CHAPTER 6

The Market for Corporate Control

THE SUCCESS OF THE AMERICAN ECONOMY depends on competition. Competition stimulates managers to respond to rapidly evolving technologies. Competition requires that firms adapt to changing market demands and calls upon them to adjust to fluctuating capital market conditions. Competition breaks down entrenched market positions, unsettles comfortable managerial lives, and provides incentives for innovative forms of business organization and finance. In sum, competition plays a central role in the evolution of the economy: It promotes efficient modes of production and eliminates processes and organizational structures that have outlived their usefulness.

CONTROL OF PUBLICLY TRADED CORPORATIONS

Competition plans a particularly important role in the market for control of publicly traded corporations. This market determines who will operate the Nation's largest business enterprises and influences the business strategies that many of these organizations follow. The Nation's economy is strongly influenced by the performance of these publicly traded corporations. As of year-end 1983, the market value of the securities of these corporations amounted to $2.5 trillion, about 22 percent of the value of the Nation's total asset base. With such a large portion of the Nation's wealth and productive capacity represented by these publicly traded corporations, the Nation has a compelling interest in maintaining their competitive and efficient economic performance.

These corporations are generally owned by stockholders who delegate substantial decisionmaking authority to a group of hired managers. Managers make the corporation's investment, pricing, production, and research and development decisions, and are primarily responsible for the corporation's success or failure. Typically, managers own a relatively small percentage of the firm's shares.

This delegation of authority from stockholders to management is highly efficient. It fosters specialization that allows managers to develop substantial firm-specific human capital. It also promotes development of a class of talented professional managers knowledgeable about the operation of large, complex organizations. In addition, it reduces the costs of diversifying investors' portfolios and facilitates mobility of financial resources among corporations competing for capital. Indeed, separation of ownership and control has been a major reason for the success of the modern corporate form as a business entity.

The delegation of authority from stockholders to management is not, however, without risk to stockholders and the economy at large. In particular, the delegation creates a possibility that management will operate the corporation in management's best interests, and not in the best interests of the corporation's stockholders. Such divergences of interest can result because stockholders are concerned primarily with maximizing the value of their shares, while managers' incentives are often more complex and can involve assurances of continued employment by an independent, publicly traded corporation.

These divergent incentives can give rise to an agency problem within the corporation—a situation in which managers are poor agents for their stockholders because they do not act in the stockholders' best interests. The adverse consequences of this agency problem can be significant because, if unchecked, it can deter socially beneficial mergers, keep assets from being allocated to higher valued uses, impede adoption of more profitable capitalization plans, and otherwise prevent publicly traded corporations from making the largest possible contribution to aggregate economic performance.

INCENTIVES AND CORPORATE MANAGEMENT

The market generally relies upon two sets of incentive mechanisms to align management and stockholder interests. The first results from the operation of the labor market for management services. In this market, executives are hired and fired and compete for career opportunities. Here, corporations also establish incentive systems designed to stimulate employee productivity and, in order to align management and stockholder interests, often grant stock options to key management personnel.

There are, however, substantial limits to the practical effectiveness of this labor market. In particular, a management team may believe that it is maximizing the value of the corporation when, in fact, it is not. Under these circumstances, management will not change corporate strategy on its own accord. Moreover, unless stockholders independently conclude that corporate performance can be improved by changing management teams, and unless some stockholders mount an expensive proxy contest to oust incumbent management, a change in corporate strategy is unlikely to occur. The labor market for management services can thereby allow a corporation to continue to be controlled by an entrenched management that does not maximize the value of the corporation's shares.

Under these circumstances, the external market for corporate control provides an important set of checks and balances. In this market, bidders directly approach stockholders and offer to purchase the corporation's shares at a premium above market price. These bidders often install new management in the event their bid succeeds. In some cases the bid is made directly by a new management team that believes it can improve the target corporation's performance.

The best assurance an incumbent management has against a successful takeover attempt is a stock price that is high relative to outsiders' estimates of the potential value of the corporation's shares. Managements that allocate capital to higher valued uses, operate efficiently, and adopt capitalization structures responsive to prevailing financial market conditions are less likely to be subject to takeovers than other management groups. Consequently, in order to prevail in the external market for corporate control, it is not enough that an incumbent management believes that it is doing a proper job, or that it persuades stockholders that it is doing so. Instead, management must demonstrate that its performance is competitive with the performance of other potential managers, and the value of management's performance must be reflected in the corporation's stock price. In this fashion, the external market for corporate control disciplines managers who believe they have maximized the value of the corporation's shares when, in fact, they have not.

Contests for corporate control are not, however, motivated solely by opportunities to improve management. As discussed below, takeovers can occur because of divergent estimates of future economic trends, opportunities to capitalize on economies of scale, distribution efficiencies, tax factors, and myriad other reasons. Therefore, even well-managed companies may find themselves subject to contests for corporate control that can be economically rational and beneficial for the economy as a whole.

RECENT TAKEOVER EXPERIENCE

The potential for divergent stockholder and management interests is most striking in hostile takeover attempts. In a hostile takeover attempt a bidder offers stockholders a substantial premium for the corporation's shares. In response, target management opposes the bid and typically resorts to defensive tactics such as litigation against the bidder, the sale of new securities to investors committed to support incumbent management, the repurchase of shares already owned by the bidder, or numerous other transactions. If successful, the defense can leave management in continued control of the target corporation. However, as explained below, management's success in maintaining the corporation's independence comes at a high price for target stockholders who typically suffer substantial losses when a bid is defeated.

THE DEBATE OVER CONTESTS FOR CORPORATE CONTROL

Takeovers have recently become the subject of extensive debate in the Congress, among executives of the Nation's largest corporations, and in the media. The debate has been stimulated, in part, by a rapid increase in the size of corporations involved in takeover battles and by the evolution of new and controversial takeover techniques.

As explained below, recent financial and legal developments have made many of the largest publicly traded corporations susceptible to takeovers. Managements of these corporations have historically perceived themselves as acquirers and not as potential takeover targets. The recent exposure of these corporations to the discipline of the market for corporate control has caused substantial controversy and has stimulated calls for legislation that would deter takeovers attempted without a target management's approval. Some critics of the takeover process also claim that bidders use tactics that are designed to coerce stockholders into selling their shares, and that regulations governing bidder practices provide insufficient time for stockholders and management to evaluate and respond to takeover attempts. More fundamentally, critics of the takeover process question whether takeovers are beneficial for the economy. They suggest that many takeovers result from a pursuit of paper profits that does not contribute to productivity. They also suggest that takeovers can damage the economy because they can increase potentially anticompetitive concentration of market power, distort the credit market, and reduce incentives for long-term investment.

Management defensive tactics are also often criticized. In particular, managements faced with unwelcome takeover attempts sometimes repurchase the would-be acquirer's shares at a premium over the market. This practice, commonly known as greenmail, can preclude a takeover premium from being paid to target stockholders whose shares are not repurchased. In other situations, target managements have sold additional stock to new shareholders who commit themselves to support management interests. Target managers have also filed numerous lawsuits opposing takeovers, and have mounted competing tender offers for the potential acquirer's shares. Critics object to these practices because they can be used by management to protect its tenure at stockholders' expense.

The outcome of this debate over takeover tactics is significant for the economy as a whole. The set of tactics permissible in contests for corporate control determines both the probability that takeover attempts will be made and the probability that they will eventually succeed. To the extent that government regulations impose costs on bidders, or reduce a bidder's chances for success, fewer takeover attempts will be made. This tends to insulate corporate managements from the competitive pressures of the external market for corporate control. Stockholders, as a group, will also suffer as a result of excessive regulation because it reduces the chance to earn takeover premiums. However, to the extent that takeover practices are abusive, either because they allow bidders to acquire corporations through manipulative means, or because they allow entrenched managements to defeat takeovers that are in stockholders' and the economy's best interests, certain controls may be appropriate.

POLICY CONSIDERATIONS

The central policy question regarding takeovers should be whether the benefits to the economy as a whole resulting from takeovers exceed their costs. As explained below, there is powerful evidence that takeovers as a group are beneficial. This evidence does not, however, suggest that takeovers are without costs or dangers. In particular, if the antitrust laws are not properly enforced, takeovers can lead to anticompetitive accumulations of market power.

Although extensive research has established that takeovers tend to be beneficial, not every takeover is successful in attaining its originally contemplated benefits, and there are many examples of takeovers that, in hindsight, appear to have been misguided. Takeovers should not, however, be singled out in this regard because investments in physical plant, research and development, petroleum exploration, and numerous other activities also often appear misguided in hindsight. However, because it is impossible to predict which takeovers will be unsuccessful, the takeover process must be evaluated in the aggregate, and cannot be assessed on the basis of isolated examples of failure or success.

In addition, even when takeovers succeed, some individuals and communities may be adversely affected if jobs are lost or plants and offices are shut down. The problems raised by such reallocations of assets are a proper subject of social concern, but they are not unique to takeover transactions. Instead, they result from the economy's need to adapt to changing circumstances. To the extent that takeovers are associated with reallocations that impose particularly high costs on specific individuals or communities, the appropriate government response, if any, should be to ease local adjustment problems rather than to interfere with the takeover process itself.

Contests for corporate control are largely economic phenomena, and they can and should be understood as such. The policy debate need not be guided by anecdotal evidence that emphasizes isolated incidents that some critics perceive as abusive. Contests for corporate control have been studied in great detail, and this accumulated knowledge provides a foundation for sound public policy. Although much additional research remains to be done, and although there are not adequate explanations for all phenomena observed in the takeover market, the current state of knowledge strongly indicates that further Federal regulation of the takeover process, particularly insofar as it would make takeovers more costly, would be poor economic policy. The remainder of this chapter assesses the economy's recent experience with mergers and acquisitions, describes the debate over certain practices employed in the market for corporate control, and evaluates proposals for further Federal regulation of this market.

MERGER AND ACQUISITION ACTIVITY IN PERSPECTIVE

Contests for corporate control are part of a larger merger and acquisition process that plays an important role in the economy's adjustment to changing market circumstances. Merger and acquisition activity historically has run in cycles, with peaks occurring during periods of strong business growth. The first recorded peak in merger and acquisition activity occurred at the turn of the century, as the Nation recovered from the depression of 1893 and before it slipped into the recession of 1904. A second peak occurred between 1925 and 1930, a period of rapid economic growth followed by the Great Depression. Merger and acquisition activity remained subdued during the Depression and World War II. After 1945 the number of business combinations began a steady increase that culminated in a merger wave spanning the late 1960s and early 1970s.

Data describing the number and value of merger and acquisition transactions are presented in Table 6–1. Those data show that recent merger and acquisition activity, as measured by the number of reported transactions, has been at a rate less than half that reported in the 1960s. Although the number of transactions remains below previous peaks, the total value of merger and acquisition transactions has recently reached new highs. The announced value of merger and acquisition transactions reported in the first 9 months of 1984 was $103 billion. On an annualized basis measured in constant 1983 dollars, this activity represents $133 billion in mergers and acquisitions, an increase of about 19 percent over the previous peak recorded in

1968. Indeed, the average annual reported real value of mergers and acquisitions during 1981-84 is approximately 48 percent greater than the average reported during any 4 years of the late 1960s and early 1970s. Thus, fewer transactions have been generating a relatively large dollar volume of merger and acquisition activity.

TABLE 6-1.—*Number and value of merger and acquisition transactions, 1963-84*

[Values are in billions of dollars]

Year	FTC estimates of acquisitions of large firms in mining and manufacturing [1]			W.T. Grimm & Co. estimates of merger and acquisition activity		
	Number of transactions	Value of assets exchanged		Number of transactions [2]	Value of consideration exchanged [3]	
		Nominal dollars	Constant (1983) dollars		Nominal dollars	Constant (1983) dollars
1963	54	2.5	7.6	1,361	(4)	(4)
1964	73	2.3	6.9	1,950	(4)	(4)
1965	64	3.3	9.4	2,125	(4)	(4)
1966	76	3.3	9.3	2,377	(4)	(4)
1967	138	8.3	22.5	2,975	(4)	(4)
1968	174	12.6	32.8	4,462	43.0	112.2
1969	138	11.0	27.4	6,107	23.7	58.8
1970	91	5.9	13.9	5,152	16.4	38.6
1971	59	2.5	5.5	4,608	12.6	28.3
1972	60	1.9	4.1	4,801	16.7	36.0
1973	64	3.1	6.4	4,040	16.7	34.0
1974	62	4.5	8.4	2,861	12.5	23.4
1975	59	5.0	8.5	2,297	11.8	20.2
1976	82	6.3	10.3	2,276	20.0	32.5
1977	101	9.2	14.1	2,224	21.9	33.7
1978	111	10.7	15.4	2,106	34.2	49.0
1979	97	12.9	17.0	2,128	43.5	57.3
1980	(4)	(4)	(4)	1,889	44.3	53.5
1981	(4)	(4)	(4)	2,395	82.6	90.9
1982	(4)	(4)	(4)	2,346	53.8	55.9
1983	(4)	(4)	(4)	2,533	73.1	73.1
1984:						
9 months	(4)	(4)	(4)	1,899	103.2	99.5
Annualized	(4)	(4)	(4)	2,532	137.6	132.6

[1] "Large" firms are defined as those with assets of $10 million or more. Excluded from the tabulation are firms for which asset data are not publicly available.
[2] The W.T. Grimm & Co. tabulations measure only publicly announced transactions and include transfers of ownership of 10 percent or more of a company's assets or equity, provided that the value of the transaction is at least $500,000.
[3] Includes only those transactions for which valuation data are publicly reported.
[4] Not available.

Source: Federal Trade Commission (Bureau of Economics) and W.T. Grimm & Co.

The large dollar volume of recent merger and acquisition activity is attributable primarily to a substantial increase in the size of the largest individual transactions, most of which involve publicly traded corporations. Of the 100 largest merger and acquisition transactions recorded through year-end 1983, measured in nominal terms, 65 occurred between 1981 and 1983, 24 occurred between 1979 and 1981, and only 11 occurred prior to 1979. Prior to 1976 the largest acquisition on record, measured in constant 1983 dollars, had a value of $3.3 billion. Today, the record stands at $13.3 billion. Indeed, transactions with a nominal value in excess of $1 billion used to be rare and only 12 such transactions were recorded in the 12-year span from 1969 to 1980. However, between 1981 and 1984 alone, there have been at least 45 such transactions.

These large mergers tend to be focused in specific industries. As Table 6-2 explains, five industries that account for less than 10 percent of national income—petroleum, banking and finance, insurance, mining and minerals, and food processing—accounted for one-half of all the consideration reported paid in mergers and acquisitions between 1981 and 1983.

TABLE 6-2.—*Value of merger and acquisition transactions, by industry, 1981-83* [1]

Industry classification of seller	Nominal value (billions of dollars)	Percent of total	Cumulative percentage
Oil and gas	44.2	21.1	21.1
Banking and finance	23.4	11.2	32.3
Insurance	16.5	7.9	40.2
Mining and minerals	14.2	6.8	46.9
Food processing	8.0	3.8	50.8
Conglomerate	7.5	3.6	54.4
Transportation	6.8	3.3	57.6
Broadcasting	5.6	2.7	60.3
Retail	5.3	2.5	62.8
Brokerage and investment firms	5.1	2.4	65.2
Other	72.8	34.8	100.0
Total	209.5	100.0	

[1] Includes only those transactions for which valuation data are publicly reported. See Table 6-1, footnote 2.
Source: W.T. Grimm & Co.

Transactions in the petroleum industry have been particularly notable for their size. Between 1981 and 1983 the reported value of petroleum industry mergers and acquisitions exceeded $44 billion. This accounts for more than a fifth of the value of mergers and acquisitions during that period. The pace of merger activity in the oil industry continued to be rapid into 1984, when $29.2 billion was paid in three transactions alone. The Federal Trade Commission has concluded that merger and acquisition activity in the petroleum industry is attributable largely to changes in underlying market conditions. Among these changes are wider use of enhanced oil recovery techniques, divergent expectations concerning the future movement of crude oil prices, and phased decontrol of crude oil. In addition, the recent decline in demand for petroleum products has created excess capacity in the industry. Such excess capacity may make consolidation in the petroleum industry efficient and desirable. Some recent petroleum industry mergers are a part of that consolidation process.

In other industries, mergers and acquisitions are responses to new opportunities created by deregulation. Deregulation in the banking, finance, insurance, transportation, brokerage, and investment industries has opened new opportunities for distribution economies, as well as economies of scale and scope that can be achieved by mergers and acquisitions. Together, these recently deregulated industries account for about 25 percent of all merger and acquisition activity between 1981 and 1983.

A significant percentage of recent merger and acquisition activity thus appears to be related to competitive pressures to adapt to new market conditions. Accordingly, any policy that would influence merger and acquisition activity must recognize the valuable role these transactions play in allowing industries to adapt to changing circumstances and the costs that can be imposed by inhibiting such responses.

Another distinguishing characteristic of current merger experience is the prevalence of divestiture transactions. In a divestiture transaction, a parent corporation either spins off a subsidiary as a free-standing entity or sells it to another firm. Divestiture transactions currently account for about one-third of both the number and value of all merger and acquisition transactions.

Divestitures often occur when firms undo prior acquisitions that did not work out as planned, or when firms decide to raise cash to reduce debt generated by earlier acquisition programs, or to invest in new projects. In addition, many divestitures are currently designed to focus the parent corporation's operations in their most profitable lines of business. This represents a trend away from the conglomerate-type mergers characteristic of the late 1960s and early 1970s and toward less diversified corporate structures that focus on product lines in which the corporation has a relatively strong market position.

Current merger and acquisition activity is further characterized by a larger number of leveraged buyout and management buyout transactions. In a leveraged buyout, the acquiring firm borrows a large percentage of the purchase price by pledging the assets of the acquired firm as collateral for the loan. In a management buyout, the acquiring company is owned in whole or in part by the management of the acquired firm. Because management buyouts are often accompanied by substantial borrowing, management buyouts are also commonly leveraged buyouts.

Although leveraged and management buyouts are not novel, they are being used with increasing frequency in the acquisition of publicly traded firms. The value of leveraged buyouts of publicly traded companies increased rapidly from $636 million in 1979 to $7.1 billion in 1983. In 1983 leveraged buyouts accounted for about 19 percent of all takeovers of publicly traded companies and about 18 percent of the market value of those takeovers.

Public policy toward takeovers should depend on whether these transactions benefit the economy. If, on balance, they promote efficient allocation of resources, the transactions are beneficial and should not be impeded by Federal or State policy. In contrast, if the costs of these transactions exceed their benefits by, for example, wasting scarce resources or causing anticompetitive increases in market power, then regulation of the takeover process may be appropriate.

The available evidence, however, is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases.

These findings are consistent with the possibility that some individual transactions turn out to be misguided and generate losses for the economy at large. Public policy should not, however, be based on the outcomes of individual transactions, because it is impossible to predict in advance which transactions will succeed and which will fail. Public policy therefore must be based on aggregate trends describing the consequences of takeovers as a whole. On this criterion, there is no economic basis for regulations that would further restrict the merger and acquisition process. Indeed, the economic evidence suggests that existing regulations impose restraints that may deter potentially beneficial transactions.

STOCK MARKET PRICES AS A MEASURE OF BENEFITS AND COSTS

Ideally, a study of the costs and benefits of takeover transactions would evaluate the gains and losses resulting from each transaction on a case-by-case basis. In addition, each takeover transaction would be evaluated by objective and well-informed observers with strong incentives to render accurate and unbiased estimates of each transaction's likely consequences. Such an evaluation would also look behind the accounting techniques and book values employed by the parties, and would arrive at an assessment based on current market values and best estimates of future market trends.

In many ways, the behavior of prices quoted in the stock market provides just such an evaluation of the probable consequences of a takeover transaction. In the stock market, each takeover transaction is evaluated on its own merits by investors who, because they stand behind their assessments with real dollars placed at risk, have a powerful incentive to judge accurately the outcome of individual takeover transactions. It is also well established that the stock market sees through accounting techniques and bases its evaluations on underlying market values. Moreover, there is extensive evidence that the stock market rapidly absorbs any information contained in the historic price patterns of stock trades. Therefore, even if the stock market goes astray in its assessment of the likely consequences of takeover transactions, such deviations would give rise to arbitrage opportunities that would return the market to a more unbiased and objective perspective. The market's evaluation of takeover transactions is therefore self-correcting over time.

Stock market prices thereby provide a reliable barometer of the likely consequences of takeover transactions. If the aggregate net change in the value of acquirers' and targets' shares is positive as a result of a takeover, then the transaction creates wealth and is beneficial. If the aggregate net change is negative, the transactions reduce wealth and are harmful.

EVIDENCE THAT TAKEOVERS ARE BENEFICIAL

The evidence is overwhelming that successful takeovers substantially increase the wealth of stockholders in target companies. Although estimates of the magnitude of the wealth increase vary, recent studies find average gains in the range of 16 to 34 percent of the value of the targets' shares.

The data regarding changes in the value of acquiring companies are not as uniform, but the best available evidence strongly confirms that the value of acquiring companies' shares also increases as the result of takeovers. A recent study of takeovers of 249 New York and American Stock Exchange traded companies concluded that the average stock price gain to bidding stockholders is about 2.3 percent. Although this gain appears small, especially in comparison with the gains accruing to target stockholders, it masks a significantly larger return on the assets acquired by the purchasing firm.

On average, an acquiring firm is four to five times larger than the firm it purchases. Because of this size difference, the average 2.3 percent gain in the stock price of the acquiring firm translates roughly into a 9 to 11 percent average return on the assets of target firms to bidding stockholders.

These results are consistent with the operation of an efficient capital market. On average, and over the long run, bidders will not desire or be able to complete acquisitions unless the acquisitions are profitable for the bidding firm. Indeed, bidders often terminate or reduce the price of their offers when scrutiny of the target leads them to conclude that the initial offer price was too high. Target stockholders will similarly refuse to sell their shares unless their wealth increases as a result of the transaction. Economic theory therefore suggests, and the available evidence confirms, that merger and acquisition transactions are, on average, beneficial for stockholders in both bidder and target firms.

SOURCES OF GAIN FROM TAKEOVER ACTIVITY

The evidence is strong that takeovers generate aggregate net benefits to the economy. Although many potential sources of gain from these transactions can be identified, it is difficult to quantify the size of the gain that results from particular sources.

Production and distribution economies are one source of gain, particularly in transactions involving firms in related industries. An acquisition can also generate economies of scale and create opportunities for more efficient forms of distribution and contracting. Mergers and acquisitions can also promote technology transfers that might otherwise be unavailable to firms operating on a stand-alone basis. For example, some petroleum acquisitions have led to the transfer of enhanced recovery techniques that have improved yields from aging petroleum reservoirs. In addition, many recent studies have found that companies with larger market shares also have lower per unit costs. These studies suggest that the cost-reducing effects associated with larger market shares more than offset the increased prices that can, in some circumstances, result from having an industry composed of fewer firms with larger market shares.

Substantial gains can also result when a takeover causes assets to be shifted to higher valued uses. A retail chain may, for example, possess real estate that is more valuable as office sites than retail outlets. Although the retail chain may be well managed, if the company announces that it will not sell its real estate or put it to any use other than retailing, then the market has little incentive to value the firm's real estate at its current market price. Even if the market believes that it is inevitable that the firm's real estate will eventually be put to a higher valued use, the stock market will substantially discount the property's current market value because of uncertainty over when the transaction will occur and the price that the real estate will bring when sold. The announcement of a takeover attempt at a firm price eliminates much of this uncertainty and can account for a significant portion of the gains resulting from mergers and acquisitions.

Improved management is another possible source of gain from mergers and acquisitions. Evidence suggests that the stock price of target firms tends to fall over long periods well before a takeover attempt is announced. These firms may be disfavored by the market because they suffer from poor management. Takeovers of these firms can discipline managements and impose new corporate strategies in place of unsuccessful ones. These findings do not establish that all target firms are poorly managed, and they do not suggest that management efficiencies are the dominant source of gain from mergers and acquisitions. They do, however, suggest that poor management at target firms cannot be discarded as a motive for takeovers, and that restraints on takeover activity can protect inefficient managers from the discipline of the marketplace.

DANGERS OF MERGER AND ACQUISITION ACTIVITY

Currently, four economic criticisms of takeovers are frequently voiced. They are that: (1) takeovers increase concentration and have adverse effects on competition; (2) tax-motivated takeovers can generate economic losses for the economy; (3) takeovers can crowd productive business projects out of capital markets; and (4) takeovers can create incentives for management to concentrate on short-term performance to the detriment of long-term corporate investment.

Effects on Competition and Concentration

There is no evidence that recent merger and acquisition transactions have caused anticompetitive price increases. The Department of Justice and the Federal Trade Commission engage in careful market-by-market analyses of mergers that raise a possibility of anticompetitive effects. These agencies have actively opposed mergers that have threatened to create anticompetitive market power. In addition, so as to assure continued competition in the marketplace, the antitrust enforcement agencies have required billions of dollars of divestitures in connection with large mergers and acquisitions.

Indeed, in order to contend that recent takeovers have been anticompetitive, critics would have to demonstrate that public and private enforcement of the antitrust laws has been inadequate. There is, however, no credible evidence that the antitrust laws have permitted business combinations that have resulted in any material lessening of competition. To the contrary, a recent study of the U.S. economy, conducted on a market-by-market basis, has found a widespread increase in competition between 1958 and 1980. In 1980 approximately three-quarters of economic activity occurred in effectively competitive product markets. About 20 percent of economic activity occurred in markets that are tightly oligopolistic, and only 5 percent occurred in markets dominated by a single firm. In contrast, in 1950, only about one-quarter of economic activity occurred in markets classified as competitive.

At the aggregate level, there is also no systematic evidence that merger and acquisition activity has, in any meaningful sense, caused a decrease in competition. Instead, the most recent data compiled by the Federal Trade Commission, and presented in Table 6-3, show that in the 5-year period from 1977 through 1981 concentration of assets in the nonfinancial sector fell for the 50, 100, 150, and 200 largest firms.

TABLE 6-3.—*Concentration of assets in the nonfinancial sector, 1977-81*

[Percent]

Asset size group	1977	1978	1979	1980	1981
Top 50	22.7	22.3	21.9	22.4	22.2
Top 100	29.7	29.2	28.9	29.4	28.8
Top 150	35.5	34.0	33.7	34.0	33.3
Top 200	38.3	37.7	37.4	37.7	36.9

Source: Federal Trade Commission (Bureau of Economics), based on data from Compustat and Internal Revenue Service "Statistics of Income."

The relative stability often found in aggregate concentration series is, however, deceiving because it masks substantial turnover in the rank and identity of the largest firms. For example, of the 500 largest industrial firms measured in terms of 1955 sales (as reported in *Fortune* magazine), only 262 remained in the top 500 in 1980. Thus, individual firms find the marketplace much more competitive than aggregate concentration data suggest: A large market share today is hardly a guarantee that a firm will be able to retain that share in the face of new competition, changing markets, and evolving technology.

Tax-Motivated Mergers and Acquisitions

Takeovers can result in tax savings for the combined firm. For example, an acquisition may allow the combined company to make better use of tax loss carryforwards, as well as depreciation deductions and investment tax credits generated by new investment programs. Occasionally, a takeover bid will be accompanied by a proposal to reorganize the company or to spin off assets according to a plan designed to reduce the company's and stockholders' tax liabilities.

These tax incentives for mergers raise difficult policy issues. Because tax laws generally prevent the transfer of deductions and credits among corporations, as well as between corporations and their stockholders, and because tax losses are not refundable, some firms have an incentive to enter into transactions that would not occur but for their tax consequences. Some of these mergers may make little economic sense in the absence of their tax benefits. Accordingly, it is possible that the economy may, as measured by the efficient allocation of resources, be better off without these transactions.

On the other hand, for some companies such transactions provide a means of avoiding at least a portion of the adverse consequences associated with nontransferable tax benefits. To that extent, tax-motivated transactions may actually reduce the risk associated with certain investment strategies and thereby ameliorate some of the distortions induced by the current tax system.

The solution to the potential problems raised by tax-motivated transactions is not, however, to place restraints on mergers and acquisitions. Instead, consideration should be given to modifications of the tax laws that would allow greater transferability of deductions and credits. Such modifications will remove a source of distortions inherent in the current tax system and eliminate incentives to engage in takeovers that are primarily tax motivated.

Effects on the Availability of Capital

Mergers and acquisitions are often financed by substantial borrowing. Concern is frequently raised that this borrowing, particularly for large takeovers, crowds out more productive applications of bank financing. This concern is unfounded.

As an initial matter, it should be recalled that takeover activity is productive and adds to aggregate wealth. In addition, takeover activity is, in essence, no different from other investment activities in which investors place money at risk by purchasing existing assets, such as real estate or shares of stock. Moreover, the borrowing required for corporate acquisitions does not impose a net new credit demand of equal magnitude on financial markets, because the proceeds are paid to stockholders of the acquired company who use the funds to make other investments or retire other loans. Thus, large portions of borrowings used to finance acquisitions flow back into the capital markets where they again finance credit needs.

The amount of borrowing used for large corporate transactions is also small relative to the size of the total capital market. During the first 7 months of 1984, a particularly active period for leveraged takeovers, loans for the purpose of completing large acquisitions amounted to about \$21.2 billion. This constitutes about 1.3 percent of the \$1.65 trillion of commercial bank loans and investments outstanding during the same period, and a substantially smaller percentage of aggregate borrowing in the economy. Such loans are unlikely to have more than minor, isolated, and transitory effects on interest rates or on the availability of capital.

Effects on Long-Term Investment by Publicly Traded Companies

Recently, some critics have complained that takeovers reduce long-term business investment. They contend that the stock market undervalues long-term investments. Therefore, in order to prevent takeover attempts induced by allegedly low and "unreasonable" stock market valuations, it is said that managers of publicly traded firms avoid long-term investment projects.

Although this argument is presented by leading executives and prominent takeover attorneys, there is no credible evidence to support it. Proponents of this theory have presented no examples of long-term investments that have been forgone because of a fear of takeovers. Indeed, even if such examples could be found, they would not constitute a loss to the economy unless other firms did not have comparable incentives to make the allegedly forgone investments.

This criticism of takeovers is also internally inconsistent. If a company continually avoids long-term investment, eventually it becomes unable to compete with other firms that have engaged in the appropriate forms of long-term investment. Thus, if a company seeks to maintain its stock price valuation in order to avoid a takeover, then at some point it must engage in appropriate forms of long-term investment simply to remain competitive.

There is also substantial evidence suggesting that the stock market does not penalize investment simply because it is long term. The stock prices of many publicly traded companies reflect high price-earnings ratios because of the market's assessment that these companies' long-term investment programs may be successful. The fact that some companies' long-term investments do not enhance the value of their shares reflects the market's assessment of the likely outcome of the particular investment programs, and is not a criticism of the long-term nature of the program *per se.* In addition, there is substantial evidence that the market accurately reflects all publicly available information about a corporation's finances and strategic plans. Because research and development, capital expenditure, and other long-term investment information is publicly available, the evidence suggests that these data are accurately incorporated into the stock market's valuation of a corporation's shares along with other publicly available information describing a corporation's prospects.

REGULATING BIDDER TACTICS

Recent calls for regulation of bidder tactics in takeover contests are based on claims that some tactics are coercive, and that they fail to allow stockholders adequate time to inform themselves about the bidder's offer. Critics also claim that target managements do not have adequate time to mount defenses against proposed takeovers. In addition, some critics question whether takeovers are, on the whole, beneficial for the economy. These critics suggest that takeovers should be subject to regulations that would make them more expensive and difficult to complete.

There is, however, little credible economic evidence that tactics used by bidders in takeover contests should be subject to further regulation. To the contrary, the available evidence is that any regulatory change that would increase the cost of mounting takeovers is likely to deter takeovers and thereby cause losses for the economy. Viewed from this perspective, proposals to increase regulation of bidder practices are not persuasive.

THE ECONOMIC CONSEQUENCES OF THE WILLIAMS ACT

Bidder practices are already subject to extensive regulation under the Williams Act. The Williams Act was adopted in 1968, partially in response to complaints about "Saturday Night Specials," takeover bids that were left open for a short period of time, often only a few days. Congress was concerned that stockholders had inadequate time to evaluate the merits of the proposed takeover bid. In response to this problem, regulations adopted pursuant to the Williams Act require that tender offers be open for a minimum of 20 business days. If an offer is oversubscribed, the offeror must purchase the shares on a *pro rata* basis, and cannot purchase them on a first-come-first-served basis. Accordingly, the Act ensures that tender offers are made on equal terms to all target company stockholders. In addition, the Williams Act requires that any person who acquires 5 percent of a company's shares make that fact public within 10 days, and disclose plans, if any, for the company in which the stock is acquired.

The Securities and Exchange Commission (SEC) has concluded that the Williams Act successfully provides stockholders with sufficient time to evaluate takeover proposals. In particular, the Commission has found that the 20-business-day minimum offering period has resulted in a negligible number of complaints from stockholders. Thus, it appears that the Act has successfully protected stockholders from whatever abuses might result from short offering periods.

The benefits that the Williams Act generates are not, however, achieved without costs. Since adoption of the Williams Act, takeovers have become more expensive for initial bidders because target managements have more time to mount takeover defenses or to find alternate purchasers. The Williams Act also limits bidders' ability to acquire toehold positions in target companies. These effects of the Williams Act are reflected in the higher premiums that bidders have been required to pay in order to complete takeovers. Estimates are that the Williams Act has increased the average cash tender premium paid to target stockholders from 32 percent before passage of the Act to 53 percent after the Act's passage and that these increased premiums have caused correspondingly lower returns to bidders. Because the Act has decreased the returns to initial bidders, it has likely caused a decrease in the number of takeovers and a decrease in the gains resulting from takeover activity.

Therefore, although the Williams Act has benefited stockholders of companies that have, in spite of the additional costs imposed by the Act, become subject to takeover attempts, it has imposed two other sorts of costs on stockholders. First, stockholders in companies that would have received takeover bids but for the higher premiums induced by the Act have suffered losses measured by the value of the forgone premiums. Second, stockholders in companies that would have made takeover bids but for the Act's requirements have forgone the gains that would have resulted from the deterred transactions.

The increased premiums paid to target stockholders as a result of the Williams Act do not, however, represent an increase in aggregate national wealth. Instead, the premiums are simply a reallocation of the gains resulting from takeovers away from bidding company stockholders to target company stockholders. The losses caused by the Williams Act are, in contrast, real economic losses and represent wealth forgone as a result of beneficial transactions deterred by the Act. Therefore, unless society places greater value on the redistribution of gains to target stockholders than on aggregate wealth effects, the costs of the Williams Act, at the margin, currently appear to outweigh its benefits.

THE DEBATE OVER BIDDER TACTICS

Currently, much of the criticism of bidder tactics emanates from management groups concerned that their companies will become targets of takeover attempts. These managements claim that certain bidder tactics can coerce stockholders into tendering their shares, and that the minimum offering period under the Williams Act is too short.

"Two-Tier Offers"

The bidder practice most frequently criticized as coercive is the "two-tier" tender offer. In a two-tier offer, the bidder makes a uniform proposal to all target company stockholders. Typically, the proposal is to pay a higher price, in cash, for the first half of all securities tendered, and a lower price, in securities, for all remaining shares. Critics claim that two-tier offers can stampede stockholders into tendering their shares, even though they do not want to accept the offer as a whole, because stockholders are afraid that unless they subscribe to the high-valued front end of the offer they will be forced to accept the lower valued back end.

There is, however, no systematic evidence that two-tier offers have such a coercive effect, and there is substantial evidence that the market prevents such abuses from occurring. In particular, the market for takeovers is competitive and bidders who attempt to structure two-tier offers that result in a below-market price for the company's assets can expect to find themselves outbid by a superior offer with a premium closer to the target's actual market value.

Indeed, the SEC has found that, on average, there is no statistically significant difference between the blended premium offered in a two-tier bid (calculated as the weighted average of the higher valued front end and the lower valued back end of the offer) and the premium offered in single-tier bids. Moreover, data collected by the SEC show that in takeover battles between competing single-tier and two-tier bids the outcome of the contest is determined by the relative values of the competing offers. Thus, no single-tier bid has ever lost to a two-tier bid with a lower blended premium, despite the allegedly coercive effect of the two-tier bid.

In addition, two-tier tender offers can be desirable for target stockholders and managements. SEC data show that two-tier offers are used in friendly takeovers about as often as they are used in hostile takeover attempts. There are at least two reasons that target stockholders could prefer a two-tier bid. If a two-tier offer is properly structured, target stockholders who accept securities in the back end of the transaction may be able to defer tax due on the appreciated value of their shares. In addition, the acquirer may find that it is easier to finance the transaction by issuing securities for the back end than by borrowing funds from banks or through other financing mechanisms. If these savings induce the bidder to offer a higher blended premium, then the two-tier offer can also be beneficial for the target's stockholders.

Minimum Offering Periods

Critics of bidder tactics also object to the 20-business-day minimum offering period provided under the Williams Act. They claim 20 business days is not sufficient time for management of the target firm to fend off the offer or to identify higher alternative bids.

The 20-business-day minimum offering period required under the Williams Act provides approximately a calendar month within which a target can mount a defense. A study of 183 takeovers between 1962 and 1980 involving firms listed on the New York and American Stock Exchanges found that approximately 26 percent of these contests involved multiple bidders. The current minimum offering period thus appears to provide ample time for many targets to find alternate bidders. In addition, longer minimum offering periods would probably generate more of the same costs that accompanied adoption of the Williams Act: They would increase the cost of takeovers, reduce the total number of takeovers, reduce the benefits generated by the takeover process, and increase the premiums paid to stockholders of the fewer companies who receive offers. Such an outcome is not in the national interest because it reduces the aggregate gain from the takeover process and increases the resources spent on nonproductive bargaining over the allocation of these gains.

REGULATING DEFENSIVE TACTICS

The debate over defensive tactics is, in form and substance, quite different than the debate over bidder tactics. Some commentators suggest that a target's management should be allowed great latitude in fashioning defensive tactics against takeovers because management must protect stockholders against abusive bidder techniques. However, as just explained, there is little credible evidence that bidder tactics are abusive.

Instead, the more fundamental debate concerns when, if ever, a target management should be permitted to oppose a takeover that promises a significant premium to the corporation's stockholders. This question arises primarily because of the possibility that managements will attempt to maintain control over corporations despite the fact that stockholders would benefit by tendering their shares.

CONSEQUENCES OF DEFENSIVE TACTICS

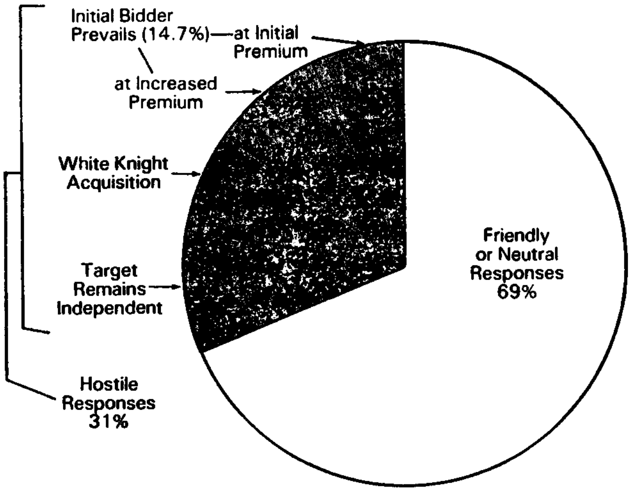
Chart 6–1 describes some of the consequences of target management opposition to takeover attempts. Between 1978 and 1983 there were a total of 429 tender offers involving publicly traded corporations. Sixty-nine percent of these offers were uncontested and 31 percent drew a hostile response.

From target stockholders' perspective, management opposition can improve the premium offered by the bidder either by inducing a higher bid from a "white knight" or by causing the initial bidder to increase its offer. Chart 6–1 shows that white knight bids and increased bids by initial bidders occur in 16.1 percent of all takeovers, or in about half of contested takeovers. In 6.5 percent of all takeovers (or about 21 percent of contested takeovers), managements' opposition has no effect on the identity of the prevailing bidder or on the premium paid. However, in 8.4 percent of all takeovers (or about 27 percent of contested takeovers) management succeeds in defeating the offer. In these cases target stockholders suffer substantial losses that various studies have estimated as ranging from 15 to 52 percent of the value that could have been obtained had the offer not been defeated.

Accordingly, from a target stockholder's perspective, it is significant to determine whether management is opposing a takeover in order to (1) start a bidding war or otherwise induce a higher price

Chart 6-1

Target Management Responses to and Outcomes of Tender Offers, 1978-83



Note.—Based on 429 tender offers.
Source: W.T. Grimm & Co.

for the company's shares, or (2) defeat a profitable bid so that the company remains independent and management retains its position. In the first case, management opposition can benefit stockholders so long as the opposition does not become so vigorous that it drives away all bidders. In the second case, if the opposition succeeds, it is almost certain to harm stockholders' financial interests by causing a substantial decline in the value of their shares.

Management's decision to oppose a tender offer is not, however, a random event. A study of 105 cash tender offers between 1972 and 1977 found that in contested takeovers the average potential wealth gain to management of the target company is significantly lower than in uncontested takeovers. This result occurs, in part, because target managements that oppose takeovers tend to own less stock in their companies than managements that elect not to contest takeovers. A recent survey of senior executives has also found that some executives place stockholder interests secondary to their personal interests in the survival of the corporation in which they have invested so much of their professional careers. This finding suggests that some managements do in fact respond to takeover bids with tactics designed to serve management's own interest, and not stockholders'.

However, even successful defensive tactics that increase target stockholders' premiums merely transfer wealth and do not increase aggregate wealth (except, perhaps, in instances when defensive tactics attract a higher white knight bid). Such contests over the allocation of gains are nonproductive from society's perspective. Indeed, if defensive tactics deter takeovers that would otherwise be beneficial, they can cause net losses for the economy as a whole. Accordingly, any defensive technique, even if calculated to increase the premium offered to target stockholders, runs the risk of causing a loss for the economy.

This risk is not, however, a sufficient basis on which to ban defensive tactics. There is no economically correct solution to the question of how the gains resulting from acquisitions should be distributed among bidders and targets. Bidders can validly claim that their activities generate the gains resulting from takeovers and that they are therefore entitled to those gains. However, targets can claim that takeover gains are not attainable without their assets, and that they have a right to negotiate for as much of those gains as they can capture. Moreover, a rule that requires stockholders to sell their shares simply because a bid at a premium has been made would not be good public policy. No such requirements are placed on privately held firms, and if there is no market failure in the governance of publicly traded firms, then there is no principled basis on which to prevent stockholders in target firms from negotiating over a share of those gains, even at the risk of losing some of those gains.

THE DEFINITION OF ABUSIVE DEFENSIVE TACTICS

The distinction between defensive tactics designed to increase bid premiums and those designed to defeat tender offers suggests a principled basis for distinguishing between abusive and nonabusive defensive tactics. As an initial matter, if a defensive tactic is explicitly adopted or sanctioned by the corporation's stockholders, it should not be considered abusive, regardless of the extent to which it might deter takeovers. Stockholders are responsible for acting in their own best interests. They have strong incentives to adopt whatever defensive measures they believe will maximize the value of the corporation's shares. Some corporations' stockholders might adopt anti-takeover measures including, for example, staggered elections for positions on the board of directors, super-majority requirements for the approval of mergers, or equal price provisions to deter two-tier offers. Other corporations' stockholders may refuse to adopt any anti-takeover measures and may even take steps designed to invite takeover bids. Indeed, in some publicly traded corporations, large stockholders have specifically sought to induce takeover bids so as to increase the value of their holdings.

The market can be expected to respond to stockholders' decisions about defensive tactics by either depressing the price of the company's shares (if the tactics make takeovers less likely or reduce the expected value of the premium) or by increasing the price of the company's shares (if the tactics make takeovers more likely or increase the expected value of the premium). Thus, the market is composed of a variety of companies with a range of takeover policies, and the implications of each company's takeover policy will be reflected in the market valuation of each firm's shares.

Defensive tactics are abusive only when management exercises its delegated discretion so as to promote management interests over stockholder interests. If a defensive tactic is used to increase the target stockholders' share of gains, but not to defeat the offer, the defensive tactic is being applied to promote the target stockholders' interests and should not be considered abusive. In contrast, a defensive tactic that seeks to prevent a takeover at a premium harms target stockholders by depriving them of the opportunity to accept the bidder's offer. On average, such defensive tactics also prevent bidders from realizing the benefits that result from takeovers. Accordingly, these tactics can be considered abusive and are a legitimate subject of concern to policymakers.

In many instances it will be difficult to distinguish whether a particular tactic is abusive. Indeed, as explained below, many commonly criticized defensive tactics have quite complex effects and cannot be labeled as abusive in all situations. Blanket rules to prohibit certain defensive tactics can therefore have unintended and undesirable side effects. Moreover, it is generally possible for managements to devise new strategies that circumvent specific statutory prohibitions. When potential abuses exist, case-by-case consideration of management defensive tactics by the courts is therefore likely to be a more effective remedy than an inflexible legislative stricture.

DEFENSIVE TACTICS FREQUENTLY CRITICIZED AS ABUSIVE

Targeted share repurchases ("greenmail") and severance contracts triggered by successful takeovers ("golden parachutes") are frequently criticized as abusive and are often the subject of debate. These practices are not, however, invariably abusive and are not proper subjects for Federal regulation.

Targeted Share Repurchases

Targeted share repurchases occur when a company buys back its stock from a large shareholder at a price greater than that at which the stock trades on the market. Often the stockholder whose shares are repurchased has proposed a takeover or other transaction that is opposed by the target's management. Critics of these repurchases claim the practice is abusive because management is using the corporation's resources to buy out a potential bidder and thereby preclude stockholders from earning a premium for their shares. Critics also claim the practice is unfair because it does not give all stockholders an equal opportunity to tender their shares. Indeed, repurchases can be used by target managements to "buy-off" potential acquirers and to entrench management's position at stockholders' expense. In many situations such repurchases can be abusive. This does not, however, establish that repurchases are invariably abusive or that they should be regulated by Federal law.

Targeted share repurchases have complex effects on the stock price of the repurchasing company. The announcement that a large blockholder has acquired a position causes a significant increase in the price of the target company's shares. The stock price increases because the acquisition signals a potential takeover of the target firm. A subsequent announcement of a repurchase causes a significant decline in the price of the target company's shares because it signals the withdrawal of a potential bidder and because the premium paid dilutes the value of remaining stockholders' equity in the firm.

The evidence regarding the net effect of such repurchases on the price of the target's shares, measured from the initial acquisition through to the repurchase, is mixed. Some studies conclude that stockholders reap substantial and statistically significant benefits over the period spanning the initial acquisition and subsequent repurchase. An examination of the question by the SEC has, however, found statistically insignificant evidence that stockholders suffer small losses over this period. SEC data also show that companies that engage in targeted share repurchases are often either acquired, recapitalized, or involved in management changes following the repurchase. Because a repurchase can act as a signal that the corporation is vulnerable to takeover attempts, the investment leading to the repurchase may therefore be a valuable stimulus for more fundamental and beneficial corporate changes.

Targeted share repurchases can also be beneficial because they can reduce the expected cost of takeover attempts, thereby increasing the number of such attempts and the number of takeovers. To the extent that the prospect of repurchases increases the volume of beneficial takeover activity, repurchase premiums can be beneficial for the economy as a whole.

Thus, although there are situations in which repurchases can be abusive, there are also situations in which repurchases are part of a sequence of events that is beneficial for stockholders. Accordingly, an across-the-board ban on targeted share repurchases would be overly broad, and it appears more reasonable to allow the merits of controversial repurchases to be judged on a case-by-case basis by the courts. Moreover, even if the Federal Government sought to prohibit repurchases, the prohibition could easily be evaded. Companies could, for example, trade assets or issue new and complex securities in return for a large stockholder's equity position. Unless the values of these assets and securities were readily ascertainable, it would be most difficult to determine whether the company paid a premium to the large stockholder who is bought out. In addition, corporations that want to ensure that they are not subject to demands for targeted share repurchases can adopt charter amendments prohibiting such transactions. Large New York Stock Exchange traded corporations have recently adopted such amendments. Corporations thus already have it within their power to protect themselves against whatever abuses they perceive in targeted share repurchases and Federal Government regulation can add little to corporations' ability to protect themselves. Indeed, as explained below, it is preferable to allow individual companies to decide whether and how they want to protect themselves than to have the Federal Government dictate an inflexible nationwide policy.

Severance Contracts

Another controversial tactic used by defending managements is the granting of lucrative severance agreements that take effect in the event of a change in corporate control. Critics of these "golden parachutes" claim they represent an attempt by target management to protect its own interests at stockholder expense. Defenders of the practice claim that the contracts give management the security it needs in order to negotiate the best possible price for the target's shares, without regard to management's concerns over its own job security.

The available evidence on the effects of these severance contracts is inconclusive. A study of 90 companies that have adopted such contracts shows a small, statistically insignificant positive effect on stock prices. Moreover, the Deficit Reduction Act of 1984 imposes substantial tax burdens on certain severance contracts. The market has not yet had an opportunity to respond fully to these new tax law provisions, and it is too soon to be able to assess the impact of this legislation on takeover-related severance agreements.

In addition, even if the Congress sought to prohibit severance contracts adopted while a takeover bid is pending, firms could readily avoid that prohibition by entering into the contracts prior to announcement of a tender offer. A recent survey of 560 of the *Fortune* top 1,000 companies showed that about 25 percent already have some form of takeover-related severance agreements with senior management. Indeed, the labor market for senior executives may in some situations require that senior managers be offered takeover-related severance agreements, just as sports stars negotiate "no-cut" and "no-trade" contracts with athletic teams.

Federal regulation of takeover-related severance contracts would thus not have any clear benefits for stockholders or for the economy at large. In addition, such regulations would be difficult to enforce and would constitute a major intrusion into an area that is traditionally subject primarily to State regulation.

REMEDIES OTHER THAN FEDERAL LEGISLATION

In addition to these two examples of frequently criticized defensive tactics, there are many other techniques that managements use in order to fend off takeovers. Each of these techniques can be judged by the same criteria applied to repurchases and severance contracts: If they are approved by stockholders, or if they are reasonably calculated to result in an increased expected premium for stockholders, then they are not abusive. However, because a given defensive tactic can often be used both for the purpose of defeating an offer as well as for the purpose of inducing a higher bid, each controversial application of a defensive technique is best judged on a case-by-case basis by the courts, and not under blanket prohibitions established by Federal regulations. Moreover, stockholders already have available to them many avenues of recourse that may be more effective remedies for management misconduct than Federal legislation.

Stockholder Suffrage

Many experts have long been pessimistic about stockholders' ability to oppose management initiatives. Much of this pessimism is rooted in the view that stockholders, as a group, have interests that are too diffuse to make it reasonable for them to band together to oppose management proposals. Recent developments, however, suggest that this situation is changing and that stockholders potentially have a more powerful voice in corporate governance than previously thought.

According to the SEC, 20 institutional investors in 1978 owned more than 10 percent of the total value of publicly held shares. More recent data show that institutional investors own approximately 36 percent of the voting stock of companies listed on the New York

Stock Exchange. When the holdings of certain trusts and investment funds are added to the total, institutions have the ability to influence or control about 50 percent of the voting power represented by shares traded on the New York Stock Exchange.

A recent study of the distribution of stockholder interests in 511 large corporations also suggests that voting power in larger corporations is not as diffuse as commonly believed. On average, the five largest stockholders in these 511 corporations control about 25 percent of the corporation's shares, and the 20 largest stockholders control about 38 percent of the corporation's shares. Thus, on average, the five largest stockholders in these corporations need to obtain the agreement of stockholders controlling only one-third of the remaining shares in order effectively to control the corporation. A coalition of the 20 largest holders, on average, would need cooperation from stockholders controlling only about one-fifth of the remaining shares in order to control the corporation.

In addition, the SEC has found a trend away from the "Wall Street Rule"—institutional investors' traditional practice of expressing displeasure solely by selling their shares—and a move toward more active participation by institutions in corporate governance. At least two major institutional stockholders have initiated litigation against corporations that have engaged in targeted share repurchases and many institutional stockholders frequently vote against anti-takeover proposals. In at least one instance, institutional investors proved instrumental in requiring that management of a major firm seeking to adopt anti-takeover amendments to the corporate charter abandon these attempts and instead appoint a committee of outside directors to consider takeover proposals. Soon thereafter, the corporation was the object of a takeover that afforded stockholders a handsome premium.

Stockholder self-help therefore has the potential to be a more effective check on management abuse of defensive tactics. A significant benefit of stockholder self-help is that it does not require that the government, either at the Federal or State level, impose restraints on what is essentially a private contractual relationship between a corporation's stockholders and its management. Instead, by relying on self-help mechanisms, each corporation will be able to select the governance structure most suited to its particular circumstances and no single rule will be imposed by law on all companies.

Under such a regime, the capital markets can be relied upon to generate a distribution of governance schemes and associated stock price values. Some companies will have governance rules that make them difficult hostile takeover targets, while others will be relatively easy to purchase with a hostile bid. The stock prices of individual companies will incorporate the effects of each company's defensive posture. If stockholder suffrage is an effective check on management conduct, this situation is far preferable to a world in which all companies are required to adopt identical takeover defense policies.

Improved Executive Compensation Contracts

The potential for abusive management conduct can also be diminished by implementing incentives that align management interests more closely with stockholders'. As previously noted, managements of publicly traded corporations tend to oppose takeover bids when the takeover is relatively harmful to management's private financial interests. Typically, this occurs when management has a relatively small equity interest in the company. This problem can be reduced by giving management a stronger private incentive to maximize the value of the corporation's shares in takeover contests. Stock options and incentive contracts that pay management a percentage of the premium offered in takeover contracts are two examples of private contract mechanisms that may be able to resolve large parts of the defensive tactics debate.

Recourse to the Courts

Stockholders also have recourse to the courts if they believe management has abused its delegated discretion. In evaluating management's response to a takeover bid, courts typically apply the "business judgment rule." Under that rule, a board of directors historically "enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is and what is not sound business judgment."

The great latitude afforded to management under the business judgment rule has often made it difficult for shareholders to persuade courts that management has behaved unreasonably in opposing a takeover bid. Recently, however, the Second Circuit Court of Appeals, a particularly authoritative Federal court in matters of corporate governance, has tightened its interpretation of the business judgment rule and has recognized that defensive measures adopted in the course of a takeover battle can involve a measure of management self-interest. The court therefore concluded that, under certain circumstances, defensive tactics adopted in a takeover contest are to be evaluated under a stricter fairness standard that gives substantially less deference to target management judgments. Other courts have also indicated increased sensitivity to problems arising in takeover situations. The state of the law is currently in flux, but it now seems possible that the business judgment rule will, through the natural evolution of the case law, provide a more powerful deterrent against perceived takeover abuses than it has in the past.

The Economic Value of Federalism

Corporate law has traditionally been the subject of State rather than Federal regulation. For many years, State regulation of corporate governance has been criticized by some commentators as the result of a race to the bottom, in which States compete with each other for the revenues generated by corporate charters. According to this theory, decisions about the legal domicile of a corporation are primarily under management's control, and the States compete with each other by fashioning corporation codes that favor management interests over stockholder rights. The States that adopt laws most favorable to management attract the largest number of corporations and win the race to the bottom. From this perspective, State corporation law fails adequately to protect stockholder rights.

The opposing view is that corporations choose domiciles that maximize the value of the firm's shares. Accordingly, competition among the States gives the States an incentive to adopt policies that are beneficial for stockholders. If this view is correct, competition among the States is to be preferred to Federal regulation of corporate charters that would inhibit experimentation and competition in the design of superior governance techniques.

This debate cannot be resolved on a theoretical level, and it is instead necessary to consider the empirical evidence regarding the stock price effects of changes in corporate domicile. The available evidence suggests that changes in corporate domicile are correlated with increased stock price valuations. This finding is consistent with the competitive model of federalism, not with the race to the bottom, which predicts decreased stock prices as a consequence of changes in domicile that elevate management interests over stockholders'. Accordingly, competition among the States appears to be beneficial, and there is no systematic evidence in support of the theory that competition among the States has harmed stockholders.

Because the evidence is that deference to the States in matters of internal corporate governance is beneficial, there is a sound economic rationale for continued reliance on the principle of federalism in the market for corporate control. Of course, if the nature of competition among the States changes, and States that charter a significant percentage of publicly traded corporations adopt protectionist statutes or interpretations of law that promote managements' ability to abuse delegated discretion, then the limits of federalism as applied to the market for corporate control may have to be reconsidered.

CONCLUSION

The public has a legitimate interest in the continued strength and vitality of the market for corporate control. Publicly traded corporations account for a substantial portion of the Nation's wealth and productive capacity, and it is important that the management of these firms not be insulated from competition in the market for corporate control. The available evidence is that the operation of this market has generated net benefits for the economy. The evidence also suggests that abusive practices in the market for corporate control are limited largely to tactics employed by target managements who, in opposing takeover bids, defeat or deter tender offers at the expense of their stockholders and the economy.

Remedies for these abuses can often be fashioned within the corporation itself. Stockholders also have recourse to the courts which have recently indicated a willingness to subject target management conduct to closer scrutiny. In addition, abusive conduct by corporate management has traditionally been a subject of State regulation; the available evidence indicates that federalism has served stockholders well. Accordingly, further Federal regulation of the market for corporate control would be premature, unnecessary, and unwise.