 billion. At the time

³⁰An earlier case, *Mesa Petroleum Company (B)*, describes this transaction in greater detail.

³¹"Speculation focuses on Mesa," *Dallas Morning News*, March 14, 1983, p. 3-D.

²⁹"Mesa's T. B. Pickens Is 'Delighted' in Spite of Failure of Offer," *The Wall Street Journal*, June 21, 1982.

of Mesa's purchases, Superior's stock was selling for about \$35 per share. Analysts placed the company's liquidation value at \$57 per share.

Many oil industry analysts quickly stated that they doubted whether Mesa intended to actually take over Superior. "I don't believe Mesa Petroleum wants to acquire Superior," said one analyst. "I think Pickens sees a company that's undervalued and the majors might want to get in there and do a deal. He's just an opportunist."³²

Mesa's purchases helped give visibility to a resolution that was scheduled to come before Superior's annual meeting. The resolution was sponsored by Wilametta Keck Day, daughter of the company founder and sister of retired chairman Howard M. Keck. The resolution called for certain above-market offers for at least 45% of Superior's shares to be submitted to a committee of three independent directors. Unless the committee found the offer unfair it was to recommend that the full board approve it. Mrs. Day's spokesman stated that she had submitted the resolution because "if an offer is submitted, she thinks the shareholders ought to know about it."³³

Mesa raised its stake in Superior to 3% over the summer. In September, Superior and Mesa reached an agreement, with Mesa selling its 3.98 million shares back to Superior for \$42 a share, a 10% premium over its market value. The buyback resulted in a \$32 million profit for Mesa.

Criticism was immediately directed at Superior. One industry observer derided the buyback as "the ultimate bailout." He continued, "To bail out a 3 percent small stockholder for a 10 percent premium above the market is going to get a lot of criticism from stockholders."³⁴

Added another analyst,

It's been a no-lose proposition for him. He takes a position in a company, the speculation takes over from that point and the company bails him out or a white knight comes in. He's making more money that way than turning the [drill] bit.³⁵

³²Ibid.

³³"Mesa Buys Stake in Superior Oil; Intent Is Unclear," *The Wall Street Journal*, March 14, 1983.

³⁴"Mesa Will Sell Stake in Superior Oil Co.," *Dallas Morning News*, September 2, 1983, p. 6E.

³⁵"Mesa Petroleum to Sell 3% Stake in Superior Oil," *The Wall Street Journal*, September 2, 1983, p. 4.

Big institutional investors were also incensed. Portfolio managers were angry that Superior did not offer to buy them out at the same premium. In the weeks following the buyback, Superior officials admitted they had received many calls from upset investors. Many of the big institutions showed signs of worry. "Major institutions are increasingly anxious to sell, and might not hold out for top dollar," warned one portfolio manager.³⁶

In March 1984, Mobil Corp. announced it had agreed to acquire Superior for \$45 a share, a total of \$5.7 billion. It would be the fifth largest takeover in history.

KN Energy Inc. Mesa's attempt in the fall of 1983 to take over KN Energy Inc. was short lived. KN Energy operated a 16,000 mile natural gas pipeline system and held various oil and gas interests. Mesa, it was said, was primarily interested in the firm's natural gas reserves.

In September, Mesa had offered to purchase all of KN's outstanding shares at a price of \$54.25 per share. A month later, Mesa backed down, declining to press for an unfriendly takeover after KN directors rejected Mesa's earlier bid.

Mesa's reticence to persevere in the takeover attempt fueled speculation that Pickens was considering bigger plays.

STALKING BIG GAME: MESA VERSUS GULF

In August of 1983, a Mesa-led group of investors had, in fact, begun quietly to purchase shares of Gulf Oil Corporation. The increased trading was soon noticed in Pittsburgh by Gulf executives who had been worried about what they perceived to be the low market valuation of the firm's common shares.

Problems at Gulf. When James E. Lee became Gulf's chairman in 1981, he took over a company that many considered to be the weakest of the Seven Sisters. Gulf had been shaken by political payoff scandals in the mid-1970s, and had not appeared to move decisively

³⁶"The Takeover Game Isn't over at Superior Oil," *Business Week*, September 19, 1983, p. 103.

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since. This apparent passivity was accompanied by a steep decline in proven reserves.

Lee moved rapidly to implement a plan to return Gulf to long-term health. His program had four major thrusts: (1) reduction of Gulf's work force, (2) repurchase of Gulf shares, (3) consolidation and elimination of many downstream operations, and (4) refocusing Gulf's exploration efforts on domestic, high-risk, frontier (arctic, offshore, etc.) ventures.

Gulf began the implementation of Lee's strategy with a repurchase of 10 million Gulf shares (out of 195 million shares then outstanding) in the latter half of 1981. Despite the repurchase, Gulf's share price fell 19% during 1981. Moreover, although Gulf had significantly increased new project spending in 1981, the firm's domestic reserves continued to fall. Gulf had, in fact, been unable to replace its reserves since 1972.

In an effort to improve the profitability of its marketing operations, Gulf concentrated on increasing market share on the East Coast, where it was the second-largest marketer with an 8% share. While Gulf's gasoline sales still decreased 3% that year, the drop was less than the 4.5% decline seen industrywide.

During 1982, Gulf continued to emphasize domestic oil and gas exploration and production. The company withdrew many of its refining, marketing and chemicals operations overseas. Write-offs during 1982 totaled \$200 million. The remaining worldwide refining, marketing and chemical operations produced an operating loss of more than \$250 million during the year. As part of the employee reduction program, Gulf in 1982 removed some 12% of its work force from the payroll. Though the firm's total revenues in 1982 remained at about the previous year's level, earnings fell by 27%.

Gulf's net margin improved somewhat in 1983, a fact management attributed to its recent cost-cutting moves. Throughout 1983, Gulf had stepped up the pace of its restructuring by closing all European refining and marketing operations, closing domestic retail outlets, reducing companywide employment by another 17%, and repurchasing more of its outstanding shares.

With both prices and demand for oil products falling, however, Gulf's strategy by mid-1983 was not impressing the markets. By August, Gulf's market capitalization³⁷

had fallen to \$6 billion on 166 million shares outstanding—a drop of almost 50% since 1980.

Mesa Closes In. As heavy trading in Gulf stock continued into the early fall, Gulf's board began to consider possible antitakeover provisions. On October 11, the board, spurred by the trading of almost 2 million Gulf shares the previous Friday, proposed abolishing cumulative voting for directors and other charter amendments designed to reduce the threat of a takeover. A shareholders meeting to vote on the proposals was set for December.

On Monday, October 17, a Mesa-led investor group revealed that it held 14.5 million shares of Gulf (8.75% of the then outstanding shares). Mesa itself held 9.6 million of the total. The partners joining Mesa were Canada's Belzberg family, Wagner & Brown (a Midland, Texas independent), Harbert International Inc. (a privately held Birmingham, Alabama construction and real estate firm), and Sunshine Mining Co. of Dallas. The announcement stated that the group had spent \$630 million to purchase the stake. The group had decided that Mesa would coordinate future purchases and have exclusive power to vote the group's shares through September 30, 1984.

In its SEC filing, the investor group intimated that it would like to restructure Gulf to increase returns to shareholders. The filing stated, "significant recapitalization transactions and assets restructurings" could be used to increase shareholders' returns. Possible methods described included, "repurchases of shares and distributions of assets to shareholders in the form of independent operating entities, royalty trusts or limited partnerships."³⁸

Gulf's senior management responded with criticism of the restructuring idea, and a defense of company policies. "We've looked at royalty trusts . . . and all the ideas that are included in the filing." The royalty trust concept had been rejected because it would mean increased tax expenses for owners. "We've been doing many of these things over the past two years," said a Gulf official. "All our actions are directed at . . . returning value to our shareholders."³⁹

³⁷Market Capitalization is defined here as the number of shares outstanding times the price of the firm's stock.

³⁸"Mesa Petroleum Group Discloses Gulf Oil Holding," *The Wall Street Journal*, October 18, 1983, p. 3.

³⁹Ibid.

Vertical Integration, Cash Returns and Market Valuation. In the fall of 1983, large oil companies' vertical integration strategies were under attack by the investment community. Integrated companies were being valued at 40% or less of their asset value, while small E&P companies were valued at an average of 90%.⁴⁰

Many analysts and oil industry consultants were advocating the breakup of integrated companies to allow earnings from oil and gas production to flow directly to shareholders. "There is a fundamental restructuring taking place," said one consultant. "You're going to see more and more of the traditional integrated companies broken up."⁴¹ An investment banker stated, "Certainly there are efficiencies with integration. But that doesn't mean we need 20 integrated oils."⁴²

Arguing against breakups and concepts such as the royalty trust, many majors contended that they needed to retain their cash flow to search for future supplies of oil and gas. In the past, the high cost of exploration had often been cited as a reason for high oil prices. Many oil executives felt that distributing profits from high-priced oil, rather than reinvesting to assure future energy supplies for America, would anger consumers and bring on new government regulations. As a government energy analyst put it, "Corporate strategy in cash-rich oil companies is a public policy matter."⁴³

In November 1983, Gulf's chairman, James E. Lee, defended the integrated companies' strategies in an interview. Answering a question concerning Pickens' philosophy he stated, "I see a mutual interest in increasing shareholder value. We may have a difference of opinion as to how best to do that." . . . Articulating his disagreement with the royalty trust concept, Lee stated, "If you're going to be an oil and gas company, everything still indicates that it's the natural resource base that really determines the value the market places on the company . . . we decided to focus our technology, our capital, toward the U.S., the frontier areas, because that's where we think we have the best probability of

successfully replacing our reserves . . . and the only way we can continue even to hold the level of oil production is to reinvest to replace reserves."⁴⁴

Countered Pickens,

Over the period 1978 to 1983 Gulf Oil only replaced about 43 percent of the oil and gas produced. . . . Over that five-year period, they actually lost 634 million [equivalent] barrels off their reserve base. Do you think the stockholders knew anything about that?⁴⁵

Pickens and his supporters argued that cash flow was being wasted on increasingly risky exploration projects that wouldn't pay off and on unprofitable downstream operations. Therefore, they wanted to force oil company managements to return more cash to investors. Pickens contended that this would force managers to abandon marginal exploration. In support of this viewpoint, an oil analyst remarked, "Full replacement of domestic reserves by domestic companies has become an all but unrealistic and impossible objective."⁴⁶

Pickens often asserted that oil companies could therefore "liquidate efficiently" by sending cash flow directly to shareholders. Spinning off assets to shareholders, according to Pickens, would both make it easier for a company to replace remaining reserves and force the market to value the company at closer to its true value.

Gulf Defense Mechanisms. Immediately after the Mesa group's announcement that it was behind the activity in Gulf's shares, Gulf officials began to analyze possible defenses. To prepare for any contingency, Gulf lined up a \$5 billion line of credit with 38 banks. At the same time, four of the banks backing the Mesa group withdrew. Pickens charged that Gulf pressured the institutions, a charge Gulf denied.

Gulf had numerous possible defenses, each with its own perils. The first defense was simply to convince Gulf shareholders that Gulf's long-term strategy would provide a better return than Pickens' short-term plans. Unfortunately for Gulf, approximately one third of its shares were held by institutions who might not only find

⁴⁰"Boone Pickens, Company Hunter," *Fortune*, December 26, 1983.

⁴¹"Restructuring Big Oil," *Business Week*, November 14, 1983, p. 139.

⁴²*Ibid.*

⁴³*Ibid.*, p. 146.

⁴⁴*Ibid.*, p. 143.

⁴⁵"Interview: T. Boone Pickens," p. 8.

⁴⁶*Ibid.*, p. 139.

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the idea of a quick pay-off appealing, but whose fiduciary responsibility might lead to a decision to sell.

The second possible defense was attacking Pickens personally—the “low road” approach. Gulf had already run ads attacking Pickens’ record of attempted takeovers, portraying him as a hit-and-run artist, an opportunist unconcerned with shareholders.

Other plausible defenses were financially oriented. Gulf could buy back the investor groups’ shares. This move risked provoking other shareholders who were not offered the same opportunity.

Gulf could also buy Mesa Petroleum and depose Pickens. Pickens had foreseen this possibility, however. His investors had agreed that in this event, voting control of the entire block would pass to the private firm, Harbert International. In addition, as pointed out by a Texan close to the investor group, this option would “make Boone several hundred million dollars richer, (with his options on millions of Mesa shares), and he’d still be around advising the group.”⁴⁷

A further option for Gulf was to purchase reserves in the market, an approach advocated by Pickens himself. This would have defused Pickens’ liquidation argument. But, there was no guarantee Pickens would not then argue for a bigger royalty trust.

October: Mesa’s Growing Stake. By the end of October, the Mesa investor group had increased its share of Gulf to 17.9 million shares. The investors also made a filing under the Hart-Scott-Rodino Act. This act required a filing if a securities purchaser may have intentions other than investment. This filing barred the Mesa group from making further purchases until the government determined that there were no antitrust problems. On the final day of October, Mesa filed with the SEC for permission to seek proxies at Gulf’s December meeting and named Lehman Brothers Kuhn Loeb Inc., as their financial advisor.

November: The Royalty Trust. By November, the battle had begun to focus on the possible shareholder value of a Gulf royalty trust. Mesa disseminated a book detailing possible Gulf trusts which would distribute

from 10% to 75% of Gulf’s U.S. oil and gas production revenues. The report predicted that the trust units would have a significantly higher market valuation than equivalent Gulf shares. It contended that the trust units would trade at 8 to 10 times cash flow, versus Gulf’s current stock price of 2 to 3 times.

As expected, Gulf officials took issue with Mesa’s report. “Contrary to the proponents’ assertions, the capital markets are sufficiently sophisticated to know that one plus one equals two,” asserted a Gulf spokesman. “Thus, except for an initial flurry of excitement . . . the distribution of [units] has resulted in a drop in the distributing company’s stock price that reflects the value attributed to the royalty trust units.”⁴⁸

Gulf’s management also rebutted the traditional argument for tax savings due to the elimination of double taxation by creating a royalty trust. They claimed that tax credits and deferments gave Gulf approximately an 8% effective tax rate.⁴⁹ In addition, they pointed out that Gulf shareholders would have to pay taxes on the initial distribution of trust units. This distribution would be treated as a dividend. Gulf officials stated that many individual shareholders would have to sell shares to pay the tax bill.

James Lee hit hard on this last point: “It’s certainly clear Mr. Pickens doesn’t care a hoot about the huge unnecessary tax bite that would hit most of our shareholders.”⁵⁰ Pickens responded to this issue by stating that when shareholders make money they should expect to pay taxes.

On November 22, Mesa was cleared by the SEC to purchase more Gulf shares. The investor group immediately began to increase its holdings. By the December 2 meeting, the investors had purchased another 1,963,200 shares for \$87.1 million.

Attempted Takeover. In the first round of Pickens’ bid to restructure Gulf, Pickens was soundly beaten. Gulf’s management won a December proxy fight that

⁴⁷ “Future of Gulf Oil Hinges on Proxy Fight Led by Mesa Chairman,” *The Wall Street Journal*, November 2, 1983, p. 18.

⁴⁸ “Gulf Oil Royalty Trust Plans Are Outlined by Mesa and Partners, Raising Questions,” *The Wall Street Journal*, November 9, 1983.

⁴⁹ “Future of Gulf Oil.”

⁵⁰ “Pickens Says He Wouldn’t Break up Gulf, Pledges Not to Sell Stake Back to Oil Firm,” *The Wall Street Journal*, November 11, 1983, p. 10.

allowed the firm to reincorporate in Delaware. Delaware laws would make it much more difficult for Pickens to elect directors to Gulf's board.

After Gulf's reincorporation, T. Boone Pickens began looking for additional financing to fund a Gulf takeover. Previously, Pickens had insisted that the investment group's goal was to force Gulf to return earnings to shareholders. Now, Pickens contended that Gulf had pushed his group into a corner, forcing a tender offer.

In early February, 1984, the investor group released a study by Drexel Burnham Lambert Inc., detailing a possible Gulf purchase plan. The plan called for purchasing Gulf at \$55 per share in a two-step takeover.⁵¹ The first step involved raising \$3.66 billion to purchase 61.3 million shares of Gulf, giving the investors greater than 50% ownership.

To raise the money, a new company would be formed. The company would sell \$1.73 billion worth of investment units consisting of common and senior preferred stock. The new company would also issue \$450 million of senior notes. The Pickens investor group would contribute another \$482 million, and the final \$1 billion would come from new bank borrowings.

The second step of the takeover plan involved the remaining Gulf shares. After Gulf and the new company were merged, the remaining Gulf shares would be swapped for additional securities worth \$55 a share. These securities would include \$3.07 billion of 20-year, 16% junior debentures, and \$1.5 billion worth of preferred stock with a 15% dividend rate.

The terms of the \$450 million of senior notes used in the first step specified that they would be paid off within 30 days of the merger. Gulf would then be liquidated over a period of up to three years with the proceeds going to the shareholders of the new company. Independent estimates of the disposal value of Gulf's assets ranged as high as \$15 billion.

Gulf's response was immediate—it filed suit in a Delaware federal court, charging the investment group with "market manipulation and other violations of securities laws." Gulf also increased its credit lines to \$6 billion. A Gulf official described the Pickens group's plans as an effort "to seize the future potential of Gulf

for the benefit of [the Pickens] investors with money borrowed on the strength of Gulf's assets."⁵²

The announcement of Mesa's acquisition plan had another effect. Numerous potential Gulf suitors began to approach Gulf's management. One of the more ardent was Robert O. Anderson, chairman of Atlantic Richfield Co. Talking with Lee over the phone, Anderson proposed a \$70 per share purchase.⁵³

Learning of the offer, Pickens moved quickly and made an offer for 13.5 million shares at \$65 per share. Pickens was said to be hoping the offer would be heavily oversubscribed. He apparently felt banks would lend the money needed to purchase any additional shares offered, knowing they could be sold to Arco for \$70.

Worried that Pickens might be offered enough shares of Gulf to obtain effective control, Gulf's management suddenly found themselves on the defensive. Gulf's board met, and, on February 29, announced that Gulf was looking for a purchaser. The board members directed its investment bankers to pursue "all alternatives."

In other moves to prepare for the sale of the company, Gulf's board awarded \$7,158,900 in bonuses to Gulf employees, set aside \$7,203,100 for "additional grants contingent upon a change in control of the company," and raised the investment bankers' combined fees to 0.35% of Gulf's final sale price.⁵⁴

To help speed the sale, and to prevent Pickens from gaining control, Gulf allowed possible purchasers to study internal company records. Some of these potential suitors included Standard Oil of California (Socal), Atlantic Richfield, Standard Oil (Ohio), Union Oil of California, and Allied Chemical.

On Monday, March 5, Gulf's board announced the sale of the company to Socal (Chevron) for \$80 per share, a total purchase price of \$13.4 billion. Gulf's announcement stated that Socal "will begin shortly a cash tender offer for all of the outstanding shares of Gulf common stock."⁵⁵

⁵²Ibid.

⁵³"Why Gulf Lost Its Fight for Life," *Business Week*, March 19, 1984, p. 84.

⁵⁴Ibid.

⁵⁵"Gulf Agrees to Be Acquired by Socal," *The Wall Street Journal*, March 6, 1984, p. 3.

⁵¹"Gulf Oil Unveils Moves to Block Pickens Group," *The Wall Street Journal*, February 13, 1984.

Onboard a Mesa corporate jet headed for New York, Pickens received the news from an aide in Amarillo. "Shucks," he said, "I guess we lost another one."⁵⁶

It was later reported that Mesa's investor group would report a pre-tax gain of \$760 million on the purchase of Gulf by Socal. Mesa Petroleum's share of the investor group's profit was said to be about \$500 million.⁵⁷ Pickens personally received a cash bonus of \$18.6 million for his performance in 1984 as Mesa's CEO. The bonus was to be drawn from a \$20 million pool set up to reward certain Mesa executives for their roles in the battle to acquire Gulf Oil. Pickens' bonus was thought to be the largest ever given to an executive of a public company.⁵⁸

BUY-BACK OF THE MESA ROYALTY TRUST

In a move that took most industry observers by surprise, Mesa, in May of 1984, made a \$570 million cash tender offer for the 16.3 million outstanding units of its own Mesa Royalty Trust. The buy-back offer for the trust Mesa had established in 1979 marked the first time an oil company had sought to repurchase oil and gas interests it had earlier spun-off to shareholders.

According to Pickens, his main objective in making this unusual move was to acquire high-quality producing oil and gas properties at a reasonable price. "We're buying gas in the ground for 92 cents [per thousand cubic feet]," said Pickens, "and that's cheaper than we can find it. . . . Gosh. Just think. We didn't make anyone angry on this deal."⁵⁹

Mesa's offer of \$35 per unit represented a 25% premium over market price. Throughout the year, the stock price for the trust had ranged from a high of \$29.875 to a low of \$24.625 and had closed at \$27.5 the day before the announcement was made.

⁵⁶ "Why Gulf Lost Its Fight for Life," p. 76.

⁵⁷ "Mesa Chief Pickens Is Awarded Bonus of \$18.6 Million," *The Wall Street Journal*, March 21, 1985.

⁵⁸ *Ibid.*

⁵⁹ "Raiding Mesa Discovers Target Right at Home," *Dallas Morning News*, May 16, 1984, p. 1D.

Analysts were quick to ascribe motives to Pickens' surprise move. The most plausible explanation concerned certain political moves being made by the Kansas legislature. The majority of the Mesa Royalty Trust properties were located in Kansas' Hugoton Field. Kansas officials, said analysts, were on the verge of reducing the spacing between gas wells. If such infill drilling were allowed, the underlying asset value of the Mesa Royalty Trust could rise to as high as \$60 to \$70 a unit.⁶⁰ It was the apparent belief of Mesa officials that investors would be willing to tender to receive a sure price immediately rather than speculate on the future.

Other observers suggested that the buy-back offer was designed to quickly bolster the firm's reserve position. It seemed likely that Mesa would fail to replace all of its reserves for the second year in a row. Still others viewed the offer as an easy way for Mesa to boost its own value—just in case Mesa should become the target of a hostile raid.

The buy-back offer was ultimately an unqualified success. By the end of June, approximately 88% of the outstanding units had been tendered and accepted for payment.

MESA VERSUS PHILLIPS

In December of 1984, Pickens announced that Mesa and its partners had acquired a 5.7% interest in Phillips Petroleum and that they intended to acquire a controlling interest in the company. Their first step in the acquisition was a tender offer for an additional 15% of the company at \$60 per share. At \$60 per share, the total value of Phillips would be \$9.3 billion. Pickens made it clear in the early going that his group was opposed to "greenmail" and would not sell their stock unless all shareholders got the same price.⁶¹

At the time, Phillips Petroleum was the nation's 11th largest oil and gas firm, with total assets in 1983 of \$13 billion, revenues of \$15 billion, and net income of \$721 million. The company's significant reserves of crude oil and natural gas are shown in Table 4. Although the

⁶⁰ *Ibid.*

⁶¹ "Phillips Novel Solution," *The New York Times*, December 26, 1984.

TABLE 4 Phillips Petroleum Reserve Base

Year	Crude (millions of barrels)	Natural Gas (billions of cubic feet)
1979	1,023	7,741
1980	834	6,778
1981	749	6,776
1982	737	6,677
1983	969*	7,646*

*Includes reserves from the purchase of 119 million barrels of oil and 487 billion cubic feet of gas from Aminoil.

Source: "The Attractions of Phillips," *The New York Times*, December 6, 1984.

appraised value of Phillips stock was \$76 per share, it had only been trading in the mid-40s prior to the bid. Said George Baker, energy analyst for Smith Barney, "At \$60 per share, Phillips Petroleum is a bargain."⁶² According to analysts, Phillips met almost all of Pickens' requirements for restructuring—it had "an above average dividend, managers that were not pushing to maximize shareholder wealth, and a lackluster record at replacing oil and gas reserves."⁶³

Phillips quickly rejected Mesa's offer and sought to block the takeover bid. Their most effective tactic was a suit against Mesa citing a breach of a non-takeover contract with General American Oil (GAO). The GAO standstill agreement called for Mesa not to try to acquire GAO "directly or indirectly" for five years. Phillips claimed that Mesa's attempted acquisition of Phillips, as it was an indirect attempt to acquire GAO, violated this earlier contract. Despite the opinion of many analysts that Mesa would eventually win the suit, Mesa was forced to postpone the beginning of its tender offer due to legal uncertainties.

On Sunday, December 22, after a weekend of tough negotiations, Phillips and Mesa came to an agreement ending Mesa's takeover bid and adopting a plan to "put more value" in Phillips stock. The agreement was a part

of a recapitalization plan for Phillips. Under this plan Phillips would:

1. Repurchase 38% of Phillips' 154 million outstanding shares using debt with an intended market value of \$60 per share. This would amount to approximately \$3.5 billion for 58.8 million shares. The recapitalization would raise Phillips' debt/equity ratio (defined as long-term debt to total stockholders' equity) from 35% to approximately 70%.
2. Spend an additional \$1 billion buying stock on the open market, approximately 20 million shares.
3. Issuance of 32 million shares to the Phillips employee stock ownership plan (ESOP). The ESOP could borrow money for these shares at low rates due to favorable tax laws. The ESOP would end up owning approximately 38% of Phillips.
4. Arrange for Mesa to sell its shares of Phillips for a minimum of \$53 per share.
5. Phillips would sell approximately \$2 billion in assets.⁶⁴

Although many of the individual actions in the recapitalization plan were relatively common ones, the packaging of them was somewhat unique. Sources involved in the negotiations said that each part of the plan was designed to please individual groups without hurting the company.⁶⁵ Alan Edgar, analyst for Schneider, Bernet and Hickman Inc., remarked on the significance of the plan:

It's a lot more important than just a partial success for Boone Pickens. It has some far-reaching ramifications. There are other companies out there that are going to get exposed to this blueprint, either voluntarily or involuntarily.⁶⁶

Pickens later boasted that Mesa had, over time, developed an in-house financial group that could compete with anyone. "Look at the Gulf and Phillips deals," said Pickens. "Gulf and Chevron paid \$64 million to investment bankers. We paid \$8.5 million. In the Phillips deal—they paid \$35 million to investment bankers; we paid zero."⁶⁷

⁶⁴"Phillips Novel Solution," *The New York Times*, December 26, 1984.

⁶⁵Ibid.

⁶⁶Ibid.

⁶⁷"Interview: T. Boone Pickens," p. 11.

⁶²"The Attractions of Phillips," *The New York Times*, December 6, 1984, p. 33.

⁶³Ibid.

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MESA VERSUS UNOCAL

The Mesa-Unocal battle began in February of 1985 when Pickens announced that Mesa and its partners had acquired a 7.9% stake in Union Oil of California. Mesa announced the purchase was for investment purposes. Fred Hartley, chairman of Unocal, commended Mesa on making a good investment. It was not until the end of March that Pickens, now with 13.6% or 23.7 million shares of Unocal, announced that Mesa was considering a takeover or restructuring of Unocal. Shortly thereafter, Mesa announced a cash tender offer of \$54 per share for just over 50% of Unocal. The other 50% would be purchased later for an equivalent \$54 per share in notes, bringing the total offer to approximately \$8.1 billion.⁶⁸ After the bid, Pickens announced that close to \$4 billion in financing had already been arranged. A Unocal adviser commented on this announcement,

All of us were just shocked when Boone came up with that money. . . . Think of it! That's green for half the company.⁶⁹

Unocal was the nation's 12th largest oil company. It had the sixth lowest finding costs in the industry, and ranked second in terms of reserve replacement.⁷⁰

Excluding the rash of name-calling in the press, the takeover battle was being fought over two basic issues. The first of these was over the date of the Unocal annual meeting. The Mesa group sought to delay the meeting so that it would have a chance to put together a slate of directors to run against the Unocal directors. Unocal strongly opposed this proposal in an effort to deprive Mesa of the opportunity to gain control of the board of directors. As Unocal had recently added several anti-takeover provisions to its charter, attempting a takeover at any time other than an annual meeting was very difficult. Due to an intense effort, Unocal was able to win the proxy fight and block Mesa's bid to delay the meeting.

A second major battle, meanwhile, was being fought in the Delaware courts. Unocal had initially counterat-

tacked the Mesa offer with a defensive tactic designed to shake Mesa's financing. Under this plan, Unocal would tender for its own stock for \$72 per share. The offer would commence only when the Mesa group got 51% of the company. Mesa would then acquire a company with a long-term debt to the total shareholders' equity ratio of 60%, as opposed to 16%. Unocal later changed this strategy, instead offering a straight repurchase of 29% of the company's securities for \$72 per share. Under the new offer, Unocal would not accept any of the Mesa shares for repurchase. It was this issue which caused Mesa to seek redress in the Delaware courts. The courts initially ruled in favor of Mesa on two occasions, but later reversed themselves. The Delaware Supreme Court overruled the lower courts and allowed the targeted repurchase to continue. Analysts expected the SEC would move quickly to block future repurchases of this type.

The two sides got together for the first time the day after the Unocal annual meeting. Although the results of the proxy fight to delay the annual meeting were not official, it was believed that Mesa had lost. At the time of the meeting, Mesa had won the initial decision in the Delaware courts and analysts expected the Delaware Supreme Court to rule in Mesa's favor. The meeting itself seemed to go well, with Pickens commenting at the end of the day,

Fred, I think we did pretty damn good today. I didn't call you arrogant, and you didn't call me an idiot once.⁷¹

Despite having made progress toward a solution, the next day the two sides found themselves far apart. Sources said that the Unocal team had decided that there was no reason to make any concessions. The Unocal draft of the solution worked out the previous day was, according to a Pickens aide, ". . . the most ridiculous deal you ever saw. . . . It went backwards from where we were the day before."⁷² Pickens and his staff walked out of the meeting and returned to Amarillo.

After losing their bid to postpone the annual meeting, the Mesa Group's primary hope of success hinged on the tender offer. Assuming Unocal lost in the Delaware courts, Mesa planned to tender its shares in the Unocal

⁶⁸"How Mesa's Boone Pickens Finally Met Match in Unocal's Fred Hartley," *The Wall Street Journal*, May 24, 1985, p. 1.

⁶⁹Ibid.

⁷⁰"Unocal Chairman Digs in," *The New York Times*, April 16, 1985.

⁷¹"How Mesa's Boone Pickens Finally Met Match."

⁷²Ibid.

\$72 offer and use the proceeds to finance the rest of the takeover bid. Shortly after the surprise ruling by the Delaware Supreme Court, Mesa lawyers contacted Unocal and the negotiations for a final settlement began. Hartley was said to be anxious to end the battle, due to worries about what the Pickens group would do next. Pickens' advisers, meanwhile, were concerned that further attempts to make cash tender offers for Unocal could be stymied if Unocal continually outbid the Mesa group while saddling the company with more debt.⁷³

The final agreement called for Unocal to include 7.7 million of Mesa's shares in the repurchase and to spin off a large proportion of its domestic oil and gas reserves into master limited partnerships (MLPs) (MLPs are larger, more complex versions of the more traditional limited partnership arrangement. The shares, or "depository receipts," of an MLP are publicly traded and therefore liquid). Despite Pickens' claims that the Mesa shareholders would not lose any money, analysts predicted that the settlement would cost Mesa from \$80 to \$110 million.

On June 2, Mesa reported an \$83 million gain as a result of the Unocal takeover bid. The gain came from an income tax rule that allowed Mesa to report the gains it received from the settlement as dividends and not

capital gains. Mesa was also able to take a write-down of \$305 million on the Unocal shares it had to hold as a part of the settlement agreement. This write-down offset gains from previous takeover attempts.

STOCK REPURCHASE

In July of 1985, Mesa's board approved a plan to purchase up to \$100 million worth of Mesa's own 67 million outstanding shares.

"We believe that our shares represent an attractive reinvestment opportunity," explained Pickens. "Mesa constantly evaluates alternatives to maximize values for Mesa shareholders, and we believe that share repurchases meet the criteria at this time."⁷⁴

Company officials stressed that the offer should not be interpreted as an antitakeover effort. "It's not of the size that would have any antitakeover type intent," said Mesa Vice President David Batchelder. "It's really a matter of having undervalued assets in the form of Mesa common stock, which we find an attractive investment. We're able to buy reserves for \$4 a barrel."⁷⁵

⁷⁴"Mesa Approves Plan to Buy Back \$100 Million Worth of Shares," *Dallas Morning News*, July 9, 1985, p. 1D.

⁷⁵Ibid.

⁷³Ibid.

EXHIBIT 7 Domestic Finding Costs (dollars per barrel)

	1979	1980	1981	1982	1983	1984
Mesa	\$ 5.43	\$13.80	\$15.06	\$17.13	\$12.89	\$ 6.06
Phillips	9.04	9.85	12.56	6.12	7.77	6.72
Unocal	8.87	10.64	13.43	12.86	6.38	10.09
Gulf	16.47	15.84	19.23	16.00	9.11	—
Superior	43.92	10.75	14.52	15.69	—	—
Industry average	11.74	10.07	12.18	11.93	8.97	7.73

Source: *Petroleum Outlook*, June 1985, *Petroleum Outlook*, June 1984.

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EXHIBIT 8 Mesa Petroleum Reserve Recognition Accounting (in thousands)

	<i>Years Ended December 31</i>		
	<i>1984</i>	<i>1983</i>	<i>1982</i>
Standardized Measure of Future Net Cash Flows of Proved Reserves (unaudited):			
Future cash inflows.....	\$ 4,594,130	\$ 3,629,048	\$ 3,439,222
Future development and production costs:			
Operating costs and production taxes	(924,386)	(984,801)	(826,489)
Federal excise tax on oil and condensate	(34,345)	(57,278)	(96,338)
Development and abandonment costs	<u>(129,836)</u>	<u>(151,349)</u>	<u>(177,052)</u>
Future net cash flows before income taxes	3,505,563	2,435,620	2,339,343
Discount at 10% per annum	<u>(1,755,174)</u>	<u>(1,160,910)</u>	<u>(1,041,935)</u>
Discounted future net cash flows before income taxes	1,750,389	1,274,710	1,297,408
Future income taxes, net of discount at 10% per annum	<u>(319,999)</u>	<u>(265,461)</u>	<u>(252,879)</u>
Standardized measure of future net cash flows of proved oil and gas reserves	<u>\$ 1,430,390</u>	<u>\$ 1,009,249</u>	<u>\$ 1,044,529</u>
Changes in the Standardized Measure (unaudited):			
Standardized measure at beginning of year	<u>\$ 1,009,249</u>	<u>\$ 1,044,529</u>	<u>\$ 1,036,113</u>
Revisions of reserves proved in prior years:			
Net changes in prices and production costs	(33,387)	25,454	46,868
Net changes due to revisions in quantity estimates	105,656	11,618	(10,577)
Net changes in estimates of future development costs	483	(205)	(22,816)
Accretion of discount	127,471	129,741	129,032
Other, primarily timing of production	<u>13,917</u>	<u>(73,984)</u>	<u>(54,401)</u>
Total revisions	214,140	92,624	88,106
Extensions, discoveries and other additions, net of future production and development costs	81,942	119,508	310,581
Purchases of producing properties	515,532	34,801	—
Sales of oil and gas produced, net of production costs	(332,152)	(316,411)	(298,497)
Sales of producing properties	(27,628)	—	—
Previously estimated development and abandonment costs incurred during the period	23,845	46,780	31,892
Distribution to Mesa Offshore Royalty Partnership	—	—	(124,991)
Net change in income taxes	<u>(54,538)</u>	<u>(12,582)</u>	<u>1,325</u>
Net changes in standardized measure	<u>421,141</u>	<u>(35,280)</u>	<u>8,416</u>
Standardized measure at end of year	<u>\$ 1,430,390</u>	<u>\$ 1,009,249</u>	<u>\$ 1,044,529</u>

Note:

Discounted future net cash flows before income taxes are calculated by discounting such cash flows at 10% per year, compounded monthly, over the expected period of realization.

Future income taxes are computed by applying the statutory tax rate to future net cash flows less the tax basis of the properties and net operating loss and investment credit carryforwards as of each year end; permanent differences and tax credits applicable to future oil and gas producing activities are also considered in the income tax computation.

Canadian reserves have an insignificant effect (less than 3%) on either the standardized measure or the results of operations. Undiscounted future income taxes totaled \$1.1 billion in 1984, \$746 million in 1983, and \$668 million in 1982.

Source: Mesa Petroleum Company, Annual Reports.

EXHIBIT 10 Ten-Year Summary of Mesa Petroleum's Financial Data (in thousands except per share data)

	<i>Years ended December 31 (not covered by auditors' report)</i>									
	<i>1984</i>	<i>1983</i>	<i>1982</i>	<i>1981</i>	<i>1980</i>	<i>1979</i>	<i>1978</i>	<i>1977</i>	<i>1976</i>	<i>1975</i>
Oil and gas revenues	\$ 413,489	\$ 391,134	\$ 376,381	\$ 367,552	\$ 332,193	\$ 266,941	164,748	\$139,257	\$ 96,527	\$ 63,426
Operating income	154,732	\$ 158,507	\$ 152,564	\$ 171,633	\$ 143,900	\$ 122,545	\$ 84,568	\$ 79,439	\$ 53,677	\$ 31,714
Other income (expense) and taxes:										
Gain on sale of securities and assets	403,549	89,221	63,967	1,730	15,931	346,012	—	—	—	—
Interest income	87,748	19,524	23,942	33,075	40,608	14,519	781	—	—	—
Interest expense, net	(184,192)	(77,513)	(40,299)	(29,332)	(32,655)	(49,601)	(18,301)	(8,840)	(3,384)	(3,708)
Dividend income and other	13,754	10,006	(4,670)	8,683	(7,359)	1,710	988	800	541	539
Provision for income taxes	(205,407)	(73,835)	(65,600)	(70,740)	(65,189)	(149,563)	(26,270)	(30,100)	(20,100)	(9,375)
Net income	270,184	125,910	129,904	115,049	95,236	285,622	41,766	41,299	30,734	19,170
Preferred stock dividends	(16,333)	(11,019)	(13,959)	(8,670)	—	—	—	(2,394)	(4,899)	(3,288)
Net income available for common	\$ 253,851	\$ 114,891	\$ 115,945	\$ 106,379	\$ 95,236	\$ 285,622	\$ 41,766	\$ 38,905	\$ 25,835	\$ 15,882
Net income per common share	\$ 3.75	\$ 1.72	\$ 1.72	\$ 1.54	\$ 1.38	\$ 4.43	\$.66	\$.64	\$.48	\$.31
Cash dividends per common share	\$.20	\$.20	\$.20	\$.12	\$.0525	\$.0975	\$.11	\$.0625	\$.025	\$.0125
Cash and short-term investments, marketable securities and interest-bearing receivables	\$2,119,835	\$ 882,426	\$ 294,506	\$ 556,072	\$ 418,688	\$ 398,951	\$ 87,204	\$ 71,876	\$ 48,247	\$ 12,498
Long-term debt, including current maturities, subordinated notes and redeemable preferred stock	\$2,586,679	\$1,429,623	\$ 924,114	\$1,094,780	\$ 661,968	\$ 626,551	\$451,233	\$321,453	\$224,571	\$150,730
Total assets at year end	\$3,955,951	\$2,305,645	\$1,667,230	\$2,069,355	\$1,426,850	\$1,268,459	\$974,963	\$800,210	\$614,627	\$496,897
Stockholders' equity	\$ 741,594	\$ 502,505	\$ 416,901	\$ 595,445	\$ 509,775	\$ 400,181	\$315,044	\$337,223	\$300,483	\$276,476

Source: Mesa Petroleum Company, Annual Reports.