

A Guide to Takeovers: Theory, Evidence, and Regulation

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The last decade witnessed an explosion of activity in the field of corporate takeovers, which ended in an environment of increased regulation of these transactions. These events have prompted extensive study into the causes for takeovers and the effects of their regulation. This article surveys and analyzes both the economic literature and the law in an attempt to determine which regulatory regimes make the most sense in light of the empirical evidence.

Though no single theory is sufficient to explain all takeovers, the empirical evidence is most consistent with explanations of takeovers as value-maximizing events for target firm shareholders that enhance social efficiency. Economic learning and public policy, however, have not marched in step. Influenced by unsubstantiated fears and suspicions, often raised by managers, about the impact of takeovers on third parties, regulation in the United States has tended to thwart and burden takeovers as if they were non-value-maximizing wealth transfers. The author concludes that an informed reading of the literature suggests that much of the existing regulatory apparatus is unwarranted.

Introduction	120
I. Theories of Takeovers and Related Transactions	122
A. Value-Maximizing Efficiency Explanations	125
1. Synergy Gains	125
a. Operating Efficiencies	126
b. Financial Synergy	127
2. Reducing Agency Costs	129
a. Replacement of Inefficient Management	129
b. Free Cash Flow	131
c. Improved Incentives from Ownership Changes in MBOs	133
B. Value-Maximizing Expropriation Explanations	133

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1. <i>Tax Benefits</i>	133
2. <i>Bondholder Expropriation</i>	136
3. <i>Expropriation from Labor</i>	137
4. <i>Market Power</i>	142
C. <i>Value-Maximizing Market Inefficiency Explanations</i>	143
1. <i>Underpricing</i>	143
2. <i>Market Myopia</i>	144
D. <i>Non-Value-Maximizing Expropriation Explanations</i>	145
1. <i>Diversification</i>	146
2. <i>Self-Aggrandizement</i>	148
3. <i>Free Cash Flow on the Acquirers' Side</i>	149
4. <i>Hubris and the Winner's Curse</i>	150
E. <i>Summary and Conclusion</i>	152
II. <i>Regulatory Implications</i>	155
A. <i>Regulation Encouraging Takeover Auctions</i>	156
1. <i>Should Auctions Be Encouraged At All?</i>	157
2. <i>Should Auctions Be Encouraged in Specified Cases?</i>	160
B. <i>Regulation Restricting Two-Tier Takeovers</i>	168
C. <i>Regulation Restricting Bidders' Ownership Rights</i>	170
D. <i>Regulation Introducing Non-Shareholder Interests</i>	171
E. <i>Regulation through the Federal Tax Code</i>	173
1. <i>Restricting Deductions</i>	173
2. <i>Taxing Defensive Tactics</i>	174
F. <i>Regulation by Antitrust Enforcement</i>	177
G. <i>Summary and Conclusion</i>	177

Introduction

There is a voluminous economic literature seeking to explain takeovers. There is also substantial regulation. This article relates the one to the other, and is a guide to both. It reviews the economic literature in order to facilitate an evaluation of the efficacy of current regulation. The premise is that if some explanations of takeovers are more plausible than others, then certain regulatory regimes make more sense than others. I refer to explanations in the plural because we do not have a comprehensive theory of takeovers. Different theories do well at explaining various subsets of acquisitions, but no theory satisfactorily explains all.

The empirical evidence is most consistent with value-maximizing, efficiency-based explanations of takeovers. Yet the thrust of regulation is to thwart

and burden takeovers, as if they were non-value-maximizing wealth transfers. The sharp discrepancy between the economic understanding of takeovers and the output of the political process in this area is a function of two factors. First, the public is largely uninformed about and uninterested in takeovers.¹ Takeover regulation is therefore low salience legislation for most voters, and interest groups are consequently able to exercise significant influence on legislators in this area. Second, there are asymmetric organizational advantages across the interest groups most affected by takeovers that favor those whom takeovers potentially harm, managers, over those whom takeovers benefit, shareholders. Managers are easier to coordinate across firms than shareholders, and they have more to lose.² The organizational advantage is important because lobbyists play a significant role in educating legislators,³ and intuition is often at odds with the economic learning.⁴ Under such circumstances, legislators are likely to be woefully misinformed concerning the probable effects of takeovers—their education is incomplete and distorted—and predisposed to regulate.

This article seeks to ease the informational problem for legislators and policymakers, as it provides a nontechnical analysis and synthesis of the scholarship on takeovers and their regulation.⁵ The current lull in takeover activity makes this an ideal time for a retrospective evaluation, as we can reflect upon what the frenzied, often dizzying and breath-taking, pace of dealmaking in the 1980s produced. The effort should also prove useful for evaluating other countries' takeover regulation, such as the proposed European Community (EC) framework. However, because markets and institutional arrangements differ

1. Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 491 (1988).

2. Managers already interact through interlocking boards and trade associations. While institutional investors may organize, their associations are less likely to be self-sustaining as they can provide less private information or benefits to members than a business trade organization. *See id.* at 468-69. *See generally* MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 144-47 (1971). This asymmetry is exacerbated at the state level because a target's managers reside in the legislating state and are politically well-connected, whereas its shareholders are dispersed across many states and thus not part of the local voting constituency. Finally, individuals are more likely to engage in collective action to avoid a public "bad", than to obtain a public good. RUSSELL HARDIN, *COLLECTIVE ACTION* 82-83 (1982). This tendency favors managers, who are seeking to avoid job loss, as against shareholders, who obtain a higher stock price. In addition, Roe contends that federal regulation of the financial services industry should be understood as an effort to eliminate effective monitoring (hence disciplining) of corporate managers by preventing concentration of ownership in the most capable shareholders, financial institutions. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

3. WILLIAM K. MUIR, *LEGISLATURE: CALIFORNIA'S SCHOOL FOR POLITICS* (1982).

4. *See* Romano; *supra* note 1, at 495-97.

5. For an earlier article in a similar spirit see John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

substantially across the United States and Europe, lessons from the U.S. experience must be drawn with care.⁶

The article proceeds as follows: in the first Part, I classify and review the numerous explanations that have been proposed for takeovers and related transactions, in conjunction with the empirical research that sheds light on the plausibility, or power, of the explanations. In the second Part, I consider the implications of the economic literature for the current patchwork of takeover regulation. I conclude that an informed reading of the literature suggests that much of the regulatory apparatus is unwarranted.

I. Theories of Takeovers and Related Transactions

One important, and undisputed, datum about acquisitive transactions should be noted from the outset: acquisitions generate substantial gains to target company shareholders. All studies find that target firms experience statistically significant positive stock price responses to the announcement of takeover attempts or merger agreements.⁷ On average, there is a 20% increase over the pre-announcement market price for mergers and a 30% increase for tender offers in the period around the takeover announcement.⁸ Abnormal returns in going-private transactions (leveraged buyouts) are of similar magnitude, ranging across studies between 20% and 37%.⁹ Without question, the announcement of a bid is good news for target shareholders. The different explanations of

6. Wright, Robbie and Thompson contend that financial markets ("buyout markets") are less developed in parts of Europe, as compared to the United States. These deficiencies make leveraged buyout transactions by management or other investors unavailable as a competitive response to a takeover in those countries. Mike Wright, Ken Robbie & Steve Thompson, *Corporate Restructuring, Buy-Outs, and Managerial Equity: The European Dimension*, 3 J. APPLIED CORP. FIN., Winter 1991, at 47-48. They also note that European buyouts involve corporations that are family-dominated or otherwise closely-held, unlike most American firms. This means that hostile takeovers will be a less frequently employed device for control changes than friendly acquisitions. Furthermore, U.S. financial institutions' ownership of equity in manufacturing companies is restricted, which makes takeovers more important as a mechanism for disciplining management in the United States than in countries, such as Germany, where there are no such restrictions. *Id.*, at 50-52.

7. Most of the studies referred to throughout this article are "event studies," which use standard statistical techniques to test whether firms' stock returns at the time of an event, such as the announcement of a bid, are significantly different from their expected returns. The difference is referred to as an average residual or abnormal return. A statistically significant abnormal return represents the market's valuation of the event (its impact on shareholder wealth). For a review of the methodology see Stephen J. Brown & Jerold B. Warner, *Using Daily Stock Returns*, 14 J. FIN. ECON. 3 (1985).

8. Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP., Winter 1988, at 49; Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

9. Steven N. Kaplan, *Sources of Value in Management Buyouts*, in LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 95 (Yakov Amihud ed., 1989); Kenneth Lehn & Annette Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FIN. 771 (1989); Laurentius Marais, Katherine Schipper & Abbie Smith, *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155 (1989).

acquisitions that will be examined are efforts at explaining the source of these gains.

The data are more ambiguous, however, concerning acquiring firms' returns. Depending on the sample and time period, acquirers experience positive, negative, or zero abnormal returns on a bid's announcement and completion. From the acquirer's perspective, there are two classes of explanations or motivations for a takeover: value-maximizing and non-value-maximizing ones. Value-maximizing explanations view takeovers as undertaken in order to increase the equity share price of the acquiring firm. Non-value-maximizing explanations consider takeovers in diametrically opposite terms, as transactions that maximize managers' utility rather than shareholder wealth. These two explanations therefore predict a different stock price reaction, positive and negative, respectively.

Value-maximizing explanations can be subdivided into efficiency, expropriation (wealth transfer), and market inefficiency explanations. This division is pivotal for policy analysis, but has no differential impact on the acquirer's expected return from the transaction. It will be positive in each case. Each non-value-maximizing explanation can be characterized as a distinct expropriation story, in which wealth is transferred from the acquiring firm's shareholders to the target firm (as well as to the managers). These transactions will thus have a negative stock price effect. To preview the classification schema, see Table 1.

There are, however, theoretically plausible reasons for not finding positive abnormal returns to bidders even when acquisitions are value-maximizing transactions. First, acquiring firms are typically much larger than target firms, making it more difficult to measure abnormal returns.¹⁰ Second, a bid may reveal information about the bidding firm unrelated to the particular acquisition, confounding the stock price effect.¹¹ Third, if the takeover market is competi-

10. Where the target is a very small fraction of the bidder's value, the acquisition is unlikely to have any measurable impact on the bidder's stock price. Asquith, Bruner and Mullins find significantly greater positive abnormal returns for acquirers of larger targets, and Jarrell and Poulsen find that acquirers' abnormal returns increase significantly as the target increases in size relative to the acquirer. Paul Asquith, Robert F. Bruner & David W. Mullins, *The Gains to Bidding Firms from Merger*, 11 J. FIN. ECON. 121 (1983); Gregg A. Jarrell & Annette B. Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, 18 FIN. MGMT. 12 (1989).

11. The unrelated information concerning the bidder could cut both ways: a bid may signal that the bidding firm has done better than expected, with cash flows high enough to make a bid ("good news"), or it may signal that the managers are going to use cash to chase a resisting target for which they might overpay ("bad news"). Studies that find that bidders' returns vary significantly with the consideration the bidder uses for the acquisition have been interpreted as evidence of a signaling effect. When bidders use stock instead of cash, researchers find a negative price effect; the interpretation is that when a bidder thinks its stock is overvalued, it uses stock rather than cash for the acquisition and the market, understanding the signal, reacts accordingly. See Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984); Nickolaos Travlos, *Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns*, 42

tive, then bidders will earn only normal returns, as abnormal profits are competed away. Finally, for acquiring firms that have an active mergers and acquisitions program, the gain from a specific acquisition may have been anticipated in the bidder's stock price at the time the mergers and acquisitions program was announced.¹²

Despite these interpretative subtleties concerning acquirers' stock price reactions, one may draw some generalizations from the data. The price movement for acquirers is small in percentage terms and less statistically significant than that for target firms. In addition, acquirers' returns have decreased over time and, in the 1980s, may have been negative.¹³ Moreover, even when acquirers earn negative returns, when their losses are aggregated with the targets' gains, acquisitions still net a positive abnormal return.¹⁴ Thus, because the division of the gain is skewed toward targets, takeovers that appear to be non-value-maximizing transactions for bidders may be socially beneficial (that is, aggregate wealth increases).¹⁵

Studies of the performance of target firms after acquisition also shed light on whether acquisitions are value-maximizing or non-value-maximizing transactions. Here, stock price data are less reliable indicators for, as the interval over which the price is examined increases, changes can no longer be readily attributed to the event in question (the takeover) because it will be confounded with other events.¹⁶ Most of these studies therefore use accounting data to determine long-term changes in performance. As with event studies of the announcement effects on acquirers, the ex-post performance findings are also

J. FIN. 943 (1987).

12. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L., ECON., & ORG. 225 (1985); Katherine Schipper & Rex Thompson, *Evidence on the Capitalized Value of Merger Activity for Acquiring Firms*, 11 J. FIN. ECON. 85 (1983).

13. Bradley, Desai and Kim find significantly negative abnormal returns to bidders in the 1980s whereas Jarrell and Poulsen find bidders' returns are insignificantly negative over the same years. Michael Bradley, Anand Desai & E. Han Kim, *Synergistic Gains from Corporate Acquisitions and their Division between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3 (1988); Jarrell & Poulsen, *supra* note 10. Both studies find bidders' returns in the 1960s and 1970s were significantly positive. In addition, Morck, Shleifer and Vishny find that the returns to acquirers making diversifying acquisitions in the 1980s are negative (as opposed to 1980s acquisitions of firms in related lines of business, and as opposed to diversifying acquisitions in the 1960s). Randall Morck, Andrei Shleifer & Robert W. Vishny, *Do Managerial Motives Drive Bad Acquisitions?*, 45 J. FIN. 31 (1990). These studies may, however, underestimate bidder returns as they necessarily exclude privately-held bidders (i.e., leveraged-buyout firms), whose transactions throughout the 1970s and at least the early 1980s were extremely profitable.

14. See, e.g., Bradley et al., *supra* note 13; STEVEN KAPLAN & MICHAEL S. WEISBACH, *THE SUCCESS OF ACQUISITIONS: EVIDENCE FROM DIVESTITURES* (National Bureau of Economic Research Working Paper No. 3484, 1990).

15. They would not be socially beneficial if the increase in wealth is due to a wealth transfer rather than an efficiency gain.

16. For a further discussion of problems with using ex-post stock price data, see Ellen Magenheim & Dennis Mueller, *Are Acquiring-Firm Shareholders Better Off After an Acquisition?*, in *KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* 171 (John C. Coffee et al. eds., 1988).

mixed. While earlier studies find no operating improvements in merged firms, more recent sophisticated studies find that performance improves post-merger.¹⁷

One difficulty in assessing post-merger performance is in determining the appropriate comparison, which entails constructing a counterfactual benchmark—what the two firms' performances would have been had they not merged. In an important paper, Jarrell compares post-merger performance to analysts' pre-merger forecasts of the firms' performance.¹⁸ She finds that five years post-merger, the merged firms perform significantly better (9%) than the benchmark, although one to two years immediately after the merger the performance was worse than the benchmark. The capital market also accurately anticipates long-term performance: using regression analysis, Jarrell finds that the abnormal stock price effects upon a bid's announcement are significantly positively related to the merged firm's subsequent profitability. These data indicate that acquisitions are, indeed, value-maximizing, for the long-term performance of the combined firms improved. They also suggest that negative findings of earlier studies are, in all likelihood, the product of failure to use an appropriate benchmark.¹⁹

A. Value-Maximizing Efficiency Explanations

There are two efficiency explanations of takeovers: to realize synergy gains and to reduce agency costs.

1. Synergy Gains

One value-maximizing efficiency explanation of takeovers is to achieve synergy gains: the value of the combined firm is greater than the value of the

17. Compare Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in *KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER*, *supra* note 16, at 211 and D. RAVENSCHRAFT & F. SCHERER, *MERGERS, SELLOFFS AND ECONOMIC EFFICIENCY* (1987) with Paul M. Healy, Krishna G. Palepu & Richard S. Ruback, *Does Corporate Performance Improve After Mergers?* (1990) (unpublished manuscript, on file with the author) and Sherry L. Jarrell, *Do Takeovers Generate Value? Evidence on the Capital Market's Ability to Assess Takeovers* (1991) (unpublished manuscript, on file with the author).

18. Jarrell, *supra* note 17. The performance measure is the ratio of net income to sales. The performance forecasts were made before any information on a bid was known. Jarrell constructs a control portfolio of firms, matched by size and industry, which did not engage in a merger, and tests for the difference between the merged firms and control firms' difference between forecasted performance and actual performance.

19. *Id.* at 39. Healy, Palepu, and Ruback, *supra* note 17, also construct a pre-merger performance benchmark to measure post-merger performance and find that profitability improves. In addition, both Healy, Palepu and Ruback and Jarrell, *supra* note 17, adjust post-merger earnings for changes in accounting methods and acquisition financing. The studies that find profitability deteriorates post-merger, *see supra* note 17, do not make such adjustments, and their results are, accordingly, less reliable.

two firms (target and acquirer) separately. The increased value may be generated by real operating efficiencies, or it may be due to financial synergies.

a. *Operating Efficiencies*

Examples of operating synergistic gains are economies of scale (fixed costs are spread over a larger volume of production), and economies of scope (complementary resources are combined, such as a merger between a firm with a unique product and another with the sales organization to market it). Another potential operating synergy involves differential managerial ability. The acquiring firm's managers may be good at managing but have excess capacity (they can efficiently manage more than the assets of their firm). The firm can use these excess managerial resources by acquiring a firm that is less efficiently managed due to shortages of managerial resources, and the combination will thereby produce a synergy gain.²⁰ This story assumes that managerial skills are indivisible, a product of a team, and further, that management teams are not available for acquisition by contract. The thesis is that good managers must develop firm-specific knowledge, and that under a contractual arrangement, the managers' capital could be appropriated by the target firm. Accordingly, to ensure that the management team receives a share of the quasi-rents it produces, its compensation is taken through "ownership" of the target's management (by acquiring the target).²¹

The synergy explanation implies that: (1) the returns to bidders and targets will be positively correlated, as synergy prevents a bidding competition that would reduce the correlation in returns to zero because the merging firms are a uniquely valuable match;²²(2) takeovers will be more valuable when there are size differentials as economies of scale are attainable; and (3) takeovers will be more valuable when economies of scope as well as economies of scale are present. There is evidence that supports these predictions. Weston, Chung, and Hoag find that the correlation between bidder and target stock returns in pure conglomerate and product-extension mergers, which are likely to produce economies of scope, from combining managerial skills or complementary

20. J. FRED WESTON, KWANG S. CHUNG & SUSAN E. HOAG, *MERGERS, RESTRUCTURING AND CORPORATE CONTROL* 93-94, 191-92 (1990).

21. A quasi-rent is the excess value of an asset over its next best use; here, the manager is worth more running the particular firm than in other employment. The difference between this differential managerial ability explanation of takeovers and the replacement of inefficient management explanation, *see* discussion *infra* Part I.A.2.a, is that the acquirer's management in the synergy explanation seeks to complement the target's management, having experience in the line of business, so it explains horizontal mergers, whereas the inefficient management explanation is applicable to any acquisition. WESTON ET AL., *supra* note 20, at 192-93.

22. *Id.* at 266.

resources, as well as financial synergy, is significantly positive.²³ Hawawini and Swary find that among bidders, small banks experience higher abnormal returns from mergers than large banks, and that the smaller the target bank in relation to the bidder, the higher the target's abnormal returns.²⁴ Finally, acquisitions of firms in related businesses, where gains from economies of scale and scope are most likely, are extremely profitable: acquisitions of unrelated companies in the 1980s produced lower returns than related-firm acquisitions;²⁵ and a significant portion of the gains from hostile takeovers are due to reallocation of target assets to related acquirers.²⁶

b. *Financial Synergy*

An historically popular explanation of merger activity that falls in the financial synergy category was the availability of certain accounting methods for acquisitions. Because the pooling method of accounting for an acquisition reports higher accounting earnings for the combined entity than the purchase method (the part of the premium attributable to intangibles--goodwill--is not recognized, and hence not amortized, under pooling), its use was thought to increase the value of a transaction. The availability of the pooling method was therefore viewed as a motive for many mergers. Belief in the power of this explanation led to restrictions on use of the pooling method under the Accounting Principles Board's Opinions 16 and 17.²⁷

Accounting-based financial synergy is, however, a spurious example of synergy because the choice of accounting method has no impact on the combined firm's cash flow. It could explain mergers, then, only if the market was fooled by the convention. Studies show, however, that the market sees through the accounting conventions to the firms' economic earnings.²⁸ In addition, Opinions 16 and 17 had no significant impact on acquirer stock prices.²⁹ These

23. *Id.* at 267-68. See discussion of financial synergy *infra* Part I.A.1.b.

24. GABRIEL A. HAWAWINI & ITZHAK SWARY, *MERGERS AND ACQUISITIONS IN THE U.S. BANKING INDUSTRY: EVIDENCE FROM THE CAPITAL MARKETS* 130-35 (1990). The finding that small banks experience higher abnormal returns than large ones may, however, be a purely technical phenomenon: abnormal returns are more likely to show up for small rather than large firms because any given gain will represent a larger percentage of firm value. See *supra* text accompanying note 10.

25. Morck et al., *supra* note 13.

26. Sanjai Bhagat, Andrei Shleifer & Robert W. Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS* 1990 1, 55 (Martin N. Bailey & Clifford Winston eds., 1990).

27. RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 267 (1986).

28. Hai Hong, Robert S. Kaplan & Gershon Mandelker, *Pooling vs. Purchase: The Effects of Accounting for Mergers on Stock Prices*, 53 *ACCT. REV.* 31 (1978).

29. Katherine Schipper & Rex Thompson, *The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms*, 21 *J. ACCT. RESEARCH* 184 (1983). A potential real effect of Opinions 16 and 17 is to make debt covenants more binding where lending agreements depend on accounting numbers for reported income. Leftwich finds some evidence of an effect (negative abnormal returns are significantly

data demonstrate conclusively that accounting-based financial synergy did not motivate takeovers.

A more plausible explanation of takeovers involving financial synergy is that takeovers reduce the cost of capital. Three distinct finance theories are implicated: (1) the risk of bankruptcy is reduced if firms' cash flows are not perfectly positively correlated; (2) the steadier income stream of the merged firms ensures and improves the usage of the firms' tax shields; and (3) there is a cost differential between internal and external funds. For expositional purposes, discussion of the first will be deferred to Part I.D.1, diversification explanations of takeovers, and of the second, to Part I.B.1, tax-based explanations of takeovers.

Capital costs are higher when funds are raised externally—flotation and transaction costs are reduced if spread over a larger issue, and eliminated if the merged firm's cash flow is sufficient to produce all necessary cash internally.³⁰ An acquisition is, correspondingly, a way to redeploy capital efficiently across low and high growth firms. Organizational changes in the 1960s enabled corporate managers to efficiently allocate funds internally to more needy divisions, and this new organizational form's efficient properties were logically extended through acquisitions to create the conglomerate firm.³¹ There is an additional, tax-related explanation of cost of capital synergy. Because of the two-tier corporate tax and differential personal tax rates on dividend and capital gain income, firms have an incentive to use retained earnings that are not subject to the dividend taxes to finance projects whose returns are lower than the marginal cost of capital were they to be financed externally.³² A merger between an internally financing firm and an externally financing one can redirect the former's unprofitable expenditures to the higher return projects that the latter firm was financing externally.³³

Some empirical evidence is consistent with this explanation. Markham found that after conglomerate acquisitions, capital expenditure planning was shifted

related to the degree of private debt leverage and debt callability), Richard Leftwich, *Evidence on the Impact of Mandatory Changes in Accounting Principles on Corporate Loan Agreements*, 3 J. ACCT. & ECON. 3 (1981), but Schipper and Thompson, *supra*, do not find any effect, or any significant cross-sectional variation. Of course, a debt contract effect does not provide evidence on the issue of importance here, whether the purchase/pooling choice motivated acquisitions.

30. WESTON ET AL., *supra* note 20, at 97-98, 197.

31. Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).

32. Ronald Masulis & Brett Trueman, *Corporate Investment and Dividend Decisions under Differential Personal Taxation*, 23 J. FIN. & QUANTITATIVE ANALYSIS 369 (1988). Although capital gains have been taxed at the same rate as ordinary income since 1986, because they are deferred until the stock is sold, the tax rate is still lower for this source of investment income.

33. *Id.* at 381-82. This explanation is consistent with Jensen's free cash flow thesis as applied to acquirers. See discussion *infra* Part I.D.3.

to the firm's corporate headquarters, but other managerial functions were not.³⁴ Nielsen and Melicher find higher premiums are paid when the acquirer's cash flow rate is higher than the target's, and Weston, Chung, and Hoag interpret this as evidence of redeployment of capital from acquiring to acquired firm industries.³⁵ They also regard Markham's finding of large increases in capital outlays after acquisitions as consistent with financial synergy because it implies that the acquirers' investment opportunities improved with the takeover.³⁶

2. Reducing Agency Costs

A reduction in agency costs is the other efficiency explanation for takeovers. Corporate law is concerned with principal-agent problems, the alignment of managers' incentives with shareholders' interests. A takeover is, in this framework, a backstop remedy when other corporate governance devices that monitor performance, such as the board of directors, fail at effective incentive-alignment.³⁷

a. Replacement of Inefficient Management

The most important agency cost explanation of takeovers is that they reduce managerial slack by replacing inefficient management. Manne put forth this view in a classic article over 20 years ago, and it is one of the central insights in corporate law scholarship.³⁸ Manne maintained that takeovers are the market for corporate control's key mechanism for disciplining managers because, unlike mergers, which require the approval of the target firm's board, the takeover bypasses target management and goes directly to the target shareholders for approval. Takeovers accordingly keep the capital market competitive, and constrain managers to work in the shareholders' interest.

A number of studies provide support for this explanation. For example, acquired firms earn low rates of return prior to mergers and acquiring com-

34. JESSE W. MARKHAM, *CONGLOMERATE ENTERPRISES AND PUBLIC POLICY* (1973). I consider this evidence of financial rather than operating (differential managerial ability) synergy because the latter source of gain implies that all managerial functions would be transferred.

35. James F. Nielsen & Ronald W. Melicher, *A Financial Analysis of Acquisition and Merger Premiums*, 8 J. FIN. & QUANTITATIVE ANALYSIS 139 (1973), discussed in WESTON et al., *supra* note 20, at 197.

36. WESTON et al., *supra* note 20, at 198.

37. For example, Morck, Shleifer and Vishny find that top management is more likely to turn over by board action when the firm's performance is poor relative to its industry, but not when the firm's industry is itself doing poorly. Randall Morck, Andrei Shleifer & Robert W. Vishny, *Alternative Mechanisms for Corporate Control*, 79 AM. ECON. REV. 842 (1989). In the latter setting, they find that top management changes through hostile takeovers.

38. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

panies are above average in profitability.³⁹ Morck, Shleifer, and Vishny find that targets of hostile takeovers, in which managers are more likely to be replaced, are poor performers, as measured by low Tobin's q ratios, compared to targets of friendly acquisitions.⁴⁰ Moreover, target firms have, on average, low q ratios, and the gains from takeovers increase when bidders with high q ratios acquire targets with low q ratios.⁴¹ Finally, Mitchell and Lehn find that bad bidders make good targets: firms that experience negative abnormal returns from acquisitions are more likely to be acquired than firms that do not.⁴² These studies all indicate that takeovers discipline management, because they are focused on firms with poor performance.

In addition, management turnover is much higher after a takeover than it is when there is no change in control or when firms engage in a friendly merger.⁴³ Most importantly, Martin and McConnell find that takeover targets whose managers are replaced earned negative abnormal returns before the takeover, as measured against their industry, while targets whose managers are retained earned positive abnormal returns.⁴⁴ Of course, turnover does not necessarily indicate that the departing managers are of poorer quality than their replacements. But if we did not observe turnover at the top after takeovers, and if such turnover was unrelated to the targets' performance, then the inefficient management explanation would be in serious jeopardy.

Finally, there is evidence that after mergers, firms' cash flows improve as a result of increased asset productivity.⁴⁵ Because the cash flow improvements do not differ across related and unrelated-firm acquisitions, the gains do not appear to come from the realization of operating synergies. This finding suggests that acquirers are better able to manage target assets. I therefore

39. Paul Asquith, *Merger Bids, Uncertainty and Shareholder Returns*, 11 J. FIN. ECON. 51 (1983); James C. Ellert, *Mergers, Antitrust Law Enforcement, and Stockholder Returns*, 31 J. FIN. 715 (1976).

40. Randall Morck, Andrei Shleifer & Robert W. Vishny, *Characteristics of Targets of Hostile and Friendly Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101 (Alan J. Auerbach ed., 1988). Tobin's q is the ratio of a firm's market value to the replacement cost of its physical assets. It thus measures the firm's intangible assets—goodwill, future growth opportunities, quality of management. As Servaes puts it, Tobin's q “measures the market's assessment of the value of the assets in place and . . . future investment opportunities [and a]s such it is a measure of managerial performance.” Henri Servaes, *Tobin's Q, Agency Costs and Corporate Control I* (1989) (unpublished manuscript, on file with the author). A low q ($q < 1$) indicates poor performance.

41. Larry H. P. Lang, René Stulz & Ralph A. Walkling, *Managerial Performance, Tobin's q, and the Gains from Successful Tender Offers*, 24 J. FIN. ECON. 137 (1989); Henri Servaes, *Tobin's Q and the Gains from Takeovers*, 46 J. FIN. 409 (1991).

42. Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990).

43. Eugene P.H. Furtado & Vijay Karan, *Causes, Consequences, and the Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence*, 19 FIN. MGMT. 60 (1990); James P. Walsh, *Top Management Turnover Following Mergers and Acquisitions*, 9 STRATEGIC MGMT. J. 173 (1988).

44. Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991).

45. See Healy et al., *supra* note 17.

consider it to be consistent with the inefficient management explanation of takeovers.

The inefficient management explanation cannot, however, explain all restructuring transactions. It cannot, for example, explain acquisitions in which the acquirer retains incumbent management, a pattern that appears to have been common in large acquisitions by conglomerate firms.⁴⁶ In particular, it cannot explain management-led leveraged buyouts (MBOs), because in these transactions top management is part of the acquiring group and stays on the job. However, even in these transactions, there are often subsequent management changes.⁴⁷

b. *Free Cash Flow*

An alternative explanation that views takeovers as a mechanism for reducing agency costs but does not predict management's replacement is Jensen's "free cash flow" theory.⁴⁸ Jensen contends that a cause of takeover activity, especially in the petroleum industry, is the agency cost associated with the conflict between managers and shareholders over the payout of free cash flow. Free cash flow is cash flow in excess of the amount required to fund all of the firm's projects that have a positive net present value. If these funds are paid out to shareholders, managers will have fewer resources under their control, and will thus be unable to waste cash by investing in projects with negative net present values. In addition, eliminating free cash flow subjects managers to capital market monitoring when they need to finance new projects, further constraining their ability to undertake negative net present value transactions.

This explanation stands the financial synergy (reduction of the cost of capital) explanation on its head, both because it is the target and not the acquiring firm with excess cash, and because external financing is deemed preferable to internal financing, due to incentive problems. But in contrast to the other efficiency explanations, an acquiring firm is not needed to realize this operating improvement. Incumbent managers can eliminate free cash flow on their own through a financial restructuring, which increases the firm's leverage and pays the borrowed cash out to the shareholders. Synergy gains, by defini-

46. MARKHAM, *supra* note 34.

47. The majority buyer in a leveraged buyout often replaces the retained incumbent management within a year or so of the MBO. *See, e.g.,* Roberts v. General Instrument Corp., Civ. No. 11639 (Del. Ch. Aug. 1990) (3 of 5 Forstmann-Little buyout firms canvassed by defendant had new, i.e., non-incumbent, chief executive officers). In addition, 12% of the firms in Smith's sample of MBOs replaced a chief executive officer under age 65 within 2 years of the buyout. Abbie J. Smith, *Corporate Ownership Structure and Performance: The Case of Management Buyouts*, 27 J. FIN. ECON. 162 (1990). These data suggest that MBOs may well be driven by Manne's explanation.

48. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER, *supra* note 16, at 314.

tion, require two firms,⁴⁹ and replacing inefficient management requires a change in the management team. Hence, of the explanations analyzed thus far, only free cash flow explains an increase in value from a defensive restructuring, as well as from a takeover.

The free cash flow theory of takeovers provides a non-tax explanation for why debt increases upon an acquisition. Issuing debt restricts future free cash flows because, unlike dividends on stock, interest must be paid to avoid the bankruptcy trigger of default. The leveraged acquisition or going-private transaction is thus a credible commitment to eliminate free cash flow. It increases the firm's value by mitigating the agency cost from the misuse of excess cash.

Lehn and Poulsen educed support for the free cash flow explanation from a study of going-private transactions: they found that the likelihood of firms going private was directly related to the size of their free cash flows and the threat of a hostile takeover (the reason why management is willing to forego free cash flows), and inversely related to growth (that is, firms tended to be taken private when there were no reinvestment opportunities for the cash).⁵⁰ They also found that the magnitude of the premium in these cases was significantly positively related to the magnitude of the firms' undistributed cash flows. In addition, target firms have low Tobin's q ratios,⁵¹ which suggests that they are firms with excess cash.⁵² Finally, managers perceive elimination of free cash flow as a takeover motive. Pound finds that firms choosing to be covered by Pennsylvania's restrictive takeover statute have significantly lower cash flow valuation ratios, though not lower cash flow, than firms opting out of the statute's coverage.⁵³ His interpretation is that managers who fear a takeover (those who did not opt out of the statute) are successful at generating cash from current assets but likely to misuse the funds (that is, their firms are free cash flow acquisition targets) because the low valuation ratio conveys the market's distrust of how management will use the cash.⁵⁴

49. There can be synergy gains in a leveraged buyout, to the extent that the buyout (financing) group brings valuable excess managerial skills to the target firm.

50. Lehn & Poulsen, *supra* note 9.

51. Lang et al., *supra* note 41; Servaes, *supra* note 41.

52. Servaes argues that Tobin's q ratio can be interpreted as a measure of agency costs because a low q is evidence of overinvestment, which may be viewed as a source of free cash flow. Servaes, *supra* note 40. He finds that the target firms in his sample, in addition to their low q ratios, have lower dividend payouts and lower debt levels than other firms in their industry, which suggests that they have more free cash flow because they pay out less to their security holders. They also have lower capital expenditures as a percent of assets, which implies that they have poor investment opportunities.

53. John Pound, *On the Motives for Choosing a Corporate Governance Structure*, (1990) (unpublished manuscript, on file with the author).

54. *Id.* at 14.

c. *Improved Incentives from Ownership Changes in MBOs*

There is, of course, a simpler agency cost reduction explanation for MBOs than eliminating free cash flows. In an MBO, management's ownership share dramatically increases. By making management a substantial stockowner, the MBO provides powerful incentives to increase productivity. This is, in fact, a classical approach to mitigating the principal-agent problem that is used quite commonly, but on a smaller scale, in stock-based incentive compensation plans.⁵⁵

The explanation of MBO gains as a result of improved incentives from increased ownership is consistent with the substantial evidence, reviewed in Smith, that post-buyout firms experience significant operating efficiencies and productivity improvements.⁵⁶ Wright, Robbie, and Thompson's study of United Kingdom MBO firms that subsequently went public provides important additional support: they find that abnormal returns, measuring the firms' increased value post-buyout, vary directly with management's equity ownership.⁵⁷ Finally, Lichtenberg and Siegel find significant improvements in productivity occur after MBOs.⁵⁸ Of course, this explanation of takeovers is limited because it applies solely to one type of acquisitive transaction, MBOs.

B. *Value-Maximizing Expropriation Explanations*

Expropriation explanations of takeovers focus on four distinct groups: taxpayers, bondholders, employees, and consumers.

1. *Tax Benefits*

Tax benefits provide another value-maximizing explanation for takeovers. Because interest is deductible, this is a more obvious explanation for leveraged acquisitions than the monitoring story of free cash flows: the increased debt load shelters more income, motivating the transaction. In addition, a firm may have tax attributes, such as favorable deductions, investment tax credits, depreciation allowances, net operating losses, that it cannot use because it has too little income. Since the tax code does not permit the direct sale of tax attributes, the firm may seek to merge with a firm that has income to capture the value of the tax benefit. In this situation, the value of the whole is greater

55. Clifford W. Smith, Jr. & Ross L. Watts, *Incentive and Tax Effects of Executive Compensation Plans*, 7 AUSTL. J. MGMT. 139 (1982).

56. Abbie J. Smith, *The Effects of Leveraged Buyouts*, 25 BUS. ECON., Apr. 1990, at 19.

57. Wright et al., *supra* note 6.

58. Frank R. Lichtenberg & Donald Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior*, 27 J. FIN. ECON. 165 (1990).

than the sum of the parts, as the acquirer can shield its income from taxes (and thus has increased real cash flows), and the target can realize the value of its deductions (which it could not do on its own). Besides this ex post tax-based merger consideration of unused tax shields, there are ex ante benefits as well: the merger effectively provides coinsurance by diversifying expected cash flows, so that deductions will not be wasted.⁵⁹ Despite the real synergistic impact on cash flows of such a tax-based acquisition, I do not classify this as an efficiency explanation because there is a social cost to such a gain, a transfer of wealth from the fisc to shareholders. This explanation is, therefore, more appropriately viewed as an expropriation explanation.⁶⁰

The tax explanation of takeovers is not compelling theoretically. The interest deduction is a tax benefit that does not require an acquisition to be realized—a target firm can leverage its capital structure on its own. This is therefore not an equilibrium story for it implies that the firm had a suboptimal capital structure pre-takeover. Consequently, to be plausible the increased interest-deduction tax explanation of takeovers must be merged with an agency cost explanation: target management has failed to maximize firm value by carrying too little debt and paying too much in taxes.⁶¹ Moreover, the benefit from increased deductions is limited by the implicit tax rate of debt: because interest income is taxed at a higher rate than capital gains, investors require a higher return to hold debt rather than equity, and at least through 1986, there was arguably no net positive return to a firm from issuing increased debt.⁶²

Similar criticisms can be raised concerning the other tax benefits alleged as merger motivations. Gilson, Scholes, and Wolfson show that the value of tax attributes such as net operating losses and step-ups in asset basis can be obtained equally well by nonacquisition techniques, such as selective asset sales and asset restructurings, as by acquisitions.⁶³ The availability of other techniques to realize tax gains severely diminishes the power of a tax-driven explanation of takeovers.

There is also little empirical support for the taxpayer expropriation explanation. Auerbach and Reishus collected a comprehensive data set of several

59. Richard Green & Eli Talmor, *The Structure and Incentive Effects of Corporate Tax Liabilities*, 40 J. FIN. 1095, 1102-03 (1985).

60. To the extent that the failure to use a net operating loss deduction is a double tax on capital, Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U.L. REV. 709, 716-18 (1981), then a merger enabling the use of the tax benefit is not expropriation from the fisc.

61. However, Kaplan finds that MBO firms' pre-buyout debt-equity ratios are not low for their industries. He views this as suggesting that the higher debt level may not have been attainable with the pre-buyout ownership structure. See Kaplan, *supra* note 9.

62. Merton Miller, *Debt and Taxes*, 32 J. FIN. 261 (1977); see WESTON ET AL., *supra* note 20, at 114, illustrating effects before and after the tax rate changes of 1986.

63. Ronald J. Gilson, Myron S. Scholes & Mark A. Wolfson, *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions*, in KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER, *supra* note 16, at 271.

hundred mergers from 1968-83 and found that reducing taxes was not a significant reason for the transactions.⁶⁴ Only 20% of these mergers could be classified as having obvious potential tax benefits, such as the transfer of losses or credits or a step-up in asset basis, and the estimated value of the tax benefits was only 10% of the target's market value, a figure far below the acquisition premiums.⁶⁵ In addition, debt-equity ratios did not increase significantly after the mergers.⁶⁶ Because the magnitude of the effect is so small, it is unlikely that the availability of income-shielding tax attributes is a significant factor in takeovers.

Auerbach and Reishus' merger sample ends before financing acquisitions by debt became as important a feature of takeovers as it was in the mid-1980s. Studies of the tax effects of leveraged buyouts, where the debt load is substantial, produce different results. For example, in a study of MBOs, Kaplan found that the excess returns to public shareholders are significantly related to tax savings from the new capital structure; in fact, the estimated tax savings explained most of the premium.⁶⁷ Schipper and Smith's findings are virtually identical.⁶⁸ In both studies, interest deductions are the key tax savings that explain MBO premiums, not net operating losses or increased depreciation deductions from asset basis step-ups. For example, Kaplan's median estimates of the interest deduction benefit ranged, depending on the assumed marginal tax rate, from 40% to 130% of the buyout premium, assuming the debt is permanent, and from 13% to 40%, assuming repayment of the debt in 8 years. When step-ups in asset basis are included, the median tax benefits ranged between 21% and 143% of the premium for the full sample, and from 45% to 161% for the MBO firms that elected an asset basis step-up, which were half of the sample firms. Schipper and Smith also find a significant relationship between tax benefits and premiums paid in MBOs: buyout premiums were

64. Alan J. Auerbach & David Reishus, *The Impact of Taxation on Mergers and Acquisitions*, in *MERGERS AND ACQUISITIONS* 69, 81 (Alan J. Auerbach ed., 1988).

65. Hayn finds that cumulative abnormal returns to targets on acquisition announcements are positively related to the amount of available net operating losses and asset basis step-ups. Carla Hayn, *Tax Attributes as Determinants of Shareholder Gains in Corporate Acquisitions*, 23 *J. FIN. ECON.* 121 (1989). Her data do not, however, lead to a substantially different conclusion from Auerbach and Reishus' conclusion concerning the significance of taxes as a motive for takeovers. Only 20% of the targets in her sample had net operating losses, and of the firms engaging in taxable acquisitions, the value of the asset basis step-ups was only 16% of the target's market value.

66. The ratio of long-term debt to long-term debt plus equity increased, on average, from 25.4% to 26.7%. Auerbach and Reishus maintain that the insignificant increase is explained by the fact that, while the mergers increased the amount of debt, equity value also increased. They conclude that the data show that "borrowing did not outstrip the growth in value of the merged firms," and therefore, interest deductions were not a significant factor in mergers (at least through 1983, when their sample collection ends). Auerbach & Reishus, *supra* note 64, at 80.

67. Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 *J. FIN.* 611 (1989).

68. Katherine Schipper & Abbie Smith, *Corporate Income Tax Effects of Management Buyouts*, (June 1988) (unpublished manuscript, on file with the author).

substantially higher than depreciation tax savings (the ratio of median benefits to premium ranged between 0 and 29%) but not much higher than the interest savings (median ratio range of 65-91%).

Although the Kaplan and Schipper and Smith studies seem to provide strong evidence for an expropriation explanation of MBOs via increased interest deductions, this research presents only one aspect of the tax story. As Jensen, Kaplan, and Stiglan point out, MBOs are also accompanied by increased tax payments by selling target shareholders, by buyout debtholders, and by the long-term increased profitability of the reorganized firm.⁶⁹ In their estimation, the net tax payments in these transactions are positive, not negative. Summers challenges this conclusion, contending that post-buyout debtholders are likely to be tax-exempt institutions.⁷⁰ However, his contention concerning the effect on total tax revenues is correct only if the total debt held by tax-exempt investors increases with the LBO, which is a disequilibrium capital market story; an equilibrium view would suggest that these investors simply shift from one debt instrument to LBO debt while their aggregate debt holding remains the same.⁷¹ It should be noted that Kaplan calculates selling shareholders' capital gains taxes at a very rough 17%, which is about equal to his lowest estimate of MBO tax benefits.⁷² Plainly, analyzing the MBO tax impact solely in terms of achieved tax savings (increased deductions) will provide an incomplete and inaccurate picture of what motivates these transactions. Moreover, Bhagat, Shleifer, and Vishny contend that the debt tax shield benefits in MBOs are significantly reduced by a rapid repayment of the debt.⁷³ Lastly, for MBO firms that go public again, post-buyout equity investors earn very high returns.⁷⁴ As the tax savings are captured by the pre-buyout shareholders, this indicates that MBO firms experience efficiency gains well beyond the tax benefits. These findings, viewed in combination, seriously undermine a taxpayer expropriation explanation of leveraged acquisitions.

2. Bondholder Expropriation

There is a third possible explanation for the use of debt in a takeover. Leveraged acquisitions may simply be mechanisms for expropriating the wealth of bondholders, rather than taxpayers. When a firm increases its leverage, the

69. Michael C. Jensen, Steven N. Kaplan & Laura Stiglin, *The Effects of LBO's on Tax Revenues of the U.S. Treasury*, 42 TAX NOTES 727 (1989).

70. *Taxation and Corporate Debt: Hearing Before the Senate Comm. on Finance*, 101st Cong., 1st Sess. 27-77, 186-204 (Jan. 25, 1989) (testimony of Lawrence H. Summers).

71. I would like to thank Jon Ingersoll for pointing this out to me.

72. Kaplan, *supra* note 67, at 626, 630.

73. Bhagat et al., *supra* note 26.

74. Kaplan, *supra* note 9, at 98.

value of preexisting debt decreases because it is now a riskier investment (the firm's cash flows may not cover the new debt load). As the bondholders are not compensated for this increased risk, the leveraged transaction redistributes wealth to the shareholders. Bondholders can and do, however, protect themselves from losses upon a leveraged acquisition by event-risk indenture provisions.⁷⁵

Several studies have sought to measure the effects of leveraged acquisitions on target debt. Although bond ratings are typically lowered after a leveraged buyout, studies find either no significant bond price effects or a small negative effect which is nowhere near the magnitude of the premium paid to the shareholders.⁷⁶ Bonds without restrictive covenants, such as event-risk provisions, which protect debtholders' investment against leverage increases, experience the greatest losses: for example, Asquith and Wizman find that unprotected bonds experienced negative abnormal returns of 5% whereas protected bonds had positive abnormal returns of 2%.⁷⁷ In addition, the size of the shareholders' gain is not correlated with the amount of outstanding debt. Bondholder expropriation cannot, therefore, be driving acquisitions because the bondholders' losses are simply too small compared to takeover premiums.

3. Expropriation from Labor

The expropriation explanation of takeovers that attracts the most attention involves labor as the victim. The most sophisticated version of this explanation is Shleifer and Summers' breach of implicit contract explanation of hostile takeovers.⁷⁸

In Shleifer and Summers' scenario, shareholders initially hire trustworthy individuals as managers, in order to make credible long-term contract commitments to workers. The long-term commitments are implicit, rather than explicit contracts. After employees are hired, shareholders will want to breach the implicit contract, in order to increase their returns by lowering labor's share. A trustworthy management prevents them from doing so by honoring the informal agreements. A hostile takeover will, however, permit shareholders to

75. Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, J.L. & ECON. (forthcoming 1992). Lehn and Poulsen's data suggest that this explanation is, at best, temporally bounded: use of event-risk covenants has increased rapidly over time (from 3% of debt offered in 1986 to 32.1% of debt issued in 1989), and those provisions are more frequently found in debt issued by firms where LBOs are likely.

76. Paul Asquith & Thierry A. Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FIN. ECON. 195 (1990); Debra K. Denis & John J. McConnell, *Corporate Mergers and Security Returns*, 16 J. FIN. ECON. 143 (1986); Marais et al., *supra* note 9.

77. Asquith & Wizman, *supra* note 76, at 201, 203.

78. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, *supra* note 40, at 33.

behave opportunistically because, unlike trustworthy incumbents, a raider will not hesitate to break implicit contracts, cutting costs and releasing the pent-up value of the firm to shareholders.

One example of an implicit contract involves overfunded pension fund assets. These assets—funds that exceed the benefits promised to employees—belong to the firm, but under the requirements of the ERISA statute that regulates defined benefit plans, the firm must terminate the plan before the excess assets revert to it and become available for other uses.⁷⁹ Firms often fund cost-of-living adjustments that are not required by their pension contract with the excess assets in a plan.⁸⁰ Because the firm has no legal obligation to increase retirees' benefits, such a use of excess fund assets is, at best, an implicit contractual obligation of the sort described by Shleifer and Summers. A takeover in which a pension plan is terminated and excess assets revert to the firm for non-plan uses might thus be characterized as a redistribution of wealth from labor to shareholders, in breach of an implicit contract.

Shleifer and Summers' paradigmatic example is Carl Icahn's acquisition of TWA, in which labor unions agreed to large concessions to prevent a more loathed hostile bidder, Frank Lorenzo, from acquiring the firm. Shleifer and Summers estimate that the cost to labor equaled 38% of the premium paid to TWA shareholders. While this is a substantial proportion of the shareholders' gain, obviously something else was also at stake in the acquisition to generate the remaining 62%.

The labor costs that were reduced in this instance could emanate from the following three sources: (1) union power (a form of monopoly rents); (2) firm-specific skills which enhance productivity;⁸¹ or (3) management inefficiency caused by failure to bargain effectively with unions.⁸² The first source is a likely candidate. The airline industry was regulated when TWA's labor contracts were originally negotiated, and research suggests that the prime beneficiary of airline regulation was labor.⁸³ The third source is related to the first: deregulation stimulates takeovers to provide more efficient managers, who bargain employee compensation down to competitive levels. The second source is where Shleifer and Summers' breach of trust argument enters. Implicit contracts protect workers who have invested in transaction-specific human capital. By breaking these contracts, shareholders, through the raider, expro-

79. Mark L. Mitchell & J. Harold Mulherin, *The Stock Price Response to Pension Terminations and the Relation of Terminations with Corporate Takeovers*, 18 FIN. MGMT. 41 (1989).

80. Jeffrey Pontiff, Andrei Shleifer & Michael S. Weisbach, *Reversions of Excess Pension Assets After Takeovers*, 21 RAND J. ECON. 600 (1990).

81. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 55 (1985).

82. See WESTON ET AL., *supra* note 20, at 214 (offering these three explanations).

83. ELIZABETH E. BAILEY, D GRAHAM & D. KAPLAN, *DEREGULATING THE AIRLINES* 95-102, 197 (1985).

appropriate the quasi-rent value of the workers' investments. But, as shareholders benefit from workers who make such investments, the implicit contracts are ex ante efficient and it is hence undesirable that they be violated ex post. We then need a device to prevent the contracts from being broken, and trustworthy managers are posited to perform that function.

Shleifer and Summers' thesis is clever but not convincing. A key problem with their explanation is that it is questionable whether workers, particularly unionized workers, would opt to protect such extremely vulnerable investments as firm-specific capital through an implicit contract rather than some other explicit governance structure. As Williamson details, if contracts cannot be specified to avoid opportunism, other mechanisms will be devised to protect the vulnerable party's investment.⁸⁴ The difficulty with the analysis is that Shleifer and Summers misuse the concept of an implicit contract. As Schwartz has observed, an implicit contract is a contract whose terms are observable to the contracting parties, but not to third parties, such as courts, and hence, are not verifiable.⁸⁵ An explicit contract is, correspondingly, one whose terms are both observable and verifiable. The choice of contract type depends upon the characteristics of the relevant contracting terms; if certain information is observable and verifiable, then it can be the basis of an explicit contract term, for performance of the contract can be conditioned on such a term and its breach can be enforced in court. The terms of concern to Shleifer and Summers—pension benefits, pension fund assets, wages, employment levels—are observable and verifiable. Thus they will be subject to explicit, and not implicit, contracting. The absence of explicit contractual provisions on these terms' continuation therefore suggests that TWA's unions (and, generally, any unions that find excess pension fund assets reverted and informal cost-of-living benefits terminated) chose not to include such terms in their contracts. They may have opted, for instance, for higher wages in exchange for assuming the risk of loss of increased pension benefits in the future. In this scenario, there is, then, no implicit contract for pension increases. It is arguable, however, that there is an implicit term which is relevant in the pension context, firm performance, that is not equally observable to both parties and is therefore unverifiable. In this alternative scenario, the firm contracts to increase pension benefits in financial good times, but not in bad times. This creates a potential implicit contracting problem, because workers may not be able to tell which state of the world obtains when the firm seeks to terminate an overfunded plan.

Unlike pension fund assets and wage and employment levels, the level of development of firm-specific human capital is unlikely to be verifiable in any

84. WILLIAMSON, *supra* note 81.

85. Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, at 14-16 (1991) (unpublished manuscript, on file with the author).

scenario, and thus could be the basis of an implicit contract that a raider could breach. The problem with this argument is that Shleifer and Summers never identify what is firm-specific about unionized TWA workers' skills.⁸⁶ Yet the assumption of firm-specific human capital motivates the contention that TWA union members are more productive than unionized and non-unionized employees at other airlines, who received lower pay for similar work. Without firm-specific capital, labor's claim for a share of takeover gains as a means of keeping implicit promises is unpersuasive.

Finally, Shleifer and Summers offer no compelling reason why a hostile bidder can so easily do what incumbent management cannot, bargain for wage concessions. Many firms, including other airlines, engage in concession bargaining, and such efforts are typically independent of any hostile takeover threat. While it is not in the shareholders' interest to overpay workers, it is also not in their interest to underpay them.

Holmstrom suggests an alternative explanation to Shleifer and Summers' implicit contract story, which builds upon reputation.⁸⁷ In this view, managers may be burdened with a reputation for weakness from past practices of capitulating to labor demands in order to make their jobs as managers more comfortable, and this reputation affects their credibility as bargainers in hard times. Thus, unlike raiders, who bring no such baggage to the negotiating table, incumbent management cannot obtain concessions. While interesting, I do not find this reputational explanation persuasive. It would be in labor's interest to grant concessions to the management it knows, rather than to a hardnosed raider, because past experience indicates that when financial conditions improve, the incumbents will be likely to seek comfort and return to the old regime of worker quasi-rents, whereas there is no basis to expect such favorable treatment from a raider.

The labor expropriation explanation, in general or as refined by Shleifer and Summers, has scant empirical support. Pontiff, Shleifer, and Weisbach find, for instance, that pension fund asset reversions are too small to be a dominant motive for takeovers: although they are more frequent in hostile than friendly transactions, reversions occur in only 14% of takeovers, and they average only 10-13% of the premiums.⁸⁸ Mitchell and Mulherin provide similar results: pension fund reversions occur in 12% of the takeovers in their sample, although they are not more frequent in hostile than in friendly bids, and the reversions

86. If TWA had newer planes than any other airline, then its pilots would have had to develop firm-specific capital, the skills to operate those planes. Given TWA's financial condition, it is, however, unlikely that it was ahead of its competitors in introducing the latest technology. While seniority is certainly firm-specific, it is not related to increased productivity or value creation.

87. Bengt Holmstrom, *Comment*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, *supra* note 40, at 56.

88. Pontiff et al., *supra* note 80.

account for a somewhat higher proportion of the premium (23%).⁸⁹ More important, most pension fund reversions do not occur after a corporate takeover.⁹⁰

The TWA anecdote is difficult to generalize, given the industry's unique circumstances of moving from regulation (where managerial discretion, the other side of management trustworthiness, is substantial) to deregulation.⁹¹ Several studies examining the aftermath of takeovers more systematically do not find a similar dramatic impact on labor as in the TWA takeover. For example, apart from the already-mentioned greater turnover of top management, it is middle management (administrative staff), and not production plant employees, whose ranks are slimmed down after acquisitions.⁹² Consistent with such data, Blackwell, Marr, and Spivey find, in a sample of 286 plant closings, that very few (48) were announced by takeover targets, either before, after, or during the bid, and only 22 of those were targets of hostile bids.⁹³ Moreover, firms experiencing ownership changes have higher employment and wage levels and increased productivity compared to firms that do not change control.⁹⁴ Finally, Kaplan finds in a sample of leveraged buyout firms that employment increased after the transaction (although it is not as large an increase as that of their industries), while Lichtenberg and Siegel find leveraged buyout firms' employment declined, compared to their industries, but at a slower rate than before the buyout.⁹⁵

Rosett tests Shleifer and Summers' breach of contract explanation more directly by examining union wage contracts before and after takeovers.⁹⁶ He finds no support for their thesis: there is, in fact, a positive *gain* in union wealth levels after hostile acquisitions. Although there are losses after friendly acquisitions, even then the losses are insignificant relative to the premiums (when measured over 18 years after the takeover, the union losses in friendly acquisi-

89. Mitchell & Mulherin, *supra* note 79. They explain this difference in terms of sample construction: Pontiff, Shleifer and Weisbach excluded mergers from their sample, which will overstate the relative frequency of hostile bids because mergers are always classified as friendly, and they counted some acquisitions by white knights as hostile rather than friendly.

90. *Id.*

91. Oliver E. Williamson, *Comment, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES supra* note 40, at 61.

92. Frank R. Lichtenberg & Donald Siegel, *The Effects of Takeovers on the Employment and Wages of Central-Office and Other Personnel* (Feb. 1989) (unpublished manuscript, on file with the author).

93. David W. Blackwell, M. Wayne Marr & Michael F. Spivey, *Plant-closing Decisions and the Market Value of the Firm*, 26 J. FIN. ECON. 277, 283, tbl. 3 (1990).

94. Charles Brown & James L. Medoff, *The Impact of Firm Acquisitions on Labor, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, supra* note 40, at 9; Frank R. Lichtenberg & Donald Siegel, *Productivity and Changes in Ownership of Manufacturing Plants, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY* 643 (Martin Neil Bailey & Clifford Winston, eds., 1987).

95. Kaplan, *supra* note 9, at 97-98; Lichtenberg & Siegel, *supra* note 58.

96. Joshua G. Rosett, *Do Union Wealth Concessions Explain Takeover Premiums? The Evidence on Contract Wages*, 27 J. FIN. ECON. 263 (1990).

tions equal approximately 5% of the shareholders' gain). Bhagat, Shleifer, and Vishny also find that layoffs occur infrequently, affect high-level white collar workers, are higher when management successfully defeats a bid (either by remaining independent or by finding a white knight) than when a hostile bidder succeeds and, most important, result in losses that are small compared to takeover premiums (10-20%).⁹⁷ In sum, while we would need counterfactual data to test the labor expropriation hypothesis fully—we need to know how many workers would have been laid off⁹⁸ or what the wage profile would have looked like if the firm had not been acquired—what we do know suggests that expropriation from labor does not motivate takeovers.

4. *Market Power*

A traditional explanation for takeovers that falls in the expropriation category is that takeovers increase market power, thereby allowing the merged firm to obtain a monopoly position and earn monopoly rents. This explanation was popular at the turn of the century, and is less important as a rationale in recent years because such combinations are illegal under the antitrust laws. It is obviously an expropriation explanation: with increased market power, a firm is able to increase its price above marginal cost, extracting consumer surplus and shutting off the market from some buyers. Takeover gains therefore represent a transfer of wealth from consumers to shareholders. Of course, this explanation is limited because there are many takeovers that cannot be motivated by monopoly power, such as acquisitions of unrelated businesses.

Studies have sought to measure the effect of potentially anticompetitive acquisitions by examining competitors' stock prices, and they have found no effect. If a merger is anticompetitive, then rival firms' stock prices should either decrease upon the merger announcement as they will be at a competitive disadvantage, for instance if the merged firm will engage in predatory pricing, or increase on the merger announcement and fall on the commencement of an antitrust challenge, as they will be able to share in the increased prices that the merged firm will be able to charge (the "collusion theory"). Studies find that rivals experience either significantly positive or insignificant stock price reactions to horizontal merger announcements, but no price effects when the merger is challenged, or invalidated, on antitrust grounds.⁹⁹

97. Bhagat et al., *supra* note 26, at 2.

98. Of course, a decrease in employment levels need not imply an efficiency loss. It could be socially efficient to reduce labor in a particular firm or sector.

99. B. Espen Eckbo, *Horizontal Mergers, Collusion and Stockholder Wealth*, 11 J. FIN. ECON. 241 (1983); B. Espen Eckbo & Peggy Wier, *Antimerger Policy under the Hart-Scott-Rodino Act: A Reexamination of the Market Power Hypothesis*, 28 J. L. & ECON. 119 (1985); Robert Stillman, *Examining Antitrust Policy Towards Horizontal Mergers*, 11 J. FIN. ECON. 225 (1983).

Other studies have found that the returns to unrelated (conglomerate) acquisitions in the 1980s are lower than the returns to related acquisitions,¹⁰⁰ and that most hostile takeovers result in reallocations of assets to related buyers in subsequent divestitures.¹⁰¹ The higher value of related acquisitions may evidence operating synergy gains, but it may also evidence anticipated gains from increased market power. However, Healy, Palepu and Ruback find that merged firms' improved cash flows are due to increased asset productivity that is not attributable to monopoly rents because there is no post-merger increase in sales margins.¹⁰² This expropriation explanation of takeovers cannot, then, be accorded much credence given current knowledge. It is altogether possible, however, that future analyses of gains from related-firm acquisitions will alter this conclusion and revive a moribund monopoly power explanation.

C. Value-Maximizing Market Inefficiency Explanations

The final value-maximizing (that is, beneficial to acquirers' shareholders) explanation of takeover gains is premised on market inefficiency, the view that stock prices do not reflect firms' "fundamental value." According to this explanation, which is probably as widely-circulated in the popular press as the labor expropriation explanation, acquirers exploit market inefficiency by identifying undervalued firms, and presumably capture a large share of the gains by paying premiums below the correct valuation. There are two distinct market inefficiency explanations: general underpricing of stocks and myopia (overvaluation of current profits and excessive discounting of future profits).

1. Underpricing

The most general version of the market inefficiency explanation of takeovers is that the capital market simply misprices securities. Acquiring firms identify undervalued securities and profit from the difference between the price they pay and the firm's true value. Given the size of the premiums received in takeovers, this explanation cannot be characterized as an expropriation explanation from current investors in targets to bidders. Because the target shareholders' gain is not a "real" gain, in that it does not depend on any

100. Morck et al., *supra* note 13.

101. Bhagat et al., *supra* note 26. Kaplan and Weisbach contend that the gain from conglomerate firms' sales of acquired firms to related-industry buyers in the 1980s is not a reflection of the initial acquisition's negative value, but rather a function of changes in antitrust law enforcement. KAPLAN & WEISBACH, *supra* note 14. Antitrust law enforcement in the 1980s permitted more efficient horizontal acquisitions that had not been allowed when the conglomerates had made the acquisitions under study, and this change is what made divestiture so profitable.

102. Healy et al., *supra* note 17, at 21.

operating improvements or other changes to be undertaken by the bidder in the future, this explanation is also classified separately from the efficiency-enhancing explanations of takeovers.

There is no evidence supporting the underpricing explanation of takeover gains. In particular, if this explanation was correct, then once a bidder identified a target, its price would rise and remain at the higher true value, regardless of whether the acquisition occurred. Several studies find, however, that the stock price of takeover targets that are not acquired returns to its lower pre-bid price.¹⁰³ Takeovers therefore do not merely provide an inefficient market with the information necessary for revaluing stock prices. More generally, the large body of event studies examining numerous events in corporate finance besides acquisitions casts doubt on this explanation, as the studies are supportive of market efficiency.¹⁰⁴

2. Market Myopia

The market myopia inefficiency explanation is more sophisticated than the underpricing hypothesis. In this explanation, investors are short-sighted and behave myopically to sacrifice long-term benefits for immediate profits. As a consequence, firms that engage in long-term planning and make substantial investments in research and development (R&D) are supposedly undervalued by the market and become takeover targets. To avoid undervalued stock, managers thus also behave myopically and shift from profitable long-term investments to more easily valued short-term projects.¹⁰⁵ This explanation of takeovers could be characterized as efficiency-enhancing, because the acquirer presumably gains by taking the firm private and undertaking the neglected long-term investments. As Netter suggests, it can also be given an expropriation

103. Asquith, *supra* note 39; Michael Bradley, Anand Desai & E. Han Kim, *The Rationale behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983); Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151 (1985).

104. Tests of asset-pricing models have uncovered anomalies that cast doubt on the models' predictability of returns; these models are the focus of the current finance controversy over market efficiency, and there are interpretations consistent with both sides. Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1577, 1609 (1991). Because of the joint-hypothesis problem, that tests of market efficiency are joint tests of efficiency and of a particular asset-pricing model, the anomalies can be understood as showing either that the asset-pricing model is misspecified or that the market is inefficient. Event studies using daily returns data avoid the joint-hypothesis problem that plagues predictability of returns studies because event studies examine abnormal returns on precise dates rather than over long intervals, and the method of estimating normal returns and hence calculating abnormal returns (i.e., the asset-pricing model) has little effect on inferences when the response to an event is large and concentrated over a few days. *Id.* at 1601-02, 1607. These studies demonstrate extremely quick market reactions to firm-specific information and they thus provide the cleanest evidence of market efficiency. *Id.* at 1601-02.

105. Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).

gloss, as a “redistribution from the future” to the present.¹⁰⁶ In this alternative view, the acquirers are myopic and slash R&D budgets to raise stock value.

There is, however, no empirical support for a myopia explanation. First, there is no evidence of market myopia regarding long-term investment. The market responds positively to announcements of increases in R&D and other capital investment expenditures.¹⁰⁷ Second, there is scant evidence of the posited manager myopia. Firms that protect themselves from takeovers by adopting defensive charter amendments, thus ostensibly freeing themselves from market myopia,¹⁰⁸ actually decrease their R&D expenditures after taking such action.¹⁰⁹ In addition, targets (especially of LBOs) are in industries with low levels of R&D activity, and there are no significant differences in R&D intensity (the ratio of R&D expenditures to sales) between acquiring and acquired firms.¹¹⁰ Finally, there are no significant differences in the growth of R&D (as measured by intensity or employment levels) between firms involved in acquisitions and those that are not.¹¹¹

D. *Non-Value-Maximizing Expropriation Explanations*

There are four non-value-maximizing explanations of takeovers. The first three are related, as they are all forms of managerialism: diversification, self-aggrandizement and free cash flow excesses by acquirers. The fourth, the hubris hypothesis, is a non-value-maximizing explanation *ex post* (once the bid is made) and not necessarily *ex ante*: managers may intend to maximize equity share prices by an acquisition but they overvalue the transaction's gains.

106. Jeffrey Netter, *Ending the Interest Deductibility of Debt Used to Finance Takeovers Is Still a Bad Idea: The Empirical Evidence on Takeovers, Restrictions on Takeovers, and Restrictions on Deductibility of Interest*, 15 J. CORP. L. 219, 231 (1990).

107. Su Han Chan, John D. Martin & John W. Kensinger, *Corporate Research and Development Expenditures and Share Value*, 26 J. FIN. ECON. 255 (1990); John J. McConnell & Chris J. Muscarella, *Capital Expenditure Decisions and Market Value of the Firm*, 14 J. FIN. ECON. 399 (1985); SEC OFFICE OF CHIEF ECONOMIST, INSTITUTIONAL OWNERSHIP, TENDER OFFERS AND LONG TERM INVESTMENTS (1985).

108. Stein, *supra* note 105.

109. Lisa K. Muelbroek et al., *Shark Repellants and Managerial Myopia: An Empirical Test*, 98 J. POL. ECON. 1108 (1990).

110. Bronwyn H. Hall, *The Impact of Corporate Restructuring on Industrial Research and Development*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1990, *supra* note 26, at 85. [hereinafter Hall, *Corporate Restructuring*]; Bronwyn H. Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES *supra* note 40, at 69 [hereinafter Hall, *Takeover Activity*]; Smith, *supra* note 56.

111. Hall, *Takeover Activity*, *supra* note 110; Lichtenberg & Siegel, *supra* note 92. Hall finds some evidence that R&D intensity decreases with increased leverage upon an acquisition, but as most leveraged acquisitions do not occur in industries where R&D is important, she cannot determine the significance of the decrease, i.e., whether the firms are foregoing positive net present value projects or there are, in fact, no attractive innovation opportunities. Hall, *Corporate Restructuring*, *supra* note 110.

1. *Diversification*

One explanation of takeovers, which focuses on conglomerate mergers, is diversification: merging two income streams to reduce risk. If merging firms' cash flows are not perfectly positively correlated, then the debt capacity of the combined firm is increased, as the risk of insolvency decreases. The benefit from the reduction in cash flow variability cannot be attained by either firm separately, and hence it can be classified as a financial synergy gain. Additionally, because the intangible capital or goodwill that a firm builds up is lost upon bankruptcy, diversification, by lowering the risk of bankruptcy, preserves the value of that reputational or organizational capital.

A diversification explanation may be important in bank mergers. As Hawawini and Swary argue, regulators impose solvency requirements on firms through capital adequacy requirements, and implicitly define the upper bounds of bankruptcy, thus providing banks with an incentive to diversify.¹¹² In addition, banks are viewed as having an important investment in goodwill in the bank-customer relationship, which, they maintain, increases the value of avoiding insolvency.¹¹³ Hawawini and Swary provide some support for this diversification thesis: mergers between banks with low stock return correlations are associated with significantly higher abnormal returns than high stock return correlation mergers, and the variance of target bank stock returns decreases significantly upon the merger.¹¹⁴

But apart from the special case of bank mergers, this explanation is not compelling. Modern finance theory indicates that diversification will not increase the market value of the merged entity beyond the sum of the separate values of the two companies, because investors can diversify more cheaply on their own by diversifying their stock portfolios (buying shares in the two companies). In addition, if investors are diversified, then they are not benefitted if a company reduces its own risk, and they will not pay to have that risk reduced. This is because diversified investors are concerned only about market or systematic risk and not idiosyncratic or firm-specific risk.¹¹⁵ Consequently, the value of the merged firm will not be greater than the sum of its parts.¹¹⁶ Moreover, the reduction in cash flow risk comes at the shareholders' expense, transferring wealth from equity to debtholders, as the risk of insolvency has

112. HAWAWINI & SWARY, *supra* note 24.

113. *Id.*

114. *Id.* at 107, 146.

115. STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY F. JAFFE, CORPORATE FINANCE (2d ed. 1990).

116. Kaiser Industries provides an excellent example. Kaiser was a holding company whose assets were controlling interests in three publicly traded operating companies; its stock, however, traded at a substantial discount from the market value of its holdings. GILSON, *supra* note 27, at 624.

decreased, which increases the value of existing debt, and correspondingly decreases the equity's value. Indeed, Galai and Masulis contend that the debt level in the merged firm must increase if the equity's pre-acquisition value is to be maintained.¹¹⁷

In some situations, however, personal diversification may be more costly than corporate level diversification, and to that extent we cannot reject this explanation out of hand. For instance, consider an investor who bought IBM stock in 1955. The price of her shares has gone up twenty-fold, and she now may have an undiversified portfolio. If she sells some IBM stock to diversify, she would have to pay substantial tax on the sale. This investor might prefer IBM to reduce her risk by diversifying its operations.¹¹⁸ A more plausible candidate is the investor who is the founder, chief executive and majority shareholder of a publicly-traded company. Such an investor will typically have a similar problem to the long-term IBM shareholder; although she is wealthy, all her eggs are in that one basket, her company. If she sells her holdings to diversify, she is likely to have a large tax due and she may have to relinquish control. In such a situation the investor may be better off merging with a firm in a different line of business. She will then have, at least, two baskets. The point of these examples is that someone who is unable to diversify might benefit from corporate level diversification. These examples are not, however, applicable to most public companies nor to most investors.

While most shareholders do not find portfolio diversification costly, and are therefore not benefited by firm-level diversification, there is a special set of individuals who do benefit from such diversification—corporate managers. The risk preferences of managers and shareholders differ: managers' wealth is tied up in their firms, and unlike shareholders, they cannot diversify. Imperfections in the capital market due to moral hazard concerns prevent managers from being able to borrow the full value of their future income stream from the firm, which would enable them to diversify their wealth. Managers are thus subject to firm-specific risk. Assuming they are risk-averse, they will seek to reduce that risk, action that is in direct conflict with the shareholders' risk preference. Accordingly, managers will engage in mergers that reduce firm-specific risk in order to diversify their own portfolios.¹¹⁹

117. Dan Galai & Ronald W. Masulis, *The Option Pricing Model and the Risk Factor of Stock*, 3 J. FIN. ECON. 53, 68-69 (1976).

118. Mutual swap-funds provided such investors a better way to diversify without any tax cost—investors contributed their different appreciated stocks to a mutual fund in a tax-free exchange for fund shares. See Marvin A. Chirelstein, *Tax Pooling and Tax Postponement - The Capital Exchange Funds*, 75 YALE L.J. 183 (1965). The incorporation provision, I.R.C. § 351, was amended in 1966 to impose a tax on these transactions. See Pub. L. No. 89-809, § 203(c) (1966).

119. Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).

Firm-level diversification presumably comes at a cost to diversified shareholders, as the firm pays a premium for the target. This explanation of takeovers is the principal-agent problem writ large: mergers are non-value-maximizing transactions that benefit managers at the shareholders' expense. Investors bear the costs of the diversifying merger but they do not receive any commensurate benefits because they are diversified and are therefore not concerned about firm-specific risk. A diversification motive for mergers therefore entails a wealth transfer from shareholders to managers.

We could, however, put a value-maximizing spin on this non-value-maximizing explanation. Because managers' risk is reduced by diversifying, shareholders may be able to pay managers less in compensation. The reduced risk may also encourage managers to make investments in firm-specific human capital which are valuable to shareholders. If either of these possibilities occur, then shareholders as well as managers will gain from diversifying acquisitions, and such transactions should therefore not be characterized as non-value-maximizing transactions (assuming any efficiency losses from the diversifying merger do not swamp the gains from the reduced compensation or enhanced human capital).

There is some evidence consistent with a non-value-maximizing diversification explanation. Amihud and Lev and Lloyd, Modani, and Hand find that manager-controlled firms are more likely to engage in diversifying mergers than are owner-controlled firms, and the income streams and operations of manager-controlled firms are more diversified than those of owner-controlled firms.¹²⁰ But to distinguish conclusively between the value-maximizing and non-value-maximizing variants of this explanation, we would need additional information that controls for executive compensation levels.

2. *Self-aggrandizement*

The manager risk reduction diversification explanation is a subset of what can generally be described as a managerialist perspective on the firm. The motivation for an acquisition is the maximization of the manager's utility rather than of the shareholders' wealth, or more simply put, self-aggrandizement. Risk may be a concern, but power or empire-building may be the goal as well, and these are indeed the more traditional managerialist explanations of takeovers.¹²¹

If the managerialist view of the firm explains mergers, then we would expect a negative correlation between bidder and target returns. Weston, Chung,

120. *Id.*; William P. Lloyd, Naval K. Modani & John H. Hand, *The Effect of the Degree of Ownership Control on Firm Diversification, Market Value, and Merger Activity*, 15 J. BUS. RESEARCH 303 (1987).

121. See, e.g., Robin Marris, *A Model of the "Managerial" Enterprise*, 77 Q.J. ECON. 185 (1963).

and Hoag's finding of a significant positive correlation in pure conglomerate and product-extension mergers is inconsistent with managerialism. However, there are studies that provide some support for the thesis. Lewellen, Loderer, and Rosenfeld find that there is a positive relation between acquirers' abnormal returns and management's stock ownership.¹²² This indicates that managerialist motives may be important when management's incentives to act in the shareholders' interest are weakest. In addition, Byrd and Hickman find that there is a positive relation between acquirers' abnormal returns and the independence of the acquirers' boards. The abnormal returns are significantly negative when less than half of the board are outside directors, and insignificantly negative when a majority are outsiders, and the difference across the two groups is significant.¹²³ This suggests that managers who are not monitored are likely to engage in non-value-maximizing acquisitions. Finally, Mitchell and Lehn's finding that bad bidders make good targets is relevant here. While it supports Manne's disciplining story regarding takeovers, it also offers some support for managerialism, for it indicates that at least some acquisitions are profoundly misconceived.¹²⁴

3. Free Cash Flow on the Acquirers' Side

While the emphasis in free cash flow theory is on the target, the acquirer may have free cash flow as well. Making an acquisition uses the excess cash. This variant of the free cash flow explanation is an example of a non-value-maximizing explanation of acquisitions. The acquisition may, however, be less wasteful than alternative expenditures the managers would undertake in its absence. As with the diversification explanation, the free cash flow explanation is a special case of the more general self-aggrandizement explanation.

Several studies provide evidence consistent with this explanation. Acquirers experience abnormal positive returns before an acquisition,¹²⁵ but they also have low Tobin's q ratios.¹²⁶ These findings suggest that acquirers have ample free cash.¹²⁷ More direct support comes from Mitchell and Lehn's study of

122. Wilbur Lewellen, Claudio Loderer & Ahron Rosenfeld, *Merger Decisions and Executive Stock Ownership in Acquiring Firms*, 7 J. ACCT. & ECON. 209 (1985).

123. John Byrd & Kent Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids* (1991) (unpublished manuscript, on file with the author).

124. The problem Mitchell and Lehn's data pose for the managerialist explanation is that some acquirers—the nontargets in their sample—experience positive abnormal returns. See Mitchell & Lehn, *supra* note 42. This should not be the case if all acquisitions were motivated by managerialism.

125. Ellert, *supra* note 39.

126. Lang et al., *supra* note 41; Servaes, *supra* note 41.

127. Unlike the target firms, the acquirers in Servaes' sample did not have lower dividend payout rates than their industry peers, although they did have lower debt levels and capital expenditures. Servaes, *supra* note 40; see *supra* note 52. Both of these latter differences were, however, smaller than the differences between the targets and their industry peers.

which bidders become targets: the managers who are subsequently disciplined by a takeover are those who engaged in negative net present value acquisitions, that is, those who wasted free cash flow. Mitchell and Lehn's finding thus fits better with a free cash flow explanation than the more general managerialist explanation. It can be understood as a marriage of Marris (managerialist explanation) and Manne (inefficient management explanation), for takeovers are both the epitome of the agency problem and its solution. Specifically, firms whose managers engage in non-value-maximizing acquisitions—wasting free cash—are themselves acquired, in keeping with the agency cost reduction theory's hypothesis that takeovers discipline managers.

Finally, a recent study by Lang, Stulz, and Walkling provides further support for this explanation.¹²⁸ They find that an increase in free cash flow equal to 1% of a bidder's total assets is associated with a decrease in the bidder's gain from the takeover equal to 1% of its common stock. In addition, free cash flow explains more of the variation in bidder returns than other variables, such as the number of bidders, target management's resistance, and the bidder's size in relation to that of the target. Their data do not, however, provide support for an expropriation explanation in which wealth is transferred from acquirers to targets, because target returns are not affected by the bidder's cash flow.

4. *Hubris and the Winner's Curse*

Roll has expounded another managerialist explanation, which he terms the "hubris" hypothesis.¹²⁹ In this view, managers seek to make value-maximizing acquisitions, but they make mistakes and overvalue targets (or their abilities to turn targets around). When the acquirer's stock price falls upon the announcement of a bid, the managers do not heed this warning of their impending mistake. Rather, they are infected with pride and persist in believing that their valuation is correct and the market is wrong. Their hubris prevents them from admitting their mistake and calling off the deal, and they end up paying too much for the target firm. The transaction thus is a wealth transfer from the acquirer's shareholders to the target's shareholders.

Roll's thesis is related to the winner's curse phenomenon in sealed-bid auctions.¹³⁰ When the value to the bidders of the auctioned item is uncertain,

128. Harry H.P. Lang, René M. Stulz & Ralph A. Walkling, *A Test of the Free Cash Flow Hypothesis: The Case of Bidder Returns*, 29 J. FIN. ECON. 315 (1991).

129. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

130. In some takeover auctions, the competing bidders make sequential public offers. Because these are not sealed bid auctions, they are not subject to the winner's curse (a bidder can learn about the value of the object, and hence the size of its estimation error, from the other bids). However, these sequential public auctions have become relatively rare ever since target boards began to run formal auctions, as they

the person who has overestimated the value the most will be the winner. This is because a positive evaluation error produces a winning bid, but a negative error does not. The intuition is that the winning bidder pays too much—that is why he is the winner. Winning is bad news (a “curse”) because it signifies that all other bidders’ estimates were lower. That is, the winner had the highest positive evaluation error.¹³¹ This explanation does not imply that the acquisition was *ex ante* a negative net present value transaction (non-value-maximizing); rather, it is so *ex post*, once there is competition and an auction for the firm.

The negative returns to bidding firms in the 1980s, when takeover auctions increased, lend support to Roll’s hypothesis.¹³² In addition, Varaiya has found that bidders overpay: the difference between the bid premium (abnormal return) and the combined market value of bidder and target firms is positive and significant (that is, there is an overpayment).¹³³ However, the finding of several researchers that the net return to acquisitions is positive—target gains are greater than bidder losses,¹³⁴ indicates that takeovers involve more than simply a wealth transfer from bidder shareholders to managers and target shareholders: there is either an efficiency gain or a third-party wealth transfer accompanying the transaction.

A winner’s curse or hubris hypothesis is, furthermore, not a long-run equilibrium explanation because we expect bidders to learn from their experience and adjust their bids downward (or not bid) to avoid the winner’s curse.¹³⁵ If, however, many bidders engage in only one transaction, it is possible that the market will exhibit no learning. The financial intermediaries that advise acquirers are repeat players, who could transmit the requisite knowledge to a new client, but this market feature may not help the one-time bidder. In any specific transaction, the intermediary’s incentive structure works against counselling a downward revision, as intermediaries are paid more when

have since the mid-1980s, after the Delaware Supreme Court’s decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). See *infra* text accompanying note 141.

131. Nikhil P. Varaiya, *The “Winner’s Curse” Hypothesis and Corporate Takeovers*, 9 *MANAGERIAL & DECISION ECON.* 209 (1988).

132. Bradley et al., *supra* note 13. I consider these data evidence of the hubris and winner’s curse explanation rather than the managerialist explanation because the negative returns appear only in the 1980s, when auctions were relatively frequent. The managerialist explanation would predict negative returns to bidders, regardless of the presence of auctions, as it considers acquisitions negative net present value transactions *ex ante*. The positive returns in the 1960s and 1970s (when auctions were both less common and unlikely to follow a sealed-bid format) are inconsistent with managerialism, but not the hubris or winner’s curse hypothesis.

133. Varaiya, *supra* note 131.

134. Bradley et al., *supra* note 13; KAPLAN & WEISBACH, *supra* note 14; Lang et al., *supra* note 41; Servaes, *supra* note 41.

135. There is evidence that bidders do adjust their bids downward to evade the winner’s curse. See R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 *J. ECON. LIT.* 699 (1987); Stuart E. Thiel, *Some Evidence on the Winner’s Curse*, 78 *AM. ECON. REV.* 884 (1988).

their client wins the auction. The key is therefore whether intermediaries suffer adverse reputational effects from client overpayments, which depends on whether deals sour quickly enough for potential clients to be able to attribute bad deals to the intermediaries' poor advice. Over the long run we would expect this effect to occur, and any problem of overbidding in the corporate takeover market should be self-correcting.

None of the studies of returns to bidders disaggregate their sample by acquirer identity (repeat or one-shot buyers). We therefore do not know whether there is learning in the takeover market (that is, whether repeat players fare better or worse than one-timers). If we found that there is learning (if, for example, repeat bidders do not earn negative returns), then concern that the negative abnormal returns data evince systematic non-value-maximizing behavior by acquirers would be mitigated.

E. Summary and Conclusion

The preceding discussion—the explanations of takeovers and supporting empirical evidence—is summarized in Table 1. There is a substantial body of research that is consistent with agency cost reduction or synergy gain explanations of takeovers. There is, however, scant support for any of the expropriation explanations, whether the hypothetical victims are bondholders, labor, consumers or the government. There is even less support for market inefficiency explanations.

The data are more ambiguous regarding non-value-maximizing explanations. Manager-controlled firms engage in more diversifying mergers than owner-controlled firms and some acquirers earned negative abnormal returns in the 1980s. But these data can also be interpreted as consistent with value-maximization: firm-level diversification may lower executive compensation costs, and competition (auctions) reduces bidders' returns and may lead to overpayment (winner's curse). Most important, the net gains of acquisitions remain positive when bidder and target returns are matched. This finding undercuts the non-value-maximizing interpretation because it indicates that the gain from acquisitions is more than a simple transfer of wealth from acquirers to targets.

Table 1
Explanations of Takeovers

Explanation	Evidence
VALUE-MAXIMIZING	
Efficiency	
1. Synergy Gains	
a. <i>Operating</i>	- positive correlation between bidder and target returns in pure conglomerate and product extension mergers; smaller bidding banks experience higher returns than larger bidding banks; higher returns in bank mergers the smaller the target bank relative to the acquiring bank; related acquisitions more profitable than unrelated acquisitions; substantial portion of gains from hostile takeovers due to reallocation of target assets to purchasers in related industries.
b. <i>Financial</i>	- capital expenditure planning shifted to central headquarters; higher premiums when acquirer's cash flow rate higher than target's; increased capital outlays after acquisitions; accounting conventions have no stock price effects.
c. <i>Diversification</i>	- low stock return correlation bank mergers associated with significantly higher abnormal returns than high stock return correlation bank mergers; target bank stock return variability decreases after merger.
2. Reduced Agency Costs	
a. <i>Inefficient Management</i>	- high management turnover after takeover; bidders have higher rates of return than targets; targets have low Tobin's q ratios; hostile takeover targets are poor performers; targets whose managers are replaced had negative returns pre-takeover; bad bidders make good targets; significant cash flow improvements after both unrelated and related-firm acquisitions.
b. <i>Free Cash Flow</i>	- probability of going private directly related to free cash flow and inversely related to growth; premiums correlated with free cash flow; targets have low Tobin's q ratios.
c. <i>Improved Incentives from Ownership Increase (MBOs)</i>	- productivity and operating improvements post-buyout; returns on going public (post-buyout value increase) directly related to management's equity stake.
Expropriation	
1. Taxes	
	- interest deduction explains significant portion of MBO premium, other tax benefits not important; net tax effect from MBO estimated as positive and debt shield value reduced by rapid repayment; post-buyout investors earn very high return in reverse buyouts.

Explanation	Evidence
2. Bondholders	- small negative or no significant impact on bondholder wealth; size of gain not correlated with amount of outstanding debt; protective covenants increasingly used in industries where LBOs more likely.
3. Labor	- no significant negative impact on employment levels, except for top and middle managers; some evidence that employment increases with control changes; no significant wage effect; overfunded pension reversions not significant factor.
4. Monopoly Power	- no effect on competitors' stock prices; unrelated acquisitions less profitable than related acquisitions in the 1980s; hostile takeovers reallocate assets to related buyers.
Market Inefficiency	
1. Underpricing	- stock prices of targets that are not acquired return to pre-bid levels; event studies generally supportive of market efficiency.
2. Market Myopia	- stock prices respond positively to increases in research and development (R&D) and capital investment expenditures; post-acquisition R&D expenditures do not decrease; targets in low intensity R&D industries and tend to spend less on R&D than industry; firms reduce R&D expenditures after adopting defensive charter amendments.
NON-VALUE-MAXIMIZING	
1. Diversification	- manager-controlled firms more likely to engage in diversifying mergers than owner-controlled firms.
2. Self-Aggrandizement	- bidder and target return correlations in pure conglomerate and product extension mergers are positive and not negative; positive relation between acquirers' abnormal returns and management stock ownership; bad bidders make good targets; acquirers' returns less negative when board is independent.
3. Free Cash Flow	- bad bidders are more likely to be acquired than good bidders; acquirers have positive abnormal returns before acquisition; acquirers have low Tobin's q ratios; free cash flow explains variance in returns across bidders; increases in free cash flow associated with decreases in bidders' gain from a takeover.
4. Hubris	- negative returns to acquirers in 1980s; bad bidders make good targets; bidders overpay in auctions.

I therefore read the literature as most consonant with the value-maximizing, efficiency-enhancing explanations of takeovers. However, different takeover theories each explain best only subsets of acquisitions and, though empirical studies might point in a particular direction, none are conclusive. There may be, then, instances of non-value-maximizing acquisitions as well as acquisitions which transfer wealth from particular groups to target shareholders, but these should be viewed as the exception, rather than the rule.

II. Regulatory Implications

Takeovers are regulated under a dual regime of federal and state laws. The principal federal legislation is the Williams Act,¹³⁶ which places disclosure and other substantive requirements on the takeover bidding process and is administered by the Securities and Exchange Commission and federal courts. Federal tax and antitrust laws also affect takeovers, and presidential review and approval is required for certain acquisitions by foreigners.

State takeover laws apply to corporations incorporated in the legislating state, although some laws extend to firms with physical operations in the state as well. While the earliest state statutes ("first generation"), which established disclosure and review requirements for bids, were struck down for unconstitutionally burdening interstate commerce in *Edgar v. MITE Corp.*,¹³⁷ subsequent statutes ("second generation"), imposing restrictions on acquirers' voting rights, were upheld in *CTS Corp. v. Dynamics Corp. of America*.¹³⁸ The primary mechanism of state regulation is, however, judicial, because courts oversee the bidding process, and can thereby immunize management's defensive tactics. Because second generation statutes and judicially-sanctioned defensive tactics go beyond the Williams Act's strictures on bidders, the states have become the more important jurisdiction for takeover regulation.

This section seeks to explicate the intended and unintended effects of this dual regulatory regime, illuminating where legislators or policymakers make mistakes, where they do not, and where the data do not permit us to draw conclusions. It is not an exhaustive review. Rather, it is selective, focusing on what I consider to be the more critical regulations. For ease of exposition, the discussion is organized by the regulation's substantive content, rather than its source (federal, state, or judicial), although on some occasions these are coterminous. To preview the section's coverage, see Table 2.

136. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78g, 78l-78n, 78s (1988)).

137. 457 U.S. 624 (1982).

138. 481 U.S. 69 (1987).

A. Regulation Encouraging Takeover Auctions

One of the primary effects of takeover regulation is the facilitation of auctions for target firms. Any regulation that delays the consummation of a hostile bid, for example, increases the likelihood of an auction by providing time for another bidder to enter the fray, upon the target's solicitation or otherwise. Major federal regulation furthers auctions through the Williams Act's minimum offer period, mandatory withdrawal rights and 5% accumulation disclosure requirements,¹³⁹ and the premerger notification, reporting and waiting period requirements of the Hart-Scott-Rodino Act.¹⁴⁰

Auctions have also been fostered at the state level. First generation state takeover statutes, whose disclosure and hearing requirements had expanded upon the Williams Act's terms, were followed by second generation control share acquisition statutes, which require bidders to wait for a shareholders' meeting before they can either purchase shares or hold shares with full voting rights. These statutes delay the completion of bids. Moreover, the Delaware court's fiduciary duty rules, as expounded in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,¹⁴¹ by commanding managers to maximize the price shareholders receive when their company is put up for sale, may require an auction.¹⁴² Finally, management's principal defensive tactic, the poison pill,¹⁴³ also promotes auctions, as it permits the board to negotiate the redemption of the pill with a preferred bidder. But by adjudicating when a poison pill is to be redeemed, courts may replace boards as the actual auctioneers, because

139. Formerly, the Act's antifraud provisions also facilitated auctions because, until the poison pill provided a better defense, target management would bring lawsuits under these regulations to gain time to find a preferred suitor. See Jarrell, *supra* note 103.

140. See 15 U.S.C. § 18a (West Supp. 1991).

141. 506 A.2d 173 (Del. 1986).

142. The auction requirement may devolve into the question whether the target has put itself up for sale. See, e.g., *Paramount Communications v. Time Inc.*, 571 A.2d 1140 (Del. 1990). Moreover, courts approve various techniques that may circumvent auctions, such as passive auctions, *Barkan v. Amsted Indus.*, 567 A.2d 1279 (Del. 1989), and mergers that shareholders approve, *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, Civ. No. 11495 (Del. Ch. Sept. 6, 1990). *Revlon's* auction rule was cut back in *Paramount Communications v. Time Inc.*, 571 A.2d 1140 (Del. 1990), which, in defining what constitutes putting the firm up for sale, in its narrowest reading, exempted stock-for-stock mergers, *Herd v. Major Realty Corp.*, Civ. No. 10707 (Del. Ch. Dec. 21, 1990).

143. A poison pill is a shareholder rights plan in which the firm issues a warrant on each share of common stock (except those owned by the triggering shareholder) that gives the holder the right to acquire preferred stock for a low price. The right is contingent upon the occurrence of either a tender offer for the common or an accumulation of a block of common stock. The preferred stock has superior dividend and liquidation rights and is convertible into shares of the acquirer, at a steep discount, if the common stock is exchanged in a merger. Boards can redeem the rights for a trivial amount in the case of a tender offer, but the rights become nonredeemable upon the block acquisition.

they not only constrain the bidding process the board chooses, but they also decide when the auction ends.¹⁴⁴

The uniform and persistent adoption of regulations that facilitate takeover auctions raises an obvious question: are auctions desirable? For ease of exposition, the question will be divided into two parts: whether auctions are desirable at all, or in specified cases.

1. *Should Auctions Be Encouraged At All?*

The practice of encouraging takeover auctions is the subject of a protracted debate in the legal literature. Many commentators maintain that auctions will reduce the number of takeovers because competition raises the winning price, which lowers bidders' returns and consequently makes them less likely to bid in the first place.¹⁴⁵ If takeovers are a mechanism for reducing agency costs, the consequence of auctions is to increase managerial slack, as a decline in bids translates into a reduction in the market for corporate control's disciplinary force. While an auction increases the returns from a takeover to a specific target ex post, it reduces the ex ante probability of a takeover, thereby loosening external constraints on managers. Shareholders are, accordingly, harmed by regulations fostering auctions. The agency-cost reduction explanation of takeovers is central to this position, which concludes that regulatory policy encouraging auctions is misguided and undesirable.

Other commentators question the importance of an adverse effect of auctions on the number of takeover bids. In their view, bidders have an alternative means of recouping their investment (selling the shares they accumulate before making an offer into the winning bid)¹⁴⁶ and search costs are low (possibly a result of the role played by financial intermediaries in the bidding process); consequently, auctions will not reduce the number of initial bids, or any decrease will be insignificant.¹⁴⁷ In addition, if targets search for bidders, then permitting auctions enhances their incentives to make value-maximizing invest-

144. See, e.g., *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989) (auction must be fair); *Grand Metropolitan P.L.C. v. Pillsbury Co.*, Civ. No. 10319 (Del. Ch. Dec. 16, 1988) (mandating poison pill redemption).

145. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L., ECON., & ORG. 229 (1986).

146. The success of this strategy is limited by federal and state restrictions on the number of shares bidders may accumulate before making a bid. Holders of 5% of a company's stock must disclose their ownership and intentions within 10 days of the acquisition under the Williams Act, and acquisitions of blocks of varying sizes trigger state takeover laws' punitive provisions. For a discussion of these statutes, see *infra* Part II.C.

147. See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

ments in assets (to increase their attractiveness to acquirers) as well as to provide information to potential bidders.¹⁴⁸ Some have even questioned whether there are social gains from search. Hirshleifer shows that there can be inefficient overinvestment in information production (when being “first” matters, as it does in buying common stock on private information), and Bebchuk contends that this analysis is applicable to takeovers.¹⁴⁹ Finally, synergy explanations of takeovers suggest a useful role for auctions: ensuring that the target is acquired by the highest-valuing bidder (the bidder with the highest synergy gain from the acquisition).¹⁵⁰ In this case, an auction may be a cheaper mechanism than a series of resales to move the assets to the highest-valuing user.¹⁵¹

The economic literature cannot readily arbitrate this debate. To do so in a compelling fashion we would need to know the unknowable—how many takeovers there would have been had auctions not been permitted. But there is some suggestive research on the effect of regulations encouraging auctions, and it tends to support auction opponents. Bidder returns tend to be negative after state takeover laws were enacted and poison pill defensive tactics jelled.¹⁵² In addition, firms with active acquisition programs experienced negative stock price effects upon the enactment of the Williams Act.¹⁵³ Furthermore, auctions increase premiums¹⁵⁴ and the number of auctions and the size of premiums increased after both the Williams Act and state takeover statutes were enacted.¹⁵⁵ This suggests that bidders pay more in regimes facilitating auctions, which lowers their returns. Hence, these regimes will deter acquirers from making bids. However, these premium increases may not be due to the Williams Act. Nathan and O’Keefe suggest that any impact of the Act

148. David D. Haddock, Jonathan R. Macey & Fred S. McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

149. Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971); cf. Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, 2 J.L., ECON., & ORG. 253, 261 (1986).

150. Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L., ECON., & ORG. 27 (1991). For an elaboration of this argument, see *infra* Part II.A.2.

151. Bebchuk, *supra* note 147; Gilson, *supra* note 147.

152. Bradley et al., *supra* note 13.

153. Schipper & Thompson, *supra* note 12; Schipper & Thompson, *supra* note 29.

154. Bradley et al., *supra* note 103; Jarrell, *supra* note 103.

155. Margaret Guerin-Calvert, Robert H. McGuckin & Frederick R. Warren-Boulton, *State and Federal Regulation in the Market for Corporate Control*, 32 ANTITRUST BULL. 661 (1987); Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980). An alternative explanation of these data is that the takeover market changed in the late 1980s with the emergence of financial bidders (leveraged-buyout investor teams), as opposed to acquirers who were operating firms, a change that occurred independently of the existence of pro-auction regulation. These new bidders were willing and able to pay high premiums due to anticipated breakup values, while the incentives of their financial intermediaries exacerbated any tendency to overpayment, as fees depended on the value of the deal. I am, however, skeptical of the independence of this explanation of the temporal trend in bidder returns from the regulatory changes, because any pressure from intermediaries on bidders to overpay would succeed only if the threat of an auction was likely.

was, at best, delayed, as they find that takeover premiums significantly increased after 1974 and not after 1968.¹⁵⁶ In addition, Franks and Harris find that takeover premiums increased in the United Kingdom after 1968, which suggests that the increases Jarrell and Bradley found in the United States after 1968 may not be attributable to the Williams Act.¹⁵⁷

Some studies provide evidence that more directly addresses the effect of auctions on the incidence of bids. Jarrell and Bradley find that the number of tender offers declined more sharply after the Williams Act than did the number of acquisitions.¹⁵⁸ The comparison is meant to proxy as a control for other economic variables that affect these transactions. The authors conclude that the Williams Act has deterred bidders. Unfortunately, they do not appear to have tested whether the difference in the decline across the two groups is significant, and they do not indicate what the relative incidence of auctions is for the two samples. These omissions weaken their conclusion concerning the effect of the Williams Act.

Hackl and Testani further find that states adopting second generation takeover statutes had a smaller increase in the number of takeovers than states with no statutes (controlling for the number of firms incorporated in a state).¹⁵⁹ This suggests that regulation promoting auctions chills takeovers. But they also find that bid premiums do not vary significantly across regulating and non-regulating states, and that regulating states do not experience more auctions than states without statutes. While the similar level of auction activity may explain the insignificant difference in premium levels across the two sets of states, these data imply that the predicted tradeoff of a higher premium for a reduced probability of takeover is not realized through regulation.¹⁶⁰ It is possible that state takeover statutes do not produce more auctions because bidders engage in preemptive bidding (they make initial bids at sufficiently high prices to deter competition) when faced with a potential auction. The equivalent premium levels across states with and without regulation are consistent with this possibility, because preemptive bidding need not maximize target reve-

156. Kevin S. Nathan & Terrence B. O'Keefe, *The Rise in Takeover Premiums: An Exploratory Study*, 23 J. FIN. ECON. 101 (1989).

157. Julian R. Franks & Robert S. Harris, *Shareholder Wealth Effects of Corporate Takeovers: The U.K. Experience 1955-1985*, 23 J. FIN. ECON. 225, 238 (1989).

158. Jarrell & Bradley, *supra* note 155.

159. Jo Watson Hackl & Rosa Anna Testani, *Note, Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study*, 97 YALE L.J. 1193 (1988).

160. Pound finds that certain antitakeover charter amendments have the same effect: they decrease the likelihood of a takeover but do not increase the premium paid when a takeover does occur. John Pound, *The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence*, 30 J.L. & ECON. 353 (1987).

nues.¹⁶¹ In any event, a finding of no tradeoff of higher premiums for fewer bids undercuts the position of auction proponents, because it indicates that a policy encouraging auctions may not maximize target revenues either *ex ante* or *ex post*.

2. *Should Auctions Be Encouraged in Specified Cases?*

While we cannot determine conclusively whether auctions should be banned, we can examine whether, once a bid is made, holding an auction makes more sense in some circumstances than in others. There is an extensive and highly sophisticated economic literature analyzing auctions and identifying procedures which are efficient (i.e., the highest-valuing user obtains the auctioned object) and which maximize returns to sellers.¹⁶² Cramton and Schwartz apply the results of this literature to takeover auctions, and emphasize that the optimal policy is a function of the auction environment.¹⁶³ This is a promising approach because it is questionable whether empirical research will be able to resolve the more general auction debate in a convincing manner.

There are two prototypical auction environments, common value and independent values. In a common value auction, the auctioned object's value is the same to all buyers, whereas in an independent values auction, each buyer values the object differently. The paradigmatic example of a common value auction is the sale of an oil lease (any buyer will obtain the same revenue from the extracted oil), and that of an independent values auction is the sale of an antique (buyers have different tastes and hence place different values on possessing the object).¹⁶⁴ Cramton and Schwartz maintain that, while current policy does not make distinctions, takeover regulation should differ by auction type because the optimal number of bidders differs contextually: it is desirable to restrict the number of bidders in the common value context but not in the independent values case. As they detail, bidders can be induced to enter or stay out of an auction by judicious use of lockups and breakup fees; the use of these devices should thus be matched with the auction environment.

161. When bidders are uncertain about the target's value, one bidder's high initial bid may deter others from investigating the target because they think the first bidder has the highest valuation. If the highest-valuing bidder is one of those deterred, then the target will not be sold for the highest possible price. Cramton & Schwartz, *supra* note 150, at 43. More important, even if the first bidder is the highest-valuing user, the target can still be sold at a price below its maximum worth. This is because the preemptive bid can deter the entry of the second highest-valuing bidder, which will result in the first (and highest-valuing) bidder paying a lower winning price. *Id.*

162. For a review, see Paul Milgrom, *Auctions and Bidding: A Primer*, 3 J. ECON. PERSP., Summer 1989, at 3.

163. Cramton & Schwartz, *supra* note 150.

164. In practice, auction environments are not pure. Oil companies' drilling costs may differ, which creates differences in profitability across buyers, and antiques can be resold, which results in a common value component. The mixed environment is referred to as a correlated or affiliated auction. *See id.*

Different explanations for takeovers mesh with different auction types, and therefore aid in establishing when different auction rules should be applied. If a takeover is undertaken to achieve synergy gains, then the auction setting is one of independent values because the value of the target will vary with the bidder (different bidders can achieve different levels of synergy gains).¹⁶⁵ In this context, an auction is appropriate because it permits the target to identify the highest-valuing bidder. The optimal form of auction differs, however, if the goal is social efficiency (ensuring the highest-valuing acquirer wins) as opposed to revenue maximization (ensuring the target gets the highest price for its shares).¹⁶⁶ For example, an auction with a reservation price (the minimum price the seller requires) extracts rents from the bidder, increasing the target's share of the takeover gain, but it can also be inefficient. If the reserve price is above the target's value to the highest-valuing bidder, then the takeover will be defeated, even though the value of the firm in the bidder's hands is greater than its value under incumbent management.

If a takeover is, however, explained by agency cost reductions (eliminating free cash flow or replacing inefficient management), then the auction environment is likely to be one of common value because many bidders will be able to mitigate the problem and each will obtain the same value from the target.¹⁶⁷ Cramton and Schwartz offer two prescriptions for the common value setting: (1) target boards should make information available to all bidders; and (2) target boards should follow English auction procedures.¹⁶⁸ Both of these practices reduce bidder uncertainty, and therefore raise bids. This is because bidders in common value auctions will lower their bids in fear of the winner's curse. Increasing the information available to bidders about the target and holding an English auction mitigate this problem by reducing uncertainty, which in turn lowers bidding costs and reduces the likelihood of the winner's curse.

Cramton and Schwartz further contend that running such a common value auction is undesirable compared to negotiating with one buyer. Assuming bidding costs are fixed, as the number of bidders increases, a bidder's probability of winning decreases. To maintain expected revenue, the bidder must therefore reduce its bid. The target's revenue is equal to its expected value less the *sum* of the bidders' costs. The target is consequently better off reducing the

165. *Id.* at 49.

166. *Id.* at 40.

167. *Id.* at 47.

168. *Id.* at 35. An English auction is a multiple-round auction in which the highest bidder wins at the reservation price of the second highest bidder. Each bid is made publicly, with the bidding continuing until only one bidder remains. Cramton and Schwartz suggest that their analysis casts a more favorable light on the RJR Nabisco board's behavior during buyout negotiations: after running a sealed-bid auction, the board encouraged another round of bids. *Id.* at 36 n.19, 45 n.32. This made the bidding process closer to an English auction, the more appropriate procedure for maximizing RJR's revenue in a common value auction environment.

number of bidders (not holding an auction), and negotiating with one bidder.¹⁶⁹ In addition, this should avoid the winner's curse. Of course, the target must obtain a higher bid out of the restriction in order to make it worthwhile. Cramton and Schwartz suggest that the threat of holding an auction if negotiations fail may bolster the target's bargaining position.¹⁷⁰

Cramton and Schwartz maintain that proper auction policy depends on the anticipated behavior of target managers as well as on the auction environment. Because different environments require different auction policies, the ideal approach is discretionary: hold an auction when the takeover involves independent values but do not when it is a common value situation. However, if target managers do not act in the shareholders' interest, then a rule granting them discretion is undesirable, for faithless managers would use this discretion to defeat bids by holding auctions when they should not, by claiming that a common value case is an independent values one.¹⁷¹

Concern over the agency problem leads Cramton and Schwartz to suggest policy choices determined by a law of averages: choose the approach that is consistent with most takeovers and eliminate all managerial discretion. They contend that most takeovers involve common value settings, and therefore propose a new regulatory approach, an auction ban. This would entail repeal of the statutes fostering auctions (in particular, the Williams Act's minimum offer period) and boards' *Revlon* duties, as well as prohibition of poison pills. The policy choice also depends on a third variable, the intended goal of regulation. Cramton and Schwartz argue for social efficiency, rather than target revenue maximization, as the proper goal, which, for common value auctions, is fostered by an auction ban.¹⁷² If the goal is instead target revenue maximization, then an auction would be appropriate even in the common value setting because it would increase revenues compared to an unregulated process in which bidders direct their offers to dispersed shareholders.¹⁷³ However, as discussed earlier, it is desirable to restrict entry in such an auction.

As Cramton and Schwartz note, their policy proposal, banning auctions, is tentative because the evidence identifying the prevalent auction environment

169. *Id.* at 35.

170. *Id.* at 36. They do not discuss the impact on the success of this strategy of adoption of their proposed no auction rule, *see infra* text accompanying note 172, although they do note that acquirers still paid premiums in tender offers before the enactment of the Williams Act (i.e., before takeover auctions became common).

171. The Time-Warner-Paramount takeover battle can be interpreted as an example of the same problem. Time management avoided an auction by merging with Warner. While this behavior (negotiating with one suitor) would be appropriate in a common value context, this was clearly an independent values setting because synergy gains were expected from the merging of the complementary entertainment businesses. Therefore, although an auction was warranted to maximize revenues, management deliberately prevented an auction from occurring.

172. Cramton & Schwartz, *supra* note 150, at 45.

173. *Id.* at 45 n.33.

is “scanty”.¹⁷⁴ If most takeovers were independent values auctions, for example, then the appropriate policy would be the opposite of what they propose, a rule of auctions in all cases. I am hesitant to advocate adoption of either blanket rule, as against a discretionary approach, for three reasons. First, reading the data most favorably to Cramton and Schwartz, the auction environment has clearly varied dramatically over time: common value takeovers appear to be more typical in recent years compared to an earlier era in which conglomerate and product-extension mergers (independent values) predominated.¹⁷⁵ Fluidity in takeover environments over time suggests caution in mandating a blanket rule, for the choice will not always be appropriate and changing the legal regime is often difficult and always costly.¹⁷⁶

Second, Cramton and Schwartz reject a discretionary approach for fear that management will be able to hold an auction by the backdoor in common value cases because while the bidder litigates to prevent an auction, target management will gain time to find other suitors (in effect, running an auction).¹⁷⁷ This problem, however, can be resolved without banning auctions. Acquirers could be permitted to recover damages for their search and bidding costs from the individual manager-defendants upon a court determination that they wrongfully held, or tried to hold, an auction. As Cramton and Schwartz note, courts will be able to determine whether management’s conduct was appropriate, as the economic learning on takeovers can instruct courts on the criteria for acceptable auction procedures by identifying the auction environment.¹⁷⁸ In

174. *Id.* at 46.

175. Cramton and Schwartz characterize bust-up takeovers, which dominated the landscape of the 1980s, as common value auctions. In bust-up takeovers, different assets and divisions of the target are sold to different buyers in related industries. Cramton and Schwartz contend that these takeovers should be viewed as common value auctions because any bidder can realize the same value by selling the pieces. The classification is not as clean as they suggest, however, and this muddies up the appropriate policy choice. Consider the Revlon takeover. The successful bidder, Ronald Perelman, retained the cosmetics division and sold the health care division to a firm in the same industry. The competing bidder, Forstmann-Little, would have retained the health care division and sold the cosmetics division. This takeover is a bust-up takeover (selling pieces created more value than keeping the firm intact) yet clearly, different acquirers’ strategies differed and synergy gains were present. Cramton and Schwartz define the latter condition as appropriate for an independent values auction, but the former as proper for a common value one. An auction that combines both components, such as Revlon, is an affiliated auction, an environment in which the English auction format is optimal. *Id.* at 44-45. Because I do not think that the Revlon situation is aberrational, I find troublesome the blanket classification of bust-up takeovers as common value auctions. This makes the choice of a mandatory rule of no auctions even more problematic.

176. The changing pattern of auction environments is interesting from a political economy perspective when we consider the timing of takeover regulation facilitating auctions. Managers are the prime movers behind state regulation. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987). Auctions should have been favored in the earlier years, when acquisitions exhibited independent values properties, yet the burst of state regulations came to the fore, and indeed accelerated, as the typical auction environment changed to one of common value. It is not surprising that laws fostering auctions were enacted when the environment shifted because in the common value setting, auctions are more likely to defeat bids, the outcome a faithless management prefers.

177. Cramton & Schwartz, *supra* note 150, at 46.

178. *Id.* at 49.

particular, specific questions can be asked. For example, is free cash flow present? Are there economies of scale or scope? Are bidder and target stock returns positively correlated? Has the target been performing so poorly that management needs to be replaced? While courts will have to obtain information from the target and acquirer to engage in this inquiry, strategic behavior—bidders and incumbents providing selective or misleading information in the hope of obtaining their preferred auction treatment—will be constrained by the litigants' interests being in sharp conflict.

Third, I am skeptical whether corporate law should, as Cramton and Schwartz maintain, instruct target boards to pursue social efficiency rather than revenue maximization when presented with a bid. Opting for efficiency rather than revenue maximization stands a commonsense understanding of property rights on its head: our economic system is premised on the consensual transfer of property in private commercial transactions. Yet from a social efficiency standard, the target shareholders ought to be *compelled* to sell to any bidder for a trivial amount above the market price, in order to move the assets to the higher-valuing user. Most of us—except strict utilitarians¹⁷⁹—would find such a rule unacceptable, but it is the logical implication of implementing such a policy.¹⁸⁰

A no auctions policy would impose a social cost, a higher price for equity capital, as common stock owners would no longer share in takeover gains. If bidders are public companies, then this would not affect the cost of equity capital because what shareholders lose on the target side they gain on the bidder side.¹⁸¹ However, in the 1980s many bidders, particularly LBO teams, were privately-held, and therefore the lost premiums would not be offset by gains on other holdings in a diversified portfolio.¹⁸² Of course, the social gain discussed in the previous section, increased bidder search for takeover targets,

179. See Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165 (1988).

180. Cf. Coffee, *supra* note 5, at 1165-66.

181. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

182. Neutrality in regulating takeover auctions may not be desirable if investors cannot diversify across targets and acquirers. This is because a bias in favor of targets compensates for acquirers' ability to obtain an unequal division of the gain, an ability that is unrelated to the discovery value of the acquirers' information about the target and its search costs (hence unrelated to the goal of social efficiency), and derives instead from a peculiar structural problem of the modern corporation: ownership is dispersed among many shareholders rather than concentrated in a few hands. This structure makes bargaining ineffectual without auction protection, providing bidders with a windfall compared to what they would receive if they were negotiating with a sole-owner. Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197 (1988). However, data on takeovers in France are apparently at odds with this contention: the premiums paid for private control blocks are substantially lower than those paid in public tender offers. B. Espen Eckbo & Herwig Langohr, *Information Disclosure, Method of Payment, and Takeover Premiums: Public and Private Tender Offers in France*, 24 J. FIN. ECON. 363 (1989). Regrettably, Eckbo and Langohr do not provide any explanation, institutional or otherwise, for this counterintuitive finding.

which would make the efficiency gains from takeovers more likely, must be balanced against this social cost of banning auctions.

Cramton and Schwartz's pursuit of social efficiency can be harmonized within a consensual private property framework as an assertion of which regime shareholders would prefer before a bid is made. Revenue maximization and social efficiency diverge when the analysis is conditioned on the existence of a bid, but the two may coincide when the analysis considers the unconditional effect of auctions on takeovers (whether auctions decrease the number of initial bids). The desirability of encouraging auctions in specific situations is, therefore, not independent of the general question whether to encourage auctions at all, and the validity of the Cramton and Schwartz policy proposal to ban auctions ultimately rests on an anti-auction outcome of the global auction debate.

This recognition highlights the need for a discretionary policy, because the resolution of that debate is uncertain. It recasts the policy question as whether shareholders behind a veil of ignorance (that is, prior to knowing that their firm is the object of a bid) would prefer a lower premium and an increased likelihood of receiving a bid (the "no auctions" policy tradeoff) to a higher premium accompanied by a reduced probability of a takeover and consequent increase in management slack (the "auctions always" tradeoff). Rather than mandate public policy on the basis of speculation concerning shareholder preferences over these tradeoffs, the most appropriate policy is to permit the parties whose wealth is at stake, shareholders, to choose whether or not to hold takeover auctions for their firms.¹⁸³ Such an approach treats the maintenance of private property rights as taking precedence over overall social welfare maximization, and thus, unlike Cramton and Schwartz's proposal, permits shareholders to trade bids for premiums, rather than requiring maximization of the number of bids.

One mechanism for implementing a policy of shareholder choice is to retain the Williams Act as the principal auction-promoting rule, with two amendments: a proviso that requires management to provide equal information to all bidders (as Cramton and Schwartz endorse for auctions); and another that permits shareholders to opt out of the Act if they do not want their firms to hold auctions. To guarantee that shareholders have the final say on whether to run an auction, all of management's defensive tactics must be subject to shareholder approval, as in proposed Article 8 of the European Community's Thirteenth Council Directive on Takeovers.¹⁸⁴ This proposal is, however, not intended

183. For a discussion of why paternalistic policies (as embodied in mandatory rules) toward shareholders are inappropriate, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1556-66 (1989); Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989).

184. RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 450-51 (Supp. 1991).

to be as limited as the Directive, which covers defensive tactics once a bid has been made, for such a restriction undermines the policy of shareholder approval by encouraging managers to undertake preemptive defensive policies so as to make their firms "takeover-proof." Moreover, state takeover statutes that encourage auctions would have to be fashioned as opt-in rather than opt-out regimes, in order to place the auction decision fully in shareholder control.¹⁸⁵

A more complex, but equally feasible, alternative would be for corporation codes to provide a menu of charter rules concerning auctions. Each firm's charter would incorporate an auction rule, just as they now contain provisions on indemnification, shareholder voting rights, and so forth. Charters could ban auctions, require auctions, provide managers with the discretion to run auctions, specify conditions under which managers must run auctions, or let shareholders run auctions, which could be accomplished by requiring shareholder approval of poison pill plans and of pill redemptions, or by including sunset provisions for poison pills (automatic lapsing without periodic shareholder approval). Under a corporate charter menu approach, the charter amendment process would have to be loosened from management's control to provide greater shareholder autonomy: shareholders must have the right to initiate and adopt charter provisions on auctions without management's approval, given concern over agency problems in the takeover setting.¹⁸⁶ The crucial issue is the choice of the default rule. While I do not believe that Cramton and Schwartz's no auction rule should be the default position, given management's stark conflict of interest in the takeover setting, the default rule should accord greater shareholder control over the auction process than does the current regime.

There is some empirical research that supports permitting shareholders to choose the auction approach, rather than mandating a no auction regime. Defensive tactics that shareholders approve tend not to have negative stock price effects compared to those they do not approve.¹⁸⁷ But there are limits to a voting system, as not all shareholder-approved charter provisions have

185. This assumes that managers will not hesitate to put a pro-auction charter provision on the agenda, compared to an anti-auction one. See Romano, *supra* note 176, at 187.

186. Forty-eight states, including Delaware, require charter amendments to be initiated by the board (California is the important exception), and most states require amendments to be approved by both the board and shareholders. LEWIS D. SOLOMON, DONALD E. SCHWARTZ & JEFFREY D. BAUMAN, *CORPORATIONS: LAW AND POLICY, MATERIALS AND PROBLEMS* 585 (2d ed. 1988). Because the current regime permits auctions, midstream charter amendments to similar effect pose no problem with respect to an adverse affect on shareholder wealth. Appraisal rights for charter reforms that have adverse wealth effects are a more adequate response to concerns about midstream opportunism than a mandatory regime prohibiting such changes. See Romano, *supra* note 183. Midstream opportunism will be a less pressing problem if shareholders, and not managers, initiate amendments.

187. Compare Scott C. Linn & John J. McConnell, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983) with Paul H. Malatesta & Ralph A. Walkling, *Poison Pill Securities: Stockholder Wealth, Profitability and Ownership Structure*, 20 J. FIN. ECON. 347 (1988).

positive stock price effects.¹⁸⁸ One explanation for the different stock price reactions depends on ownership composition. Stock prices react positively to defensive charter amendments when management's stock ownership is low (under 10%) and the provision thus improves dispersed shareholders' bargaining power, and negatively when management's ownership is high and it can thereby block a bid.¹⁸⁹ We might expect to find, then, under a charter menu approach, differences in firms' ownership composition mapping into different preferences over auction rules. Different states would therefore be likely to choose different auction default rules, depending on their corporate clienteles.

There is a question whether the effect of a charter provision requiring shareholder approval of poison pill redemptions is any different from one in which poison pills are banned, such as Cramton and Schwartz's regime. If shareholders would not tender their shares whenever they would also not redeem a pill, then the two regimes would be the same. We need to know whether shareholders can force an auction (upward bid revision), which is the ostensible purpose of a poison pill, by not tendering into a low bid in the absence of a pill. If they can, then their right to redeem pills would be unnecessary and undesirable since it would add a further layer of expense onto a bid's consummation. While no data address this question directly, there is some probative indirect evidence. Shareholders do not appear to be coerced into accepting low bids. Partial offers at small premiums tend to be rejected, and when there is competition between an offer for any or all shares and a two-tier bid, the one with the highest value, as calculated by the blended premium, wins.¹⁹⁰ In addition, firms without poison pills appear more likely to be the subject of an auction than firms with such defenses.¹⁹¹ These data are consistent with the view that shareholder redemption of poison pills and a poison pill ban are equivalent regimes (i.e., shareholders will not be compelled to tender into low bids, and auctions will still occur, in the absence of poison pills). But because these findings are from a regime in which auctions are permitted, we cannot readily extrapolate from them what premiums would look like, or how shareholders would react, if auctions were prohibited.

Under the corporate charter menu approach to auctions, legislators troubled by the uncertain equivalency can retain the status quo as the default rule.

188. See, e.g., Gregg A. Jarrell & Annette B. Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. FIN. ECON. 127 (1987).

189. Victoria B. McWilliams, *Managerial Share Ownership and the Stock Price Effects of Antitakeover Amendment Proposals*, 45 J. FIN. 1627 (1990). For a model of shareholder voting that is consistent with these results and critical of rational apathy stories of shareholder voting that produce calls for mandatory rules rather than shareholder choice, see Romano, *supra* note 183, at 1608-10.

190. Robert Comment & Gregg A. Jarrell, *Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free-Riding Shareholder*, 19 J. FIN. ECON. 283 (1987).

191. Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988).

Shareholders will simply choose between these, as well as other options on takeover auctions, and the information necessary to resolve the question will be obtained from experience developed under different auction regimes. This flexibility seems particularly apposite given a dynamic auction environment, in which different rules are appropriate for different contexts.

B. *Regulation Restricting Two-Tier Takeovers*

Many state takeover laws prevent bidders from making two-tier acquisitions (a tender offer for control followed by a merger to obtain 100% of the shares) that are structurally coercive, that is, front-end loaded. In a front-end loaded, two-tier takeover, the gain is distributed unequally across the two steps to induce target shareholders to tender in the first step, in which the bidder gains control. This type of regulation's explicit concern is horizontal equity, ensuring that all target shareholders receive the same price for their shares. Equal treatment, which is thought to prevent shareholders from being forced to tender, is consistent with the corporate law fiduciary principle that requires shareholder distributions to be pro rata. Examples are fair price, redemption rights, and business combination freeze statutes.¹⁹² The Williams Act's requirement of pro rata acceptance of shares in oversubscribed offers indicates a similar horizontal equity concern.

Concern for horizontal equity is independent of the explanation of takeovers, and thus evaluation of the efficacy of this regulatory approach need not turn on whether the premium is due to efficiency gains or wealth transfers. However, if these statutes deter bids, then the distinction would matter because efficiency-enhancing, as opposed to purely redistributive, transactions should presumably be encouraged. We must also consider whether we are simply confronting the auction debate in a different guise: do shareholders prefer equal treatment in exchange for a reduced probability of a bid, over unequal treatment in exchange for a greater chance of a bid? There is some evidence that shareholder voting on these amendments parallels the likelihood that the investor will be unequally treated. Institutional investors, who are able to tender quickly and will thus always participate in a two-tier bid's first step, thereby benefiting from a front-end loaded bid structure, oppose the amendments.¹⁹³ However, it is not analytically obvious that two-tier bid restrictions will decrease the number

192. The business combination freeze statute also has the effect of making a takeover less likely by prohibiting the acquirer from taking cash out of the target in a related transaction for a specified number of years, even at a fair price. This more restrictive feature is the subject of Part II.C, *infra*.

193. Romano, *supra* note 176.

of bids, as they need only redistribute funds among target shareholders rather than increase premiums.¹⁹⁴

There is very little empirical evidence that statutes restricting two-tier bids deter takeovers. For example, fair price statutes do not appear to have a negative stock price effect although other, more restrictive statutes do.¹⁹⁵ In addition, Hackl and Testani find that fair price statutes have less of a negative impact on the number of successful takeover bids than other statutes.¹⁹⁶ There is also evidence suggesting that the threat of front-end loaded two-tier bids is overstated. Blended premiums in two-tier bids are not significantly different from the premiums in offers for any and all shares.¹⁹⁷

More important, the voluntary adoption by shareholders of charter amendments with similar effect to these statutes suggests that shareholders may well desire equal treatment. Fair price charter provisions have insignificant stock price effects, while other antitakeover amendments produce significant negative returns.¹⁹⁸ This indicates that investors are, in all likelihood, not troubled by these restrictions or that these restrictions have no bite concerning a bid's occurrence or success (explanations that are not mutually exclusive). Because legislation does not require shareholder approval, whereas a charter amendment does, I have contended elsewhere that opt-in rather than opt-out takeover statutes are preferable.¹⁹⁹ This approach mutes any concern that managers lobby for legislation when they anticipate that voluntary shareholder approval cannot be obtained. But the economic literature does not provide much of a basis from which to take serious exception to horizontal equity regulation.

194. Grossman and Hart contend that acquirers must be permitted to make front-end loaded two-tier bids, or otherwise dilute the returns to target shareholders, in order to induce target shareholders to tender into the bid. Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980). However, Grossman and Hart's theory is not robust. Under a variety of reasonable conditions, it is not necessary to exclude public shareholders (i.e., to require dilution in a two-tier bid) for successful takeovers to occur. See Mark Bagnoli & Barton L. Lipman, *Successful Takeovers without Exclusion*, 1 REV. FIN. STUD. 89 (1988). Thus, as a matter of theory, these statutes need not deter bids.

195. Hackl & Testani, *supra* note 159; Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second Generation Takeover Legislation*, 25 J. FIN. ECON. 291 (1989); Romano, *supra* note 176; Laurence Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York's 1985 Takeover Statutes*, 19 RAND J. ECON. 557 (1988).

196. Hackl & Testani, *supra* note 159.

197. Comment & Jarrell, *supra* note 190.

198. Jarrell & Poulsen, *supra* note 188.

199. Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987).

C. Regulation Restricting Bidders' Ownership Rights

Several second and third generation state takeover laws go much further than regulating two-tier offers or encouraging auctions, and, by severely restricting bidders' ownership rights, have the effect of "show-stoppers" (tactics that kill a bid).²⁰⁰ Control share acquisition statutes deny bidders' shares voting rights (or deny bidders the right to purchase shares) without the approval of all other shareholders. Business combination freeze statutes prohibit bidders from engaging in related transactions with a target after they gain control, for a specified number of years, even if the remaining public shareholders approve of the transaction and a fair price is paid. Disgorgement statutes prevent unsuccessful bidders from selling their target shares at a profit. These statutes raise the cost of some takeovers prohibitively, and thus chill some bids. Shares without voting rights are obviously of no value to acquirers seeking control to implement their own business plans,²⁰¹ highly leveraged buyers need access to target assets to service the debt that makes their bids possible, and firms may not make toehold acquisitions, which may be crucial for a takeover's success,²⁰² when they face a tax at 100%.

Empirical research shows that these statutes have a far more damaging effect on takeovers than two-tier bid regulation. Hackl and Testani find a steeper decline in successful takeovers in control share acquisition statute states than in other states, including those with fair price regulation.²⁰³ Stock price studies also find more significant negative abnormal returns on the enactment of business combination freeze, control share acquisition and disgorgement statutes than fair price and other provisions.²⁰⁴ Thus, investors assess these

200. The dividing line between "generations" is the statute's popularity before and after the Supreme Court's *CTS* decision. For example, control share acquisition and fair price statutes are called second generation statutes, whereas business combination freeze and disgorgement statutes are considered third generation statutes. The Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988 authorizing broad Presidential review and approval of acquisitions by foreigners fits in this category of regulation that could stop certain takeovers. It is not discussed in the text because relatively few transactions have been sent to the President for a decision, and all but two were approved. GILSON, *supra* note 184, at 676. The small number of reviewed transactions may evidence that the Act has had a chilling deterrent effect on foreign investors, or that it has had little impact in practice.

201. Some practitioners contend that control share acquisition statutes are not effective deterrents because once a bidder announces a proposed acquisition, the target's shares will be acquired by arbitrageurs who profit if the bid succeeds and who will therefore always vote in favor of the bidder. See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 907 (1990). Revised control share acquisition statutes in Pennsylvania and Ohio remedy this concern by stripping voting rights from shares acquired after the disclosure of the proposed control share acquisition.

202. Dosoung Choi, *Toehold Acquisitions, Shareholder Wealth, and the Market for Corporate Control*, 26 J. FIN. & QUANTITATIVE ANALYSIS 391 (1991); cf. John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988).

203. Hackl & Testani, *supra* note 159.

204. Cf. Karpoff & Malatesta, *supra* note 195; Schumann, *supra* note 195; J. Gregory Sidak & Susan E. Woodward, *Corporate Takeovers, the Commerce Clause, and the Efficient Anonymity of Shareholders*, 84 NW. U.L. REV. 1092, 1104 (1990); Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in*

statutes' impact more adversely. Moreover, when firms opted out of the Pennsylvania takeover statute, which included the most refined control share acquisition and disgorgement provisions, they experienced positive abnormal returns.²⁰⁵ These data, in conjunction with the evidence that most takeovers are efficiency-enhancing transactions, indicate that statutes whose effect is to thwart bids are poor public policy.

It should be noted, however, that managers are able to thwart bids even without these statutes' assistance, through a number of defensive tactics approved by courts. It appears that poison pills and defensive charter amendments are, in fact, quite potent substitutes for takeover statutes. Karpoff and Malatesta find that the stock price effect of takeover laws is significantly negative for firms without takeover protections, but not for firms with such defenses.²⁰⁶

D. Regulation Introducing Non-Shareholder Interests

The most recent state takeover statutes introduce non-shareholder interests into decisions about takeovers. "Other constituency" statutes require or permit boards of directors to consider the interests of non-shareholder groups, such as workers and local communities, in their decision-making process. Some statutes also require severance pay for workers who are discharged after a takeover. These statutes make explicit concerns that may motivate legislators when enacting any takeover regulation, that a takeover will adversely affect the local labor market. However, the statutes, ironically, protect managers more effectively than workers. Workers have no right to challenge board decisions for failing to consider their interest, while shareholders' ability to sue managers successfully for opposing a bid is diminished. There is no severance pay for plant closings commenced by incumbent management, but a bidder's ability to reduce costs by layoffs, and hence the value of a takeover, has been reduced.

the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310 (1991) (unpublished manuscript, on file with the author); Romano, *supra* note 176. Pugh and Jahera, however, provide only mixed support for the proposition: they study the enactment of four business combination freeze and control share acquisition statutes and pick up significant negative returns on only a few of their many event dates. William N. Pugh & John S. Jahera, *State Antitakeover Legislation and Shareholder Wealth*, 13 J. FIN. RES. 221 (1990). They also find that Delaware's business freeze statute had no significant impact in Delaware firms' share prices, although as they note, commentators emphasize that Delaware's statute is less restrictive than those of other states. John S. Jahera & William Pugh, *State Takeover Legislation: The Case of Delaware*, 7 J. L., ECON., & ORG. 410 (1991).

205. Szewczyk & Tsetsekos, *supra* note 204.

206. Karpoff & Malatesta, *supra* note 195. Pugh and Jahera report a similar result for only one of their four portfolios of firms without defenses, but they also did not find significant negative stock price effects for as many event dates involving statute enactments. Pugh & Jahera, *supra* note 204. They also do not find such a result among Delaware firms. Jahera & Pugh, *supra* note 204.

Corporate law conventionally instructed boards to consider only the shareholders' interests (to maximize profit) for good reason. Maximizing equity share prices provides managers with a clear-cut decision rule, on which all shareholders agree in a perfectly competitive capital market,²⁰⁷ with the following benefits: (1) it allocates resources efficiently and thereby maximizes social welfare;²⁰⁸ (2) it maximizes shareholder utility because investors can trade against the increased share value to fulfill their diverse, preferred consumption patterns;²⁰⁹ and (3) it best matches organizational design with incentives because equity investments, as residual claims, are more vulnerable than other stakeholders' investments, which can be protected by contract.²¹⁰ By rejecting this stricture and introducing other constituencies' interests into the boardroom, the statutes create a situation in which there is no longer a coherent decision rule for managers to follow, as the many constituencies' interests often conflict. This will result in decisions maximizing managers' utility, because shareholders' ability to police board decisions has been legally attenuated, and it will thereby raise the cost of equity capital and impair the market's allocative efficiency.

The economic literature on takeovers also suggests that these statutes are utterly misguided. As we have seen, the best available data consistently indicate that takeovers are *not* a mechanism for transferring wealth from labor to shareholders. Layoffs are infrequent and when they occur they affect managers more than production workers, whose jobs are the object of legislators' concern. The statutes further exacerbate the agency problem that takeovers aim to mitigate, by reducing management's accountability to shareholders. Enhancing management's ability to resist a takeover is unlikely to be in the shareholders' interest, as the overwhelming evidence demonstrates that target shareholders gain handsomely from a successful bid. Shareholders, correspondingly, appear to assess these statutes negatively. An event study of one of the earliest versions of an other constituency statute, Ohio's 1986 takeover statute instructing managers to consider long-term rather than short-term interests, found the law had a significantly negative impact.²¹¹ Further, the subset of firms that opted

207. See Louis Makowski, *Competitive Stock Markets*, 50 REV. ECON. STUD. 305 (1983). It should be noted that in a world with uncertainty, profit maximization is properly replaced with equity share price maximization.

208. See generally HAL R. VARIAN, MICROECONOMIC ANALYSIS 189-249 (2d ed. 1984).

209. RICHARD BREALEY & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE 384-400, 544-47 (3d ed. 1988).

210. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984).

211. Michael Ryngaert & Jeffrey M. Netter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 J.L., ECON., & ORG. 373 (1988). Over a longer interval extending beyond the announcement date, the negative abnormal return is no longer significant. Donald G. Margotta, Thomas P. McWilliams & Victoria B. McWilliams, *An Analysis of the Stock Price Effect of the 1986 Ohio Takeover Legislation*, 6 J.L., ECON., & ORG. 235 (1990). But if investors are able to understand the legislation's effect upon its introduction, the shorter event interval is appropriate. Michael Ryngaert & Jeffrey Netter, *Shareholder Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effects*, 6 J.L., ECON., & ORG. 253 (1990). There

out of the Pennsylvania statute partially, so as to retain coverage under the other constituency provision, did not experience significant positive abnormal returns on the announcement, while those opting out of all of the statute's provisions did.²¹² Managers may have a similar assessment of these new laws. Pound finds that firms that did not opt out of Pennsylvania's takeover statute at all *and* firms that did not opt out of its other constituency provision have lower cash flow valuations than firms that opted out of the statute completely, and may thus be more likely takeover targets.²¹³ In short, the objectives of these statutes are, like those of the most restrictive takeover statutes, unsupported by theory or empirical evidence, and therefore unwise public policy.

E. Regulation through the Federal Tax Code

Several efforts were made to discourage takeovers through the federal income tax laws during the late 1980s.²¹⁴ Some provisions were directed at tax benefits accruing to acquisitions (restrictions on the transferability of net operating losses,²¹⁵ and repeal of the *General Utilities* doctrine²¹⁶), while others penalized specified defensive tactics (excise taxes on golden parachutes,²¹⁷ and greenmail²¹⁸).

1. Restricting Deductions

The 1986 tax reform act restricted the ability of firms to take net operating loss deductions. Restricting net operating losses is poor tax policy, violating the tax goals of equity and efficiency. It favors old and established firms over new ones, thereby furthering concentration of business and the growth of unprofitable diversified conglomerate firms; results in the taxation of capital rather than income; and distorts investment decisions away from risky projects.²¹⁹ As Campisano and Romano argue, the optimal policy on losses is

are as yet no event studies of the more recent "other constituency" statutes. Because many of these statutes were enacted at the same time as other takeover regulations, such as statutes restricting bidders' ownership rights, it would be difficult to isolate their effects.

212. Szewczyk & Tsetsekos, *supra* note 204.

213. Pound, *supra* note 53, at 13.

214. In addition, the House Ways and Means Committee in 1987 proposed strict restrictions on interest deductions for debt used to effect a takeover. Researchers have documented a negative stock price reaction to the proposal, and contend that it contributed substantially to the October 19, 1987 stock market crash. See Mark L. Mitchell & Jeffrey M. Netter, *Triggering the 1987 Stock Market Crash: Antitakeover Provisions in the Proposed House Ways and Means Tax Bill?*, 24 J. FIN. ECON. 37 (1989).

215. I.R.C. § 382 (1988).

216. See Tax Reform Act of 1986, Pub. L. No. 99-514 (amending I.R.C. §§ 311, 336-338, and repealing I.R.C. § 333).

217. I.R.C. § 280G (1988).

218. I.R.C. § 5881 (1988).

219. Campisano & Romano, *supra* note 60.

one of recoupment (a taxpayer receives a refund when it has no income to offset), and consequently, transferability of losses ought to be encouraged, not contracted.²²⁰ In a second-best world, there may be reasons to deviate from optimal policy, but the takeover literature provides no basis for any divergence. As already discussed, tax savings from net operating losses are not a significant factor in acquisitions, and hence, investment decisions on takeovers are not distorted by the possibility of loss offsets. Accordingly, this tax code revision, which moves us further from the optimal tax policy for losses, cannot be justified by concern over tax-driven acquisitions.

Under *General Utilities*,²²¹ corporate distributions of appreciated property to shareholders and sales of such assets pursuant to a plan of complete liquidation were not subject to the corporate level tax. The acquirer of the assets thereby achieved a step-up in asset basis without payment of the corporate tax. The repeal of *General Utilities* in 1986 eliminated this major loophole in the double tax regime, which had been criticized by commentators without avail until its use in hostile takeovers made it a prime target for reform.²²² While the repeal removes tax-free increased depreciation deductions as a motive for an acquisition, as discussed earlier, this tax benefit was not a significant factor when it was available, in either mergers or MBOs. Unlike the changes in the treatment of net operating losses, this reform is arguably sensible tax policy, for it maintains the integrity of the two-tier tax on corporate income.²²³ But just as in the reform of the net operating loss provisions, the desirability of the policy repealing *General Utilities* has no connection with its congressional inspiration, takeovers.

2. Taxing Defensive Tactics

Two defensive tactics have been singled out for federal tax penalties—golden parachutes and greenmail. Taxing these tactics is ironic because they are likely to benefit shareholders by increasing the probability of a takeover. The benefit is rather clear cut regarding golden parachutes; it is more ambiguous for greenmail.

220. *Id.*

221. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

222. Congressional movement to close loopholes because of anti-takeover sentiment was not an uncommon practice in the 1980s. For example, Congress restricted the favorable treatment for corporate shareholders in partial liquidations in the 1982 tax reforms, setting the stage for the *General Utilities* repeal. See Martin D. Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171 (1983). In addition, numerous tax bills intended to restrict takeovers were introduced during these years. See Romano, *supra* note 1, at 471-72.

223. Eric S. Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities*, 12 J. CORP. TAX'N 3, 51-63 (1985).

Golden parachutes are lucrative severance pay contracts for top management that are triggered by a control change. Although considered a defensive tactic—they raise the price of a bid because the acquirer is burdened with excessive severance payments—golden parachutes benefit shareholders by aligning managers' incentives with the shareholders' interest, as managers are financially rewarded for approving a takeover.²²⁴ Shareholders apparently recognize the beneficial role of golden parachutes: stock prices significantly increase on the announcement of golden parachute plans.²²⁵

Greenmail refers to a target's repurchase, at a premium, of the shares owned by a hostile bidder. Because the repurchase terminates the takeover, it is viewed as a defensive tactic. But greenmail has a more positive interpretation as well: it facilitates an auction (if the greenmailer is not the highest-valuing user of the target, paying greenmail can result in the target receiving a higher premium from another bidder), serving as compensation for those who supply valuable information to the market by identifying a takeover target and hence aiding in monitoring managers.²²⁶ The idea is that the second, higher-valuing bidder will enter only if it knows that the greenmailer is out of the picture so that there will be no competition to its bid. The firm's stock repurchase accomplishes this, but it comes at a risk: management must make the payment before it knows for sure whether a second bidder exists. If it knew there would be no other bidder it would not want to repurchase the shares, but failing to make the repurchase ensures that no bidder will emerge.²²⁷ Thus, an *ex ante* efficient decision to pay greenmail, having a positive net present value, may produce negative stock returns *ex post* if no second bidder appears. The difficulty with this story is distinguishing when greenmail is used by faithful managers, who hope that the action will produce a better bid, as the models hypothesize, and when it is used by self-serving managers who are confident that no subsequent

224. See David P. Baron, *Tender Offers and Management Resistance*, 38 J. FIN. 331 (1983).

225. Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making and Shareholder Wealth*, 7 J. ACCT. & ECON. 179 (1985). However, a possible interpretation of this finding is that shareholders are not valuing the tactic, but rather revising the stock price in expectation of a takeover, viewing adoption of a parachute as a signal that management expects a bid to be forthcoming. But because adoption of some defensive tactics is associated with negative stock price effects, *see infra* text accompanying notes 229-232, where a signalling story is equally operative, parachutes at worst are perceived as less harmful by investors than those other strategies.

226. Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985); Andrei Shleifer & Robert W. Vishny, *Greenmail, White Knights, and Shareholders' Interest*, 17 RAND J. ECON. 293 (1986). Macey and McChesney maintain that greenmail facilitates an auction without discouraging the occurrence of other bids, so that the critiques of auctions discussed *supra* in Part II.A.1 are unwarranted in this context. This is because the greenmailer produces valuable information that reduces other bidders' search and bidding costs. These bidders will consequently not be deterred from bidding, and the greenmailer is not deterred from investing in search because it is compensated by the share repurchase. Of course, if a successful bidder purchases the greenmailer's shares, the greenmailer would be equally well compensated.

227. Shleifer & Vishny, *supra* note 226.

bid will be forthcoming.²²⁸ The possibility that managers will be unfaithful renders the effect of greenmail more ambiguous than that of golden parachutes.

Stock price data concerning greenmail is, correspondingly, less straightforward than that on golden parachutes. The stock price effects of greenmail payments are negative, but when abnormal returns are cumulated from the time the greenmailer acquired its block through the shares' repurchase, the net effect is positive.²²⁹ Additional data supporting the favorable interpretation of greenmail is that firms paying greenmail do not have unusually low probabilities of experiencing a control change after a repurchase.²³⁰ The decline on the repurchase appears to be related to information reversal—there will be no takeover premium as no white knight has emerged—rather than a wealth transfer from target shareholders to the greenmailer, and hence it is not interpreted as a clear signal of shareholder harm from, or disapproval of, the tactic.²³¹ In contrast, the stock price reactions to other defensive tactics, such as poison pills and defensive restructurings, are negative and not subject to a plausible competing information-signalling story.²³²

It is ironic, but not surprising, given the constellation of political interests in which managers are the moving force behind takeover regulation,²³³ that the defensive tactics that are penalized are those that are more likely to benefit shareholders rather than the most oppressive defensive tactics. To repeat a by-now familiar refrain, because the data are consistent with efficiency rather than expropriation explanations, there is no justification for using the tax code to discourage takeovers, unless entrenching incumbent management is a bona fide policy goal. Moreover, if it was desirable to restrict these specific tactics, an excise tax would not be the preferable approach. An excise tax has little practical effect on the use of golden parachutes: boards simply pay the managers' excise tax by grossing-up the amount of the parachute to cover the tax. Nor is an excise tax necessary for eliminating greenmail, because firms can and do adopt charter amendments that prohibit greenmail payments.

228. Jeffrey N. Gordon & Lewis A. Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295 (1986).

229. Clifford G. Holderness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555 (1985); Wayne H. Mikkelson & Richard S. Ruback, *Targeted Repurchases and Common Stock Returns*, 22 RAND J. ECON. 544 (1991).

230. Mikkelson & Ruback, *supra* note 229 (control change in 29% of sample). This is higher than the unconditional probability of a firm's control change, *id.*, but lower than that accompanying other defensive tactics, such as litigation, *see e.g.*, Jarrell, *supra* note 103.

231. Mikkelson & Ruback, *supra* note 229; Shleifer & Vishny, *supra* note 226.

232. *See* Larry Y. Dann & Harry DeAngelo, *Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure*, 20 J. FIN. ECON. 87 (1988); Malatesta & Walking, *supra* note 187; Ryngaert, *supra* note 191.

233. Romano, *supra* note 176; Romano, *supra* note 1.

F. Regulation by Antitrust Enforcement

The Justice Department revised its Merger Guidelines in the early 1980s, making fewer related-firm acquisitions subject to antitrust challenges. The more favorable attitude toward takeovers in antitrust, compared to tax, policy is explained by the policy's source: the Reagan administration could implement the change without congressional participation.²³⁴ The economic literature suggests that the policy shift toward more accommodating antitrust enforcement was beneficial.²³⁵ Conglomerate mergers—which were encouraged by antitrust enforcement in the 1960s-70s—are less profitable than related-firm mergers,²³⁶ and the gains from related-firm acquisitions seem to be derived from operating synergies and cost-cutting rather than increased market power.²³⁷ Efforts to reverse policies that are less hostile to acquisitions are therefore unwarranted.

G. Summary and Conclusion

An informed reading of the economic literature indicates that much of the takeover regulatory apparatus is misconceived and poor public policy. Table 2 summarizes the evaluation of current takeover regulation. Because the overwhelming balance of research views takeovers favorably, the more restrictive of takeovers, the more ill-conceived the regulation. Consistent with this assessment, we find that the more restrictive state laws (business combination, freeze, control share acquisition and disgorgement statutes) have a greater negative stock price effect than the less restrictive ones (fair price statutes).

Policies intended to aid employees or the fisc (regulation introducing non-shareholder interests into the takeover decision and regulation by means of the tax code) simply extract wealth from shareholders and redistribute it to management because there is no evidence that takeovers systematically affect labor or the treasury adversely, while there is evidence of managerial job loss accompanying takeovers. The change in antitrust enforcement policy during the 1980s appears to have been beneficial rather than a wealth transfer from consumers, because the data suggest that the source of the gains in the more profitable

234. I have argued that the Administration was an important reason why, in the midst of anti-takeover sentiment and one-sided lobbying, the federal securities laws were not amended to restrict takeovers in the 1980s. Romano, *supra* note 1, at 489. The difference in attitude between the legislative and executive branches was due to two factors: President Reagan's free market ideology, and institutional features of the presidency that make it less vulnerable to the interest group politics that plague Congress.

235. Bhagat et al., *supra* note 26, at 57; Gregg A. Jarrell, *Financial Innovation and Corporate Mergers*, in *THE MERGER BOOM* 52, 54-55 (Lynn Browne et al. eds., 1987).

236. KAPLAN & WEISBACH, *supra* note 14; Morck et al., *supra* note 13.

237. Bhagat et al., *supra* note 26; Healy et al., *supra* note 17.

related-firm acquisitions, which the new enforcement policy permits, are from operating efficiency improvements and not increased market power.

The most difficult regulation to evaluate is the varied set of rules that have the effect of promoting takeover auctions. Empirical research cannot decisively arbitrate the debate on the efficacy of auctions because a conclusive resolution calls for counterfactual data concerning regulation's impact on the number of takeovers. What little we can glean from the available data suggests a more cautious policy toward auctions is in order. First, there is some evidence that regulation facilitating auctions reduces the frequency of takeovers without significantly increasing premiums. Second, investors perceive such regulation as harmful. Third, bidders have fared poorly since regulation fostering auctions has become common. Finally, auctions may be desirable in selected situations, depending on the auction environment, which can be identified by the explanation for the takeover. Conditional on a bid's occurrence, where a takeover is motivated by synergy gains (independent values situation), rather than agency-cost reduction (common value situation), an auction will be desirable. This strategy may not be optimal unconditionally; the answer pivots on the more general debate on auctions. This uncertainty suggests that a discretionary approach to auctions is best. This is particularly so because the typical auction environment (and hence the appropriate legal response) changes over time. Moreover, since managers' and shareholders' interests are in intense conflict in this context, it is important to fashion legal rules that permit shareholders, and not managers, to control if and when firms hold takeover auctions.

The common theme from examining the numerous takeover regulations is that economic learning and regulatory policy on takeovers have, for the most part, not marched in step. Policy has been founded on unsubstantiated fears and suspicions about the impact of takeovers on third parties, which are raised by managers and their lobbying organizations, who view corporate governance as one more arena for pork barrel politics.

The level of takeover activity has slowed in the 1990s. The collapse of the junk bond market and the corresponding credit crunch, caused by banking and financial services sector weakness and new government policies restricting financial institutions' holdings of high yield debt, surely contributed to the decline in takeovers. To the extent that government policy toward financial market regulation is premised on a negative perception of the economic impact of takeovers, this article suggests that the policy is profoundly misguided. Of course, if the concern is that certain institutions, such as lenders whose deposits the government insures, should not invest in high yield corporate bonds, that is a different question, which is beyond the focus of this article. But the long-term solution to such a concern surely is not the evisceration or destruction of the market for corporate control. Whatever the cause, the current respite from

the frantic pace of dealmaking in the 1980s does offer an opportunity to reflect deliberately on the policy ramifications of takeover regulation, as the more potent political pressures are in abeyance. Hopefully, this will lead to a policy realignment in which the regulatory regime comes to mesh with what we know about takeovers.

Table 2
Evaluation of Takeover Regulation

Form of Regulation	Assessment
<p>1. Regulation Encouraging Auctions (Williams Act; Hart-Scott-Rodino Act; first generation takeover statutes; <i>Revlon</i> fiduciary duties)</p>	<p><i>While empirical research is inconclusive, caution warranted:</i> premiums higher in auctions; takeovers decrease after regulation but in some cases premiums do not increase; negative stock price effect of regulation.</p>
<p>2. Regulation Restricting Two-Tier Bids (Fair-price and other similar second generation statutes)</p>	<p><i>Little impact:</i> insignificant stock price effect of regulation and voluntary counterparts (charter amendments); blended premium in two-tier bids no different from any-or-all bid premiums.</p>
<p>3. Regulation Restricting Bidder Ownership Rights (Business combination freeze, control share acquisition, and disgorgement statutes; Exon-Florio amendment)</p>	<p><i>Unwarranted:</i> more negative stock price effect and steeper decline in takeovers after this regulation than other regulation.</p>
<p>4. Regulation Introducing Non-Shareholder Interests (Other constituency and severance pay statutes)</p>	<p><i>Unwarranted:</i> negative stock price effect; no evidence of other constituents being harmed by takeovers; important social benefits from board considering solely shareholder interests.</p>
<p>5. Regulation through Federal Tax Code (Restrictions on carryover of net operating losses; imposition of corporate level tax on asset basis step-up; excise taxes on greenmail and golden parachutes)</p>	<p><i>Policy issues unrelated to takeovers and excise taxes ill-conceived:</i> no evidence of takeovers being driven by loss carryovers or asset basis step-ups; shareholders may benefit from golden parachutes and greenmail.</p>
<p>6. Regulation through Antitrust Enforcement (Merger guideline revisions relaxing related-firm acquisitions)</p>	<p><i>Beneficial:</i> related acquisitions more profitable than unrelated, but gains appear to be from asset productivity and operating efficiency improvements and not increased market power.</p>