Hostile takeovers and the market for corporate control

Do hostile takeovers create new wealth? Or, do they simply move wealth from Column A to Column B, enriching some at the expense of others? The evidence is mixed

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"In recent years, the tender offer takeover has been praised and damned with a ferocity suggesting that the survival of capitalism is at stake. The truth, as in most disputes with substantial metaphysical content, is more prosaic." F. M. Scherer, *Journal of Economic Perspectives*, Winter 1988, pg. 69.

The market for corporate control—firms competing for the rights to manage their corporate resources—has become an increasingly important element of the corporate landscape. Mergers and acquisitions have increased every year since 1982, reaching an all time high of 3,336 net announced transactions in 1986. (See Table 1.)

Although contested tender offers— hostile takeovers—only account for a small fraction of all merger and acquisition activity, they involve large publicly traded companies with substantial market values across many industries. The $12.8 billion aggregate dollar value of 15 successful hostile takeovers in 1987 accounted for 7.7 percent of the total dollar value of the 972 mergers and acquisitions for which such data were disclosed. Moreover, the number of unfriendly takeovers was higher in each of the past three years than in any of the previous eleven years.[1]

Hostile takeover activity has a substantial impact on corporate behavior. Indeed, organizations involved incur substantial costs and devote much time to developing defensive or offensive strategies. Such battles may also impose large costs on shareholders, creditors, management, employees, customers, and communities. These private and social costs of takeovers have recently spurred significant legislative interest in hostile takeovers and defensive tactics.[2]

This paper discusses the corporate control market by focusing on hostile takeovers as a mechanism for corporate control. It discusses the causes of hostile takeovers and the methods of defensive action by hostile takeover targets. It then analyzes their effects not only on the bidder and target shareholders but also on other stakeholders (e.g., management and employees). A final section reviews the evidence on the sources of takeover gains. Are such gains redistributions of wealth to one group at the expense of another or are they derived from improved efficiency? Finally, what does this evidence imply about the effect of hostile takeovers on social welfare?

Hostile takeovers: Why do they occur?

Hostile takeovers, those opposed by the target's board of directors, became an "accepted" part of the corporate control market in 1974 with Morgan Stanley and Company's representation of International Nickel Company of Canada in its hostile takeover of ESB, Inc. In a hostile takeover, a bid is made directly to the shareholders of the target rather than to the target's management. The acquirer obtains the needed

TABLE 1

Merger and acquisition statistics[1]

Year	Total mergers & acquisitions	Total tender offers		Contested tender offers: Total contested		Successful offers[2]		Target remained independent		Acquired by white knight	
		#	% of col. 2	#	% of col. 3	#	% of col. 4	#	% of col. 4	#	% of col. 4
1978	2,106	90	4.3%	27	30%	13	48%	8	30%	6	22%
1979	2,128	106	5.0%	26	25%	8	31%	9	35%	9	34%
1980	1,889	53	2.8%	12	23%	3	25%	3	25%	6	50%
1981	2,395	75	3.1%	28	37%	13	46%	6	21%	9	33%
1982	2,346	68	2.9%	29	43%	17	59%	10	34%	2	7%
1983	2,533	37	1.4%	11	30%	7	64%	1	9%	3	27%
1984	2,543	79	3.1%	18	23%	10	56%	6	33%	2	11%
1985	3,001	84	2.8%	32	38%	14	44%	9	28%	9	28%
1986	3,336	150	4.5%	40	27%	15	38%	10	25%	15	37%
1987	2,032	116	5.7%	31	27%	18	58%	6	19%	7	23%
Ten year total	24,309	858	3.5%	254	30%	118	46%	68	27%	68	27%

[1]Data refer to net announcements (completed or pending transactions) or publicly announced formal transfers of ownership of at least ten percent of a company's assets or equity where the purchase price is greater than or equal to $500,000 and one of the parties is a U.S. company. Tender offer data refer to tender offers for publicly traded companies. Successful offers refer to both fully and partially successful deals.

[2]Offers still pending as of year-end are also included in these totals.

SOURCE: W.T. Grimm, *Mergerstat Review*, selected years.

votes, gains control, and replaces existing management. But what factors need be present in the target and the bidder firms for hostile takeovers to occur?

Conflicts of interest between the target firm's management and shareholders lie at the root of the hostile takeover phenomenon. These conflicts result from the separation of ownership (shareholders) from control (management). Conflicts arise from management's desire to use the firm's resources to achieve outcomes that do not coincide with shareholders' interest, which is maximizing the net present value of the firm's future profits.

Economists term the lost profits arising from the separation of ownership and control, agency costs. Internal controls are generally sufficient to hold down these agency costs. But when agency costs become too high and internal controls, particularly the board of directors, have failed to protect the interests of shareholders from inefficient performance and non value-maximizing behavior of management, the firm is likely to become the target of a hostile takeover bid.[3]

Several factors can influence the level of agency costs. Often factors such as deregulation and increased competition create a need for valuation and restructuring of corporate assets in an effort to continue to maximize shareholder value. But sometimes current management fails to undertake the necessary steps to do so. New management without prior ties to employees or the community may be more objective and better able to adapt the firm's productive assets to its changing environment. Hostile takeovers are one way of effecting the necessary changes.[1]

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Firms that are undervalued by the market, that is, there is a mismatch between realizable asset value and stock price, for whatever reason, are prime takeover targets. It is often argued that firms with managements that concentrate on long-term investments (e.g., research and development) at the expense of short-term earnings are susceptible takeover targets. The premise to this explanation of hostile takeovers is that markets are short-sighted and poor current profits lead to stock undervaluations which create favorable takeover conditions. Agency costs arise here as the market puts more emphasis on current cash flows and management places greater weight on future cash flows. However, evidence does not support this "myopic market" hypothesis.[5]

Significant amounts of free cash flow also contribute to agency costs. Free cash flow is that cash flow in excess of the amount required to fund all projects that have a positive net present value when discounted at the relevant cost of capital. With high levels of free cash flow, managers may seek to secure their own position by making inefficient low-return investments rather than paying out the free cash flow to shareholders in the form of dividends.[6] Yet, it may be difficult to distinguish this behavior from prudent investing that turns out to be less profitable than expected.

Agency costs may also explain why some companies choose to initiate hostile takeovers. Companies with significant free cash flow and unused borrowing power may engage in unwarranted acquisition activity—paying significant premiums for targets to fulfill objectives other than value maximization. Acquisitions aimed at diversification, geographic expansion, or increased firm size may be pursued in order to further management's goals of self-entrenchment or "empire-building" rather than enrich shareholders. Thus, unwarranted acquisition activity not only explains why firms may become targets, but is also one explanation of bidder behavior in takeovers. This may also explain instances of negative returns to shareholders of acquiring firms—management benefits at the expense of shareholders.

Firms initiating hostile takeovers may also be victims of hubris. This "winner's curse" hypothesis asserts that takeovers may be motivated by the bidder's overestimation of the value of the target firm, when there may not be any true gains to be had.[7]

Defensive tactics—the target's response

Whatever the cause of the hostile takeover attempt, a target or potential target must respond. Data in Table 1 indicate that only 25 percent of all targets are successful in remaining independent. Another 25 percent are saved from the hands of the hostile bidder but are acquired under friendly terms by a "white knight." The remaining 50 percent ultimately fall prey to the hostile acquirer.

Despite the fact that few targets are successful at fending off hostile suitors, there are several defensive measures available to boards, managements, and shareholders to assist them in their efforts to maintain an independent organization or current management.

The best defense

It is often said that the best defense is a strong offense. In the case of hostile takeovers a firm's best defense is the restoration of a closer relationship between asset values and share price. Thus, increased returns to shareholders or increased price/earnings ratios may be the most effective and direct "defensive" measure for an organization. Indeed, taking actions to increase the firm's value (e.g., selling underperforming units) before someone else takes over and does so may also achieve the results of increased stock prices and possible shareholder gains.

An evaluation of the firm's business strategies, ownership composition, and capital structure is a prerequisite to achieving these goals. Internal restructurings have a dual benefit of improving shareholder value through a more efficient allocation of resources and reducing the need to rely on other more costly takeover defenses.

Employee stock ownership plans (ESOPs) and leveraged recapitalizations or leveraged cash-outs (LCOs), are among the commonly used methods of restructuring a firm's capital and equity position and subsequently building its takeover defenses.[8] Both of these methods have a positive impact on shareholder wealth through an

improved alignment of shareholder and management interests and shareholder tax benefits.

ESOPs change the equity structure toward a greater proportional ownership by employees. Also, ESOPs may improve takeover defenses because the trustees of the voting stock of the ESOP are often controlled by management. LCOs, which require shareholder approval, increase firm leverage and management's proportional ownership. Efficiency and performance should improve under incumbent management as commitments to debt repayment reduce management's discretionary use of free cash flow. Hence, the agency costs of management/shareholder conflicts decline because default on debt service would have substantial negative financial impacts on management. In addition to increasing capital market scrutiny of the firm, the increased leverage also decreases the opportunity for a bidder to borrow against the assets of the firm to finance its acquisition.

Although size alone was once thought to be an effective takeover deterrent, it has become increasingly evident that it is no longer a reliable defense. Small firms may obtain acquisition resources for larger firms by issuing claims on the value of the target firm's assets, as with any other corporate investment. The ability to do this has been facilitated by the increase in financial market liquidity, particularly with increased acceptance of, and usage of, junk bonds.[9]

Antitakeover amendments

Despite an excellent offense, protection from hostile takeovers may still be difficult without some other line of defense. There are numerous defensive mechanisms or "shark repellents" available through corporate bylaws and charter amendments. Not all of these provisions require shareholder approval. (See Box.)

Yet, as defensive tactics develop, so too do methods to render them ineffective. As a result, antitakeover amendments do not generally halt takeovers, rather they make them more difficult, more costly, more time consuming, and may also be harmful to shareholders. Basically, these defensive tactics impose conditions that must be met before control can be changed, whether by tender offer, merger, or replacement of the board. For example, shareholder rights plans dilute the equity holdings of the bidder and fair price amendments increase the cost of acquisition.

A study of hostile takeover attempts in 1985 indicates that the most often used defensive measures of targets in those cases were acquisition by a white knight, recapitalization such as a stock buy-back, and litigation.[10] As noted earlier, leverage-increasing transactions such as recapitalizations can diminish the attractiveness of the target by decreasing the ability of the acquirer to borrow against the assets of the target to finance the acquisition. LCOs also enhance takeover defenses by reducing the agency costs created when high levels of free cash flow are available. Litigation serves as a defense by increasing the costs and uncertainty of takeover and thus deterring bidders.

The ability of a firm to defend itself is also affected by its state of incorporation. The powers of firms, shareholders, and managers are controlled by state statutes that define and regulate corporations. (See Table 2.) The constitutionality of state restrictions on takeovers was supported by an April 1987 Supreme Court ruling.[11]

Also affecting the battle lines between bidders and targets are administrative and regulatory requirements. Tender offer disclosure, delay rules, and regulatory approval periods slow the acquisition process. This usually gives targets additional time to build defenses and often leads to increases in multiple and preemptive bidding and auction contests, all of which tend to decrease bidder returns by increasing target premiums.[12]

The impact of antitakeover amendments

Several researchers have studied the impact of antitakeover amendments on targets' shareholders. Those amendments adopted by management without shareholder approval are in most cases found to be detrimental to shareholders. Although amendments requiring shareholder approval should be less likely to harm share-

TABLE 2

Provisions of state corporation laws in the Seventh District

State	Effective date	Statute	Code
Illinois	1985	Fair price amendment Nonmonetary factors	Ill. Rev. Stat. Chpt. 32, 7.85 & 8.85
Indiana	1986	Control share acquisitions Business combination	Ind. Code Ann. 23-1-43-(1-24)
Iowa	None	None	None
Michigan	1984	Fair price amendment	Mich. Comp. Laws Ann. 450.1775-1784
Wisconsin	1986 1987	Fair price amendment Anti-greenmail Business combination (sunset provision effective 9/10/91)	Wis. Stat. Ann. 180.725 & 180.726

Other states with the same provisions[1]

Fair price amendment: CT, FL, GA, KY, LA, MD, MS, NC, PA, VA, and WA

Business combination: AZ, DE, KY, MN MO, NJ, NY, and WA

Control share acquisitions: AZ, FL, HI, LA, MA, MN, MO, NV, NC, OH, OK, OR, and UT

Nonmonetary factors: AZ, ME, MN, and PA

Anti-greenmail: AZ, MN, and NY

[1]The specific characteristics of these provisions may vary across different states.

SOURCE: *State Takeover Statutes and Poison Pills,* Robert H. Winter, Robert D. Rosenbaum, Mark H. Stumpf, and L. Stevenson Parker, Vol. 3 of *Shark Repellents and Golden Parachutes: A Handbook for the Practitioner.*

holders, about half of them have also been found to result in significant negative abnormal returns to target shareholders. (See Box.)

Among the most common defensive devices that require shareholder approval are fair price amendments, which have been found to have no significant effects on shareholders, and classified boards and supermajority clauses, both of which have been found to have significant negative impacts on shareholder wealth. The poison pill, which does not require shareholder approval, has proven to be an effective and popular, yet controversial, defensive measure. However, its adoption has been shown to have significant adverse effects on shareholders.[13]

Why do shareholders approve amendments that may decrease shareholder wealth? Proponents of antitakeover amendments argue that such amendments are in the shareholders' interest by giving boards the power to ensure that the shareholder receives a fair price reflecting their maximum possible share of expected acquisition gains. Management, by acting as a negotiating agent for diffuse shareholder interests, is better able to hold out for the best price by reducing individual incentives to tender at too low a price. Of course, the composition of ownership will also affect the dispersion of shareholder interests. The greater the proportion of insider (management) stockholders, the more likely antitakeover amendments will be in the shareholders' interest.

According to this shareholder interest hypothesis, antitakeover amendments are a negotiating tool rather than a takeover deterrent. This argument seems to rest on the assumption that antitakeover amendments are ineffective at ultimately deterring take-

elect directors even if the majority opposes because each shareholder is entitled to cast a number of votes equal to the number of shares owned multiplied by the number of directors to be elected—thus one could accumulate votes for a particular director or group of directors.)

■ ***Staggered directors or classified board:*** directors are broken into classes (usually three groups) with only one class being elected each year; works best with limit on number of board members; makes it difficult for a substantial shareholder to change all of the board at once without approval or cooperation of the existing board, but also makes any change of directors more difficult; also lowers the effectiveness of cumulative voting; has impact of significant negative abnormal returns.

■ ***Supermajority clause:*** increases the number of votes of outstanding common stock needed to approve changes in control to two-thirds or nine-tenths from a majority of one-half (director must also be removed for cause); found to have significant negative stock-price effects around their introduction and on average they appear to reduce shareholder wealth; important to have an escape clause (provision allowing for simple majority vote) so that friendly offers are not also foreclosed; almost always combined with a lock-in provision.

■ ***Lock-in provision:*** prevents circumvention of antitakeover provisions; most common provision requires a supermajority vote to change antitakeover amendments or limits the number of directors; has impact of a significant negative abnormal return.

(Shareholder approval not required)

Negative impact on target shareholder wealth

■ ***Litigation by target management:*** a win by target may harm shareholders in that chances of acquisition may be lost or lowered—this may be reflected by a fall in share price, whereas the acquisition is likely to have increased share prices (examples: charges of securities fraud, antitrust violations, or violations of state or federal tender offer rules); delays control fight, yet also gives management time to find a friendlier deal.

■ ***Shareholder rights plans or poison pills:*** do not require majority voting approval by shareholders; are triggered by an event such as a tender offer, or by the accumulation of a certain percentage of target's stock by a single stockholder; trigger allows target shareholders with rights to purchase additional shares or to sell shares to the target at very attractive prices; can be cheaply and quickly altered by target management yet makes hostile takeovers very expensive by diluting the equity holdings of the bidder, revoking his voting rights or forcing him to assume unwanted financial obligations; different types include: flip-over, flip-in, back-end, and voting plans; generally harmful to stock values; judicial approval of certain types of plans (e.g., flip-in and back-end) is still not clear.

■ ***Target block stock repurchases or greenmail:*** target repurchases, at a premium, the hostile bidders block of target's stock; often results in substantial fall in stock returns for the target or reduced shareholder value from foregone takeover potential as opposed to normally positive stock price effects of a repurchase of stock by a nontargeted firm; yet evidence indicates that a net positive stock price may result from the initial hostile bidder purchase (positive impact) to the target repurchase (negative effect); benefits returns for bidder firm shareholders; practice is controversial and has been challenged in federal courts, congressional testimony, and SEC hearings.

*For empirical evidence of the effects of defensive tactics and the market for corporate control see footnote 14 of the text.

companies between 1981 and 1986 to be 47.8 percent, or an estimated dollar value of $134.4 billion. Additionally, the average premium on all mergers and acquisitions in 1987 was 38.3 percent whereas the average for hostile takeovers that year was 42.7 percent.[19]

Bidder shareholders may gain or lose

For the acquiring firm, the results from the same studies are not so unequivocal. They indicate that on average there is no significant short-period effect, positive or negative, on shareholder returns, and, if anything, there is at best a slight positive impact on the acquirer's share value.[20] Evidence from longer-period event studies (one to three years) suggests that increases in target stock prices during takeovers overestimate the post-merger increase in firm value. Despite this overvaluation, recent research concludes that the average successful tender offer results in a statistically significant positive revaluation of the combined firm. Such increases have been fairly consistent over time. However, bidder gains have been diminishing over the last two decades while target returns have increased.[21] Thus, it appears that on average takeovers and mergers enhance shareholder value.

While it is concluded that mergers and acquisitions enhance shareholder value, this conclusion does not imply that such value is derived entirely, or at all, from increased efficiency (e.g., resource reallocation, removal of inefficient management, or economies of scale or scope).

Sources of gain: Improved efficiency or wealth redistribution

Although easily measured, shareholder gains do not provide an accurate measure of welfare gains. If takeover gains are a result of wealth transfers, then the increase in share prices overstates the efficiency gains of takeover. Shareholder gains must be weighed against the losses of other stakeholders such as management and employees.

As opponents of hostile takeovers argue, takeover gains result primarily from wealth redistributions: one stakeholder's gain—the target shareholder—is at the expense of another's economic loss—such as the target employee or bondholder. In the extreme, such takeovers are merely costly and disruptive restructurings of corporations that provide no social benefits. Preventing such takeovers would, it is argued, improve economic welfare.

Proponents argue that takeovers provide net gains to society by reducing the agency costs related to management/shareholder conflicts, which, in turn, improves resource allocation and efficiency and encourages value-maximizing behavior. Thus, attempts to prevent a free corporate control market would have negative effects.

Overall, research is not conclusive on the sources of takeover gain and indicates that gains from redistribution as well as increased efficiency may be occurring. The sources of gain vary from deal to deal, from industry to industry, and from year to year. Studies have addressed the wealth transfers to target shareholders from target bondholders, government, and target labor.

One version of the redistribution theory asserts that the gain of one class of security holders comes at the expense of another. For example, bondholder values may decline as common shareholder values increase. This example may be more relevant to highly leveraged transactions in which corporate bond prices may fall and yields rise as increased leverage contributes to uncertainty about the acquirer's ability to service its debt. Despite some recent examples of such behavior related to leveraged buy-outs, studies of both mergers and leveraged buy-outs have failed to find consistent support for this theory.[22] Moreover, when such redistributions have occurred, the increase in shareholder value often more than offsets the fall in bond values. Thus, takeovers appear to result in net gains to investors as a group. In general, target shareholders' gains do not occur at the expense of either bidder shareholders or other classes of target or bidder investors.

The increase in shareholder value resulting from hostile takeovers could also be a redistribution from the government to shareholders. Hostile takeovers may generate tax savings without any underlying efficiency gains. Thus, government becomes

another stakeholder in the takeover battle. But the evidence indicates that tax benefits have been only a minor force behind takeovers.[23]

Another form of redistribution espoused recently is that shareholder gains come at the expense of labor through long-term labor contract concessions which reduce employment or wages. Evidence from small firm acquisitions (not hostile takeovers) does not support assertions that acquisitions have an overall negative effect on labor in terms of lower employment and wages.[24] However, hostile takeovers usually involve large organizations and create a fear that both explicit and implicit commitments by target management to labor will be broken following the takeover. A notable example is Carl Icahn's hostile purchase of TWA which resulted in improved management and shareholder premiums worth $300 to $400 million, but also resulted in wealth transfers to Icahn from three labor unions which one researcher valued at $600 million or one and a half times the takeover premium.[25] In this case, it would appear that shareholders gained principally at the expense of labor. The unanswered question is whether such labor concessions are simply wealth transfers or actually enhance efficiency.

Labor-related inefficiencies may result from the inability of management to respond appropriately to factors, such as technological developments, which decrease the demand for labor, or result from failure to deal successfully with a labor force that wields market power. In either case, these inefficiencies create conditions ripe for hostile takeovers, which in turn become the mechanism by which efficiency is enhanced. This does not mean that labor will always be a casualty in a hostile takeover battle. Takeover activity, and hence the fear of takeover, may be favorable to labor in that efficiency gains at potential target companies can lead to job preservation and greater long-run growth and employment.

Economic efficiency theories argue that net gains may occur from increases in economic efficiency achieved through major restructurings and better management of corporate assets. Takeovers can reduce agency costs and result in more efficient capital investments by subjecting the firm to the scrutiny of the capital markets and by reducing resources under management control. Benefits accrue when target shareholder wealth that had been appropriated to target management, employees, suppliers, or customers under non value-maximizing behavior is reallocated to target shareholders and the acquirer upon acquisition.

Business line financial data has been used to test the efficiency enhancement theory of takeovers by analyzing the *ex post* financial performance of acquiring firms. Two implications of the theory that takeovers increase efficiency due to improved management have been tested. First, the target's pre-takeover profits should be less than its industry peers', and second, *ceteris paribus*, post-takeover profitability should be relatively higher than pre-takeover profitability.

Examining these hypotheses, Scherer found that targets were slight underperformers relative to their industry norm, but that "operating performance neither improved nor deteriorated significantly following takeover," and "there is no indication that on average the acquirers raised their targets' operating profitability net of merger-related accounting adjustments."[26]

Generally, studies using accounting data to analyze post-takeover performance do not clearly support the economic efficiency theory of takeover gains. Unless this inconclusiveness can be attributed to measurement problems associated with the use of accounting data or the lack of coordination in the use of market and accounting data in analyzing shareholder gains and the sources of those gains, one must question whether there are any true wealth gains derived from the supposed improved management and efficiency subsequent to takeover.

While operational efficiencies may be elusive, it appears that financial market inefficiencies do create opportunities for takeover gains. If takeovers lead to the revaluation of undervalued firms, the cost of raising additional capital will be lower and more investment will take place. Several studies have tested the market undervaluation hypothesis. Evidence on it is mixed.

Empirical evidence using stock price data do not generally support the theory that target firms are victims of undervaluation. Stock prices of targets successful at fending off hostile bidders decline to approximately pre-bid levels. That is, the tender offer process does not reveal to the market significant new information about the intrinsic value of the target such that substantial price adjustments (increases) occur due to prior undervaluations of the target by the market. It is not merely the information generated from putting a firm into play, but the actual acquisition and expected gains that result in positive stock returns.[27]

However, an analysis of market valuation of large, multidivisional targets using business line financial data as well as market data provide somewhat different results. If the sum of the liquidation or replacement value of the firm's parts is greater than the market value of the firm as a whole then it is undervalued by the market. It is argued that this provides incentive for takeover by creating opportunities to improve performance and add value by divesting the target of certain units whose assets are more productively managed elsewhere. This has been the strategy in the recent takeovers of many conglomerates formed by previous diversification acquisitions.

Recent research suggests "that there is some undervaluation in the market as a whole, which can probably be attributed to underpricing of both multi-industry companies and small companies." Further, this undervaluation is proportional to the number of firm divisions and is more prevalent in certain industries and organizations with low institutional holdings.[28]

Conclusion

Although contested tender offers are a small fraction of all merger and acquisition activity, the target and bidder costs of fighting a hostile battle and the slight chances of targets remaining independent, as well as the attendant social costs of the fight, magnify the importance of understanding and dealing with the corporate control market.

A successful and profitable takeover depends on the extent to which the target firm is undervalued, the inefficiency of target management, the cost of overcoming the target's takeover defenses, the ability of the acquirer to transfer wealth from other stakeholders, and the ability of the bidder to divert some gains from the target shareholders.

Target shareholders are definite winners in the hostile takeover battle. Bidder shareholders, on average, have equal probabilities of gaining or losing and, at best, obtain modest gains.

However, the source and quantification of the gains to target shareholders remain elusive. Research does not provide clear support for the hypothesis that there are real efficiency gains from takeovers. Support for the several versions of the wealth redistribution theory is mixed. Wealth transfers are most likely to have negative effects on target management.

What is clear, however, is that net shareholder gains are not an accurate measure of welfare gains resulting from takeovers. Only with additional research can the social and economic welfare implications and policy directives regarding hostile takeovers be more precisely drawn.

Footnotes

[1]Data on net merger and acquisition announcements are from *Mergerstat Review* 1978-1987. (Chicago: W. T. Grimm & Co.) Of the 2,032 net merger and acquisition announcements in 1987, there were only 972 in which the dollar value of the deal was disclosed.

[2]For instance, S. 1323 and S. 1324, 100th Cong. 1st sess. (1987) (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C.).

"Securities Regulation, Hostile Corporate Takeovers: Synopses of Thirty-Two Attempts," United States General Accounting Office, March 1988, GAO/GGD-88-48FS, a study of 32 hostile takeover attempts in 1985 provides data indicating that, although financial-advisory-related service fees totaled approximately $60 million, this is only a minor fraction of the total value of the deals. Nonetheless, that data also indicate that in successful hostile takeovers, the target spent approximately twice as much as the bidder on such services.

[3]For a sample of papers dealing with the value maximization hypothesis, see Eugene F. Fama and Michael C.

Jensen, "Organizational Forms and Investment Decisions," *Journal of Financial Economics*, Vol. 14, No. 1, (March 1985), pp. 101-119; Eugene F. Fama, E. and Martin H. Miller, *The Theory of Finance*, (Hinsdale, Ill.: Dryden Press, 1972), Chapter 2; and Paul Asquith, Robert F. Bruner, and David W. Mullins, Jr., "The Gains to Bidding Firms from Merger." *Journal of Financial Economics*, Vol. 11, No. 1-4, (April 1983), pp. 121-139. Andrei Shleifer and Robert W. Vishny, "Value Maximization and the Acquisition Process," *Journal of Economic Perspectives*, Vol. 2, No. 1, (Winter 1988), pp. 7-20, examine the failure of internal control mechanisms as one explanation of hostile takeovers.

[4]Randall Morck, Andrei Shleifer, and Robert W. Vishny, "Characteristics of Targets of Hostile and Friendly Takeovers," in Auerbach, *Corporate Takeovers*, pp. 101-136 study the characteristics of hostile takeover targets and suggest that hostile takeovers occur in declining industries and those in a state of change, where management is slow to adjust to the changing environment for whatever reasons--e.g., to maintain their control or to protect employees from pay reductions or job eliminations.

[5]Michael C. Jensen, "Takeovers: Their Causes and Consequences," *Journal of Economic Perspectives*, Vol. 2, No. 1, (Winter 1988), pp. 55.; Randall J. Woolridge, "Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?," *Journal of Applied Corporate Finance*, Vol. 1, No. 1, (Spring 1988), pp. 26-36 finds that a myopic market is not to blame as "common stock prices react positively to announcements of corporate strategic investment decisions and the market appears to place considerable emphasis on prospective long-term developments in valuing securities." See also Bronwyn H. Hall, "The Effect of Takeover Activity on Corporate Research and Development," Alan J. Auerbach, ed., *Corporate Takeovers: Causes and Consequences*, (Chicago: University of Chicago Press, 1988), pp. 69-100; John J. McConnell and Chris J. Muscarella, "Capital Expenditure Decisions and Market Value of the Firm," *Journal of Financial Economics*, Vol. 14, 1985, pp. 523-553; and Jeremy C. Stein, "Takeover Threats and Managerial Myopia," *Journal of Political Economy*, Vol. 96, No. 1, (Feb. 1988), pp. 61-80.

[6]See Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers." *American Economic Review*, Vol. 76, No. 2, (May 1986, Papers and Proceedings, 1985), pp. 323-329.

[7]Richard Roll, "The Hubris Hypothesis of Corporate Takeovers." *Journal of Business*, Vol. 59, No. 2, (April 1986), pp. 197-216.

[8]For a series of articles discussing methods of and effects of corporate restructuring including Employee Stock Option Plans and Leveraged Cash-outs, see *Journal of Applied Corporate Finance*, Vol. 1, No. 1, (Spring 1988). For evidence of stock price reactions to capital structure changes generally indicating a direct correlation between changes in leverage and stock prices, see Michael C. Jensen and C. W. Smith Jr., "Stockholder, Manager and Creditor Interests: Applications of Agency Theory," in E. Altman and M. Subrahmanyam, eds., *Recent Advances in Corporate Finance*, (Homewood: Richard Irwin, 1985), pp. 93-131.

[9]Although 30-40 percent of the junk bonds issued since 1985 have been used in acquisition-related financing, these junk-bond-financed transactions only accounted for approximately 8 percent of total merger financings in 1986, up from 4.3 percent in 1985. *(Mergers and Acquisitions*, 1987).

[10]GAO, Securities Regulation.

[11]Supreme Court of the United States, *CTS Corp. v. Dynamics Corporation of America*, 107 S Ct 1637(1987). Appeal from the United States Court of Appeals for the Seventh Circuit, No. 86-71. Argued March 2, 1987 and decided April 21, 1987. This decision reverses prior court trends and raises the possibility that state legislation may have a substantive impact on corporate control contests. The case upheld one form of takeover statute, the Indiana control share acquisition provision. For an invalidation of a state control share statute on constitutional grounds, see *RTE Corporation* v. *Mark IV Industries*, Civ. Action No. 88-C-378 (E.D. Wis.) May 6, 1988. Also see Lynn E. Browne and Eric S. Rosengren, "Should States Restrict Takeovers?" *New England Economic Review*, Federal Reserve Bank of Boston, (July/August 1987), pp. 13-21, for a discussion of state antitakeover laws.

[12]Sanford J. Grossman and Oliver D. Hart, "Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation." *Bell Journal of Economics*, Vol. 11, No. 1, (Spring 1980), pp. 42-64 discuss the ability of bidders to gain from takeover, and Andrei Shleifer and Robert W. Vishny, "Greenmail, White Knights, and Shareholders' Interest," *Rand Journal of Economics*. Vol. 17, No. 3, (Autumn 1986), pp. 293-309 discuss the accumulation of shares prior to full disclosure.

The Williams Act, a 1968 amendment to the Securities and Exchange Act of 1933, Public Law No. 90-439, 82 Stat. 454 (July 29, 1968) as amended in 1970 Public Law No. 91-567, 84 Stat. 1497 (December 22, 1970) governs tender offers with disclosure, offer period and other procedural requirements, as well as antifraud provisions. It was intended to protect shareholders by allowing sufficient time and information to properly analyze a tender offer.

[13]For empirical evidence of the effects of defensive tactics and the market for corporate control see Greg A. Jarrell, James A. Brickley, and Jeffery M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," *Journal of Economic Perspectives*, Vol. 2, No. 1, (Winter 1988), pp.49-68; Gregg A. Jarrell and Annette B. Poulsen, "Shark Repellents and Stock Prices, The Effects of Antitakeover Amendments Since 1980." *Journal of Financial Economics*, Vol. 19, No. 1, (Sept. 1987), pp. 127-168; John Pound, "The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence," *The Journal of Law and Economics*,

(Oct. 1987), pp. 353-367; and Michael Ryngaert, "The Effect of Poison Pill Securities on Shareholder Wealth," *Journal of Financial Economics*, Vol. 20, No. 1-2, (January/March 1988), pp. 127-168.

[14]Scott C. Linn and John J. McConnell, "An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices," *Journal of Financial Economics*, Vol. 11, No. 4, (April 1983), pp. 361-399.

[15]Harry DeAngelo and Edward M. Rice, "Antitakeover Charter Amendments and Stockholder Wealth," *Journal of Financial Economics*, Vol. 11, No. 1-4, (April 1983), pp. 329-359 find weak support for the managerial entrenchment hypothesis.

[16]Kevin J. Murphy, "Corporate Performance and Managerial Remuneration: An Empirical Analysis," *Journal of Accounting and Economics*, Vol. 7, No. 1-3, (April 1985), pp. 11-42 found a positive relationship between stock performance and managers' pay; and James A. Brickley, Sanjai Bhagat, and Ronald C. Lease, "The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth," *Journal of Accounting and Economics*, Vol. 7, No. 1-3, (April 1985), pp. 115-130; and Hassan Tehranian and James F. Waegelein, "Market Reaction to Short Term Executive Compensation Plan Adoption," *Journal of Accounting and Economics*, Vol. 7, No. 1-3, (April 1985), pp. 131-144 find introductions of incentive-based compensation programs cause stock price increases. The problem of management performance not achieving cost minimization and profit maximization at the expense of shareholders (absentee owners) was first identified by Adolf A.Berle, Jr. and Gardiner C. Means, *The Modern Corporation and Private Property*, 1932, (New York, New York: Macmillan, 1932).

[17]Jarrell and Poulsen, "Shark Repellents and Stock Prices." Today, institutional investors account for approximately 66 percent to 75 percent of equity ownership and trading compared to about 5 percent in the early 1960s.

[18]GAO, Securities Regulation. 1985 data indicate that insider holdings averaged 21.8 percent for nine targets of unsuccessful takeover attempts and averaged 4.8 percent and 9.5 percent, respectively, for nine successful takeovers and seven targets acquired by white-knights. T. Boone Pickens, Jr., "Professions of a Short-Termer," *Harvard Business Review*, Vol. 64, No. 3, (May/June 1986), pp. 77 states that takeover targets from 1981-1984 averaged 22 percent institutional ownership compared to a market average of 35 percent.

[19]Bernard S. Black and Joseph A. Grundfest, "Shareholder Gains From Takeovers and Restructurings Between 1981 and 1986: $162 Billion is a Lot of Money," *Journal of Applied Corporate Finance*, Vol. 1, No. 1, (Spring 1988), pp. 5-15; Michael C. Jensen and Richard S. Ruback, "The Market for Corporate Control," *Journal of Financial Economics*, Vol. 11, No. 1-4, (April 1983), pp. 5-50; Roll, "The Hubris Hypothesis of Corporate Takeovers"; Jarrell, Brickley, and Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," *Journal of Economic Perspectives*, (Winter 1988), pp. 49-58; Michael Bradley, Anand Desai, and E. Han Kim, "Synergistic Gains from Corporate Acquisitions and Their Diversion between the Target and Acquiring Firms," Working Paper, School of Business Administration, University of Michigan, 1987; and Asquith, Bruner, and Mullins, Jr., "The Gains to Bidding Firms from Merger."

[20]Jensen and Ruback, "The Market for Corporate Control" provides an extensive review of corporate control market studies and finds shareholders of acquirers do not lose; and Roll, "The Hubris Hypothesis of Corporate Takeovers" finds statistically insignificant results showing that acquirers, on average, do lose on bid announcements. Jarrell, Brickley, and Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980" updates and confirms the earlier Jensen and Ruback (1983) study.

[21]In contrast to the earlier studies using aggregate data, Michael Bradley, Anand Desai, and E. Han Kim, "Synergistic Gains from Corporate Acquisitions and Their Diversion between the Target and Acquiring Firms" study the gains and losses of matched pairs of bidders and targets from 1962-1984 and find a statistically significant synergistic gain of 7.5 percent created from tender offer combinations.

For empirical evidence on post-merger (long-run) negative returns and discussion of the issue, see F.M. Scherer, "Corporate Takeovers: The Efficiency Arguments," *Journal of Economic Perspectives*, Vol. 2, No. 1, (Winter 1988), p. 71; Jensen and Ruback, "The Market for Corporate Control," pg. 20; and Ellen Magenhein and Dennis C. Mueller, "On Measuring the Effect of Mergers on Acquiring Firm Shareholders" in John C. Coffee, Jr. et.al, eds. *Knights, Raiders and Targets*, (New York: Oxford University Press), 1988.

[22]Debra K. Dennis and J. McConnell, "Corporate Mergers and Security Returns," *Journal of Financial Economics*, Vol. 16, No. 2, (June 1986), pp. 143-187; Kenneth Lehn and Annette B. Poulsen, "Sources of Value in Leveraged Buyouts," in *Public Policy Towards Corporate Takeovers*, (New Brunswick, NJ: Transaction Publishers), 1987; Paul Asquith and E. Han Kim, "The Impact of Merger Bids on the Participating Firms' Security Holders," *Journal of Finance*, Vol. 37, No. 5, (December 1982), pp. 1209-1228; and "Buyouts Devastating to Bondholders," *New York Times*, October 26, 1988.

[23]Alan J. Auerbach and David Reishus, "Taxes and the Merger Decision," in J. Coffee and Louis Lowenstein, eds., *Takeovers and Contests for Corporate Control*, (Oxford: Oxford University Press, 1987); D. Breen, "The Potential for Tax Gains as a Merger Motive," Federal Trade Commission, Bureau of Economics, July 1987; and Lehn and Poulsen, "Sources of Value in Leveraged Buyouts."

[24]Andrei Shleifer and Lawrence Summers, "Hostile Takeovers as Breaches of Trust," in Auerbach, *Corpo-*

rate Takeovers, pp. 33-68; and Charles Brown and James L. Medoff, "The Impact of Firm Acquisitions on Labor," in Auerbach, *Corporate Takeovers*, pp. 9-32. In Bernard S. Black and Joseph A. Grundfest, "Shareholder Gains From Takeovers and Restructurings Between 1981 and 1986: $162 Billion is a lot of Money," on pg. 7 the authors noted that "Yago and Stevenson also find 'no evidence that unsolicited deals had systematically different effects than friendly transactions'."

[25]Andrei Shleifer and Lawrence Summers, "Hostile Takeovers as Breaches of Trust," pg. 50.

[26]Scherer, "Corporate Takeovers: The Efficiency Arguments," pp. 75-76; and David J. Ravenscraft and F. M. Scherer, "Life After Takeover," *The Journal of Industrial Economics*, Vol. 36, No. 2, (December 1987), pp. 147-156.

[27]Michael Bradley, Anand Desai, and E. Han Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy?," *Journal of Financial Economics*, Vol. 11, 1983, pp. 183-206. Frank H. Easterbrook and Gregg A. Jarrell, "Do Targets Gain from Defeating Tender Offers?," *New York University Law Review*, 1984, Vol. 54, pp. 277-299 show that stock returns of targets of defeated hostile bidders fall to approximately pre-bid levels. Sanjai Bhagat, James Brickley, and Uri Lowenstein, "The Pricing Effects of Inter-Firm Cash Tender Offers," *Journal of Finance*, Vol. 42, 1987, pg. 965-986 find that increased valuations of target firms are too large to be explained solely by adjustments for prior undervaluations.

[28]See Dean LeBaron and Lawrence S. Speidell, "Why are the Parts Worth More than the Sum? 'Chop Shop,' A Corporate Valuation Model." *The Merger Boom*, Federal Reserve Bank of Boston, pp. 78-101; and Michael E. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review*, Vol. 65, No. 3, (May/June 1987), pp.43-59.

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