The Case Against Federal Intervention in the Market for Corporate Control

Douglas H. Ginsburg and John F. Robinson

With one notable exception, the United States has traditionally relied on the owners of the business—the shareholders—to decide whether a proposed business combination should take place. The exception is for mergers that are likely to have serious anticompetitive effects, that is, where there is a strong public interest in the outcome because the companies would be able to charge monopolistic prices. Federal law charges two agencies, the Department of Justice and the Federal Trade Commission, with the duty to investigate and prevent combinations that seriously threaten competitive harm. Apart from that narrow exception, which is outside the scope of this article, Congress has consistently sought to be scrupulously neutral, neither encouraging nor discouraging mergers that are not anticompetitive.

Some argue that it is now time for the government to abandon its neutral stance and enter the fray. These critics and the popular press breathlessly report that we are embarked on an era of skyrocketing “merger mania” that will harm the economy if left unchecked. Recent statistics on mergers help put our present situation in perspective. The number of transactions (measured broadly to include divestitures and “going private” transactions) was about 3,000 in 1985, approximately 20–25 percent more than the relatively constant number of transactions each year between 1975 and 1984. The largest number of transactions occurred, however, in 1968: 6,107, or twice the 1985 level. Moreover, during each of the seven years from 1967 to 1973, the level of transactions equaled or exceeded the 1985 level.

The number of transactions is only part of the story, of course. An important change has occurred in the dollar volume of such transactions and, in particular, the number of very large companies that now are being acquired or are going private. The first $1 billion transaction was in 1970; by 1978, only four more deals of that size were completed. In contrast, 18 such deals (three of them over $5 billion) were completed in 1984 and 24 in 1985. Even after adjusting for inflation, the 1985 dollar volume now exceeds the prior peak in 1968 by about 40 percent.

While these statistics may or may not suggest a merger mania, they certainly help explain why the subject is receiving so much attention. It is no longer a simple matter of big companies acquiring small ones. Some of the country’s largest and most familiar companies are being acquired, restructured, or taken private. Large numbers of shareholders and employees are being affected. And the professional managers of the Fortune 500 companies have discovered that the massive size of the companies they manage is no longer a prohibitive barrier to shareholder challenges to their control through a “hostile takeover”—an acquisition that is opposed by the management of the target company.

Although most of the public debate has focused on hostile takeovers of large companies, only five of the twenty-four $1 billion transactions in 1985 arose from hostile takeover attempts. It should not, however, be surprising that hostile takeovers spark the most intense interest; conflict is more dramatic news than concord. Also, managers of large corporations are speaking out against the possibility of challenges to their control now that they find themselves vulnerable to being on the wrong side of a takeover challenge. Indeed, a coalition of corporate executives recently formed “Stakeholders in America” to oppose hostile takeovers. And some managers have resorted to extreme and even destructive tactics in their attempts to fend off such challenges.
Benefits, Costs, and Public Policy

Not even managers who oppose hostile takeovers dispute that mergers in general can and often do benefit the economy. They can directly increase the country’s wealth and productivity. Mergers can result in joint operating efficiencies that enable the same products or services to be delivered at a lower cost. They can make it possible to realize economies of scale or scope, as well as financial economies. They can provide both the acquiring and target companies with resources—capital, management, or technology—that lead to new or better products than either company could have developed independently.

Mergers and takeover attempts, even unsuccessful ones, can also identify undervalued assets, causing them to be more appropriately valued or to be redeployed in a more valuable use—an extremely important function for the economy’s productivity. Acknowledging such a role for takeovers does not imply that the managers of companies that are takeover targets are either lazy or stupid. The available evidence indicates they are not. It merely requires one to believe that they are not perfect and that it is possible for someone else to make a company’s assets still more valuable to shareholders, even if the company has been a strong performer in its industry. Disagreement over this point is at the root of the debate over whether hostile takeovers are good for the economy or not.

Hostile takeovers perform another very important function for the economy, one that is different from the friendly merger. They provide an antidote to the “agency problem” that is associated with widely held public corporations. The agency problem stems from the sometimes significant divergence of interests between the owners—that is, the shareholders—and the managers who, as the owners’ agents, run the corporation. Because the shareholders find it difficult and costly to act in concert, and the managers are able to use the resources of the corporation to defend their position, it can be prohibitively expensive and time consuming for shareholders to replace their management by use of the proxy machinery.

The hostile takeover attempt can be the only effective way for the shareholders to overcome the agency problem and receive full value for their ownership of the corporation. It is also often the most efficient way in which a competing management team can “go over the heads” of incumbent managers and make its case directly to the shareholders. More important, while an actual takeover provides such a remedy, even the threat of a hostile takeover attempt can be an effective incentive for incumbent managers to review their operations continually and to make sure they are getting the most value out of the assets they are charged with managing.

Notwithstanding the good for the economy that can come from mergers—hostile and friendly—a merger can also destroy wealth by moving assets to less efficient hands. We saw examples of such errors during the conglomerate building era of the late 1960s and early 1970s. We are witnessing the fallout from that period

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in the divestiture programs that many companies have now begun in order to focus their energies and resources on the businesses they know best. Indeed, about one-third of today's corporate acquisitions involve a seller divesting a firm acquired at an earlier time. But these examples simply illustrate the fact that sometimes business people err, which is neither surprising nor avoidable.

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Because many mergers and acquisitions may not deliver the efficiency-enhancing gains that were originally expected by the parties involved—indeed some have resulted in significant losses—some have suggested that the federal government should step in to discourage takeovers that appear to be nonproductive. Most such critics would have the government intervene only in cases where they see harm—for example, hostile takeovers and the use of high yield securities are two favorite targets. It is not possible to say, however, that all, or even most, transactions of a particular type are harmful, especially since the mere possibility of a hostile takeover has a salutary competitive effect of unknowable significance.

The key question, then, is whether the government or some governmentally appointed agent of the public interest can distinguish, in advance, between individual transactions that will be good and those that will be bad for the economy. Can the government determine whether a merger will work out in the efficient and profitable way that the parties are betting it will? We think it is clear that the government is incapable of making that judgment.

It is important to keep the nature of these transactions in mind. They are capital investment decisions, similar to other business decisions, such as new product development or new plant construction, except that the stakes are often larger. Sometimes the decision turns out very right, sometimes very wrong, and sometimes in between.

Government decision-makers, who do not have their own money at stake, are sure to be less accurate than the parties themselves in evaluating the business prospects of a merger. Government agents are also necessarily less familiar than the parties with the business and the particular companies. Nor does the government have any better access to aggregate data or confidential information that would alter the parties' evaluation of the transaction if only they were aware of it.

If there is no decision rule that can be devised in advance and no public authority that can be set up to evaluate individual mergers correctly, the next question is whether mergers or hostile takeovers are, on average, good or bad for the economy. Unless it is clear that they are bad for the economy, we should not discourage them. Three types of empirical data shed some light on this question. No one of them is flawless, but some of the studies are far more rigorous and persuasive than others.

The primary data on the effects of these transactions come from "event studies," conducted by financial economists who track the behavior of stock prices before and after tender offers. The second type consists of accounting studies, which focus on the profitability of firms engaged in merger transactions. The third type of information is the anecdotal experience of critics of hostile takeovers, principally corporate managers.

Evaluating the Data

The best information comes from the stock market's reaction to events during takeovers. The data are timely, forward-looking, comprehensive, and avoid problems associated with accounting conventions. The studies of stock prices reveal the consensus of all the participants in the market as to the expected value of the takeover proposal to shareholders of both the acquiring and acquired companies.

This evidence is unambiguous. In successful tender offer acquisitions, shareholders of the target company typically gain a premium of at least 30 percent over the pre-offer market price. That these shareholders always gain is to be expected, of course—otherwise they would have no reason to accept the tender offer. More significant, therefore, is that companies that make tender offers experience increases in their share values of about 3 percent.1 Because these companies are usually larger than the companies they acquire, however, the actual gain on their investment in the takeover is closer to 9 percent (above their average return before the takeover). Clearly the judgment of the market is that, on average, takeovers are likely to increase the value of both companies.

These event studies have been criticized by those who believe that the stock market is an unreliable indicator of value. Both sides of the debate


2It is worth noting that, in making this judgment, the market takes into account the transaction costs to both sides—lawyers, investment bankers, management distraction, etc. All of the costs are borne by the parties, and there are few negative externalities, so the market's private judgment is based on the same considerations as a more global social welfare judgment and is a good proxy for the "public interest" as it is affected by the takeover. The two factors that the market may not consider are: (1) the interests of adversely affected employees, including, most often, incumbent managers in hostile deals; and (2) tax consequences that the Treasury will absorb. While it has often been argued that the tax system favors acquisitions, that proposition has recently come under attack on both theoretical and empirical grounds (see Ronald J. Gilson, Myron S. Scholes, and Mark A. Wolfson, "Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-motivated Acquisitions" [working paper no. 24, Law and Economics Program, Stanford University, January 1986] for the theoretical argument and Alan J. Auerbach and David Reishus, "Taxes and the Merger Decision," National Bureau of Economic Research, Inc., [working paper no. 1855, March 1986], for the empirical side.

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generally agree that hostile takeover attempts occur because the target company's stock price is "undervalued." But they disagree sharply over why it is possible for an acquiring company to offer a significant premium and yet make a profit on the investment.

Until recently, this debate had reached what seemed to be an ideological impasse. Those who believe that the stock market is a reasonably unbiased (albeit imperfect) indicator of a company's prospects at any given time argue that a company is undervalued because either the existing management is not making the best use of the firm's assets or the bidder brings new value-creating ideas or resources to bear on those assets.

Takeover critics, on the other hand, argue that the stock market systematically undervalues takeover targets because the market is increasingly dominated by institutional investors whose own performance is measured on a quarterly basis and who therefore base their analyses of corporate performance largely on short-term earnings. These critics argue that, notwithstanding the wealth increases resulting from takeover transactions, the market's

effects should not be used to determine the government's policy towards takeover and merger activity.

This "myopic market hypothesis" appears to be false based upon even cursory observation of stock price behavior. First, if it were true, any new venture, especially one with no earnings history, would be unable to raise capital in the public equity markets. They do, of course, and the allegedly short-sighted institutional investors are among the principal purchasers of such offerings. Second, if the market were myopic, different companies in the same industry would not sell at different multiples of their current (or predicted near term) earnings. Unless the market is totally irrational, investors must believe that the long-term prospects of such companies differ significantly.

More important, however, three empirical studies that test the short-term hypothesis have recently been completed. First, the Office of the Chief Economist at the Securities and Exchange Commission (SEC) compared the amount of institutional ownership of, and research and development expenditures by, companies representing a cross-section of American industry with companies that were targets of tender offers between 1980 and 1983. The SEC staff discovered, contrary to the short-term hypothesis, that: (1) institutional investors not only do not shun corporations making above average research and development investments, they actually seem to prefer them; (2) takeover targets invested substantially less than the industry average in research and development during the years preceding the tender offer; (3) the percentage of institutional ownership of target companies was three-fifths of the percentage of institutional ownership of nontarget companies; and (4) the capital markets positively value companies that announce they are embarking on a research and development project. The staff concluded that its empirical findings appear to refute the short-term hypothesis.

Two other studies have been completed more recently by John Pound for the Investor Responsibility Research Center (IRRC). One study (using 1981-84 data) tested the hypothesis that the increasing presence of institutional investors causes systematic undervaluation of takeover targets. It examined levels of institutional ownership, size of takeover premiums, and the success of management resistance. The findings are generally consistent with the SEC staff study in refuting the alleged adverse effects of institutional investors: (1) institutional ownership is lower for takeover targets than nontargets; (2) the level of premium paid in takeovers is unrelated to the extent of institutional ownership; and (3) the level of institutional ownership appears to have no bearing on the ability of managements to resist unwanted takeovers successfully.

The second Pound/IRRC study was designed to test the causes of the undervaluation in target companies' stock. Although this study uses accounting data (for the years 1978-84), and is thus subject to the usual criticisms of such data, it reaches much the same conclusion as the SEC staff study: there is no evidence to support the hypothesis that takeover targets have "hidden" resources that are masked by short-term earnings reports, nor is there evidence that takeover targets invest more heavily in long-term activities and are, therefore, systematically undervalued by a stock market focused on the short run. In fact, this study, like the SEC study, finds evidence that takeover targets invest less in long-term activities than nontarget firms.

Some takeover critics have argued that companies maintaining conservative debt levels are especially vulnerable to hostile takeovers and that such takeovers should be curtailed because they often lead to "overleveraged" companies. The second Pound/IRRC study also tested whether takeover targets are systematically undervalued because they have less debt on their balance sheets and are thus being penalized by the market for their "short-term focus" is harmful to the economy's long-run productivity because it systematically undervalues corporations that engage in long-term planning and investments and thereby causes managers to underinvest in long-term projects. Therefore, these critics contend, stock price

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more cautious management. Pound discovered, however, that there is no significant difference in leverage among the control group of corporations, those involved in friendly mergers, and those taken over in hostile transactions. Indeed, targets of hostile takeover attempts were slightly more leveraged than nontargets. Remarkably, however, those companies that had successfully resisted takeovers had substantially greater leverage— before the takeover attempt—than all three of the other groups.

These three recent studies refute the hypothesis that there is a systematic flaw in the stock market valuation of takeover targets. The myopic market hypothesis is not supported in fact any more than it is in economic theory. It offers no valid reason to conclude that the wealth created by takeovers is somehow contrary to our national interest.

The only other significant empirical research that attempts to determine whether mergers or takeovers are, in the aggregate, good or bad relies on analyses of accounting data. The work of Professor F. M. Scherer of Swarthmore College and David Ravenscraft of the Federal Trade Commission Bureau of Economics is among the most recent and interesting of these efforts. Using line-of-business accounting profitability data between 1974 and 1977, they have compared lines of business that experienced substantial merger activity between 1950 and 1977 with lines that did not experience such activity. They conclude that, although profitability may be slightly higher (for mergers between "equals" and those using "pooling of interests" accounting) or slightly lower (for mergers using "purchase" accounting) in lines of business that have sustained substantial merger activity, when the premium paid to effect the merger is counted, the net effect is negative.

Accounting studies, however, particularly those that attempt to measure profitability, suffer from serious methodological problems that limit their relevance for policy purposes. For example, they do not take into account the real market values of acquired assets—only the accounting valuations, which may significantly misstate their value. Moreover, unlike the studies based on stock price data, accounting studies have not yielded consistent significant results. As a result, the interpretation and value of these studies is highly uncertain.

The third category of evidence on the question whether mergers and takeovers are good or bad is the experiential and anecdotal information offered by some corporate managers and some of their investment bankers and lawyers. Notwithstanding their obvious self-interest, these people should at least be heard—they are on the industrial frontlines making the economy work, and they may know intuitively what investors, or even economists, have not yet discovered. In general, the managers object to being forced (in their view) to "waste" valuable management time and resources worrying about and defending against the possibility that someone may be able to take control of "their" business because an irrational, capricious, or shortsighted stock market has undervalued it. Institutional investors have been the prime villains, to hear these managers, although the recent empirical research by the SEC staff and Investor Responsibility Research Center should put an end to that particular bit of finger-pointing.

The ultimate object is to squeeze the most output from all available resources. Erecting barriers to takeovers on the premise that creating new assets is always "better" would be a grave error. No public interest is served when someone creates new assets at a greater cost than would be required to use existing assets. Indeed, even if the capital market's undervaluation of existing assets were irrational (and the evidence indicates it is not), economic productivity is greatest when assets flow into the hands of those who value them most. This is the best assurance that they will be put to their most productive use.

Curbs on Defensive Tactics

The only area associated with corporate takeovers that is cause for some concern is the occasional use by target company managers of defensive tactics that are not in their own shareholders' interest. The agency problem between shareholders and managers of widely held public corporations enables some managers to preserve their control, and thus their employment, at the expense of their principals. State corporation laws, which govern the relationship between shareholders and their hired managers, continue to evolve, however, in order to deal with such problems as they arise. Moreover, shareholders can protect themselves through corporate charter amendments and the contractual arrangements they enter into with their managers. Indeed, state corporation laws have accommodated rapid innovation in the last several years in order to adapt to newly possible hostile takeovers.

While we may not agree with all of these state law developments—or every decision of the courts or of shareholder votes under them—we should be extremely reluctant to displace them with federal laws. We should
prefer to solve these problems at a level closer to the problem and to the facts, preferably at the shareholder level. A federal statutory rule would be both overbroad (prohibiting activities it should allow) and underinclusive (missing some abuses, as they will continue to evolve). Unless there is convincing evidence of a serious problem of national dimension, the diversity of state law is preferable to a single federal law because it provides a laboratory for a variety of approaches and minimizes the cost of error. We have seen no such evidence of a serious problem, however.

There is also evidence that the courts are devising a more probing approach than in the past, when their unquestioning deference to managements under the "business judgment rule" appeared to give managers completely free rein to defeat unwanted tender offers. It would be entirely premature to conclude at this point that there has been a breakdown that warrants federal intervention into corporation law.

**Conclusion**

From the available evidence, we conclude that the market for corporate control works well. There is no market failure that should cause the government to intervene. Both economic theory and the great weight of the available evidence clearly point to a net benefit to the economy from takeover activity. While there certainly are mergers and takeovers that individually may reduce wealth rather than create it, the government is less capable of distinguishing between these two types of cases than are the private parties, who have better information and a substantial financial incentive to be right in making these judgments.