

MOTIVATIONS OF OFFEROR COMPANY DIRECTORS IN CORPORATE ACQUISITIONS

BY
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1. INTRODUCTION

This paper examines the motivations of offeror directors when engaging in corporate acquisitions. Despite the importance of the subject for policy formulation, it has received little attention in the Law Reviews. In contrast, the related but opposite subject of target company directors' duties has been extensively discussed. Such neglect can be explained by the legal system's failure to adequately appreciate the issue of managerial motivation. The fiduciary obligations imposed by general law, while prohibiting fraud, misrepresentation, and to some extent self dealing (through the twin requirements of loyalty and good faith), imposes no positive obligations. Statutory law has altered the scene to a small degree only. Under the disclosure philosophy, prospectus-type information must be provided in certain circumstances. Legislation also has strengthened the prohibition against self dealing. More specific legislation, dealing with tender offers, makes the provision of information continuous and timely, while providing certain guarantees of fair treatment for all target shareholders. Similar obligations are also imposed on the offeror. None of this, however, gets to the root of what is known as the "agency" problem (*e.g.*, the problem resulting from the separation of control from ownership). Based on a study of these offeror director motivations with respect to corporate acquisitions, and empirical evidence of the results of acquisitions, this paper argues that greater restraints should be imposed on the number of acquisitions taking place. The point made is that what is needed in all jurisdictions is not more acquisitions (mergers), but acquisitions that increase net gains.

2. AGENCY THEORY AND ACQUISITIONS

The firm, in economic theory, means the gain producing entity. In this sense, the entity could vary from the sole trader to the large modern corporation. The focal point, therefore, is the abstract entity which

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transforms inputs into outputs. As far back as 1776, Adam Smith highlighted the agency problem with respect to the corporation.¹

Despite identification of the problem at so early a point of time, the orthodox tradition in economics continued to view the firm as a single unit in the nature of a single owner manager making all the relevant decisions in a market environment that is perfectly competitive. In this rarefied atmosphere, corporations, like individuals, are regarded as being engaged in the relentless pursuit of profits. As is evident, this view does not acknowledge any conflicts of interest between the agents (management) and the corporations, and between agents. Consequently,

¹ A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (E. Cannan ed. 1937). To quote:

The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Id. at 700.

To illustrate the agency issue further, assume principals A and B and respective agents A1 and B1. Transactions entered in to by A and B (independent of A1 and B1) supposedly benefit both parties. Absent extraneous considerations, such a transaction would not have been entered into by the principals unless both parties indeed do benefit. However, where the transaction is entered into by A1 and B1 on behalf of A and B respectively one of several consequences can result:

- (1) A and B both benefit;
- (2) only A or B benefits;
- (3) A or B benefits at the expense of the other;
- (4) neither A nor B benefits;
- (5) A1 and B1 may choose to ignore transactions beneficial to the two principals;
- (6) A1 and B1 may act to directly further their own interests; and
- (7) numerous other outcomes.

The difficulty is that each of the above could be the product of (1) the natural bargaining process, (2) calculated misconduct, or (3) indifference. It is argued that since the welfare of agents depends on the welfare of their principals, agents would therefore act as their principals would. Such an argument, however, presumes that every time the principal benefits the agent also benefits. While concern for the principal's welfare is necessary in an aggregate sense, there is no need for the agent to have that concern in every transaction. Often, the interest of the agents may well differ from those of the principals they are presumed to serve.

The illustration given above typifies only single layer principal-agent relationships. Because of the highly diffused nature of stock ownership, the relationship between principal and agent may be so far removed as to make the entire relationship one between agents. Thus, a hierarchy of agents may be present. These hierarchies arise for several reasons, including (1) functional inseparabilities; (2) the nature of the employment relationship; (3) uncertainty concerning one's own abilities or other's perceptions of them; and (4) informational economies of scale. Where a hierarchy of agents is present in the modern corporation the possibilities of non-optimal agent behavior multiplies.

it views acquisitions as yet another form of profit maximization. Offerors are regarded as seeking and acquiring firms whose resources are undervalued² in the share market and putting them to more efficient use. The theory also regards acquisitions as conferring on firms the

² A firm's shares may not reflect their true value either because its assets are undervalued or because its price-earnings ratio is low. Assets may be undervalued because of their inefficient use (present and potential), inadequate use of debt capital (and hence an inefficient capital structure), and poor distribution of dividends. Valuation is commonly determined by the ratio -

$$\frac{\text{share price}}{\text{net assets per share}}$$

where the numerator shows the value of shares as placed by the market, and the denominator shows the value of net assets per share as placed by the company. Where the ratio is less than unity, the company is undervalued, i.e. the lower the ratio, the greater the undervaluation. A company would be an attractive target even if its valuation ratio is greater than unity if it is a major competitor, or if the acquirer's valuation ratio is itself high. Acquisition in the latter instance will serve to provide additional asset backing to the acquirer's shares.

Where share price is determined by reference to earnings, asset value will be of little direct importance, though it will still be a factor influencing its determination. Price-earnings is determined by the ratio -

$$\frac{\text{share price}}{\text{earnings per share}}$$

where the lower the ratio, the more likely it is to be subject to a bid. Where a share sells at \$1 and earns 10 cents the ratio is 10, i.e. the share is said to be selling at 10 times its earnings (or at 10 years non-discounted earnings attributed to that share). Likewise, where the share sells at \$1.50 the ratio is 15, and if it sells at 50 cents, the ratio is 5. A low ratio reflects a poor growth outlook, which bidders may feel could be improved. Even if a firm's ratio is comparable to the industry it is in, it would still be an attractive target to an offeror who has an even higher ratio. The purposes for acquisition attributable to undervalued assets apply equally to low price-earnings ratios. Even a company with a high price-earnings ratio (compared to the offeror) could be an attractive target if its price-earnings ratio can be expected to grow faster than that of the offeror.

A few other measurements commonly used to determine the prospective worth of a target are profitability, liquidity, and dividend performance. Profitability is derived from the ratio -

$$\frac{\text{earnings}}{\text{capital employed}}$$

This analysis indicates the rate of return that will be earned post-acquisition under existing management and policies. A low return generally implies inefficient management, though it may also be explainable in institutional terms. Again, it is an inappropriate measure of efficiency and performance in times of rapid firm expansion or contraction. An allied measurement is growth in profitability viewed in terms of the company's past performance (percentage change in earnings per share) over a period of years. From this figure, future earnings for the firm are projected. A poor growth rate indicates inefficient management.

Gearing reflects the balanced use of loan and equity capital. Excess liquidity may indicate inefficient use of capital, but offers the attraction of cash or dividend stripping. Dividend performance is not in itself an influential factor unless it is seen as heralding a decline in future profits. See generally M. FIRTH, *SHARE PRICES AND MERGERS* ch. 4 (1976).

benefits of synergy from resulting economies of scale, finance benefits, diversification benefits and tax benefits.³ Against this, it is argued that acquisitions are primarily motivated by reasons of managerial self interest.⁴ The views of William Baumol⁵, Oliver Williamson⁶ and Robin Marris⁷ are representative of this latter viewpoint. They assume that management pursues its own goals, including the growth of firm size, rather than shareholder welfare, though such growth is subject to a profit constraint. The contention is that beyond a prescribed point, further growth will, by reason of productive and administrative inefficiencies, depress profitability. The growth objective itself takes different forms. Baumol assumes sales maximization, Williamson assumes utility maximization (comprising administrative expenses, managerial emoluments and discretionary projects — the extent of these corresponding to firm size — and hence the desire for growth in firm size) and Marris assumes growth maximization generally. They are all maximizing models.

2.1. *Baumol's Model*

Baumol claims that firms act to maximize sales revenue (*e.g.*, the dollar volume of sales not the physical volume of the goods sold) rather than profits. He presents two models: (1) a static single-period model, and (2) a dynamic multi-period model, each having two versions, one with advertising activities, and the other without. Baumol points out

³ See Watson, *The Determination of Share Exchange Ratios in Mergers*, in THE CORPORATE MERGER 117 (W. Alberts & J. Segall ed. 1974); see also J. BUTTERS, J. LINTNER & W. CARY, EFFECTS OF TAXATION ON CORPORATE MERGERS (1951) (examination of the effects of tax laws on corporate mergers); Levy & Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FIN. 795 (1970) (real economic gains are produced even from a large conglomerate merger). But see Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303 (1974) (such benefits will not be available in a competitive acquisitions market where the offer price would reflect the potential gains); Ruback, *Competition in The Acquisition Market*, 11 J. FIN. ECON. 141 (1983) (limited empirical evidence exhibits a competitive market for corporate acquisitions).

⁴ The theory does not assert that all mergers are unprofitable, but rather the converse that not all mergers are profitable. Presumably, a greater percentage fall into the latter category. Some argue that acquisitions also result in market concentration, monopolistic power, and the generation of monopoly rents. See Mueller, *The Effects of Conglomerate Mergers*, 1 J. BANKING & FIN. 315 (1977); S. RHOADES, POWER, EMPIRE BUILDING AND MERGERS (1983).

⁵ See W. BAUMOL, BUSINESS BEHAVIOUR, VALUE AND GROWTH, (1967) (firms act to maximize sales).

⁶ See O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM 28-37 (1967) (personal gains are important motivators within organizations).

⁷ See R. MARRIS, THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM (1967) (manager will maximize the rate of growth within a secure framework).

that declining sales can bring all sorts of disadvantages.⁸

Both of Baumol's models assume conventional cost and revenue functions (U-shaped cost curves and downward sloping demand curves) as the firm is considered to act independently of the actions of its rivals. The theory also implicitly assumes that the firm has market power, including control over its price and expansion policies unaffected by competitors' reactions. It does not explain observed market situations where the price is kept in the range of elastic demand for long periods of time. The theory, although dealing with oligopolies, does not explain

⁸ See W. BAUMOL, *supra* note 5, at 45.

There is a reason to fear that consumers will shun a product if they feel it is falling in popularity, though their information on these matters is certainly often spotty. Banks and the money market will tend to be less receptive to the desires of a firm whose absolute or relative sales volume is declining. Perhaps even more important in this connection is the very real danger that firms whose sales are falling will lose distributors - a major marketing setback. Management also is not unmoved by the fact that in a declining firm personnel relations are made much more difficult when firing rather than hiring is the order of the day. The firm that declines (or remains small when others expand) can lose monopoly power and the power to adopt an effective competitive counter strategy when one is called for, and it may become more vulnerable to a general deterioration in business conditions. For all these reasons the executive may reasonably conclude that maintenance of as large a sales volume as possible is the only way to succeed in business.

Even if size did not promote profits, personal self-interest could well induce the managers of a firm to seek to maximize sales. Executive salaries appear to be far more closely correlated with the scale of operations of the firm than with its profitability. *Id.*

Under the static single period model the firm maximizes its sales revenue subject to a "minimum profit constraint", i.e., an amount high enough to keep stockholders satisfied and contribute adequately to the financing of company growth. Failure to achieve the minimum constraint, says Baumol, will result in share prices being depressed, the firm becoming a takeover target and/or incumbent management being dismissed. In the short run, the constraint is imposed by the capital market. The long run presents a tradeoff problem. The larger the earnings the easier it would be to obtain funds from the capital market. But sales maximization implies a reduction in profitability. So an intermediate level of profit that is optimal is aimed at. Looked at in this way, says Baumol, the profit level does not take the form of a constraint, but "becomes an instrumental variable whose value is determined as part of the optimality calculation. *Id.*, at 50. Thus, where profits are too high firms would increase their advertising outlay to increase their revenues. Conversely, the existence of such excess profits indicates that sales are less than they would have been if these extra profits had been used for sales promotion.

In his dynamic model, Baumol reformulates his argument by expressing the objectives of the firm in growth-maximizing terms, e.g., that growth is desired primarily as a means to greater profitability. A. KOUTSOYIANNIS, *MODERN MICROECONOMICS* 342 (2d ed. 1979); see Baumol, *On The Theory of The Expanding of The Firm*, 57 *AM. ECON. REV.* 1078, 1085 (1962); W. BAUMOL, *supra* note 5, at 86. The firm's time horizon is not limited to a single period but extended over its entire lifetime and the profit constraint is endogenously determined. This overcomes the main criticisms against the static model. Also, profit is not a constraint as under the static model. It is an instrumental variable, i.e., a means whereby top management achieves its goals of sales maximization. Profit, however, is the main means of financing sales growth. See Baumol, *On The Theory of The Expanding of The Firm*, *supra*.

the core problem of uncertainty in non-collusive oligopoly markets.⁹ Also, the various empirical studies to test Baumol's hypothesis have proved to be largely inconclusive.¹⁰

2.2. *Williamson's Model*

According to Williamson, managers seek to maximize their non-pecuniary goals in many ways.¹¹ These include such items as security, dominance (including status, power, and prestige which are tied to the size of the firm), and professional excellence. Williamson notes that even though salary in itself has an important bearing in relation to the business enterprise, it is not a "motive" in the same sense as the other factors listed, but is only a means of achieving security and dominance. Williamson provides a framework of reference to his "managerial utility" maximizing model. Under this model, managers act to maximize their own utility by reference to "expense preferences" which include staff, emoluments, and discretionary profit (*e.g.*, the difference between investment decisions made out of economic necessity and managerial aggrandizement). The latter recognizes that managers are able to direct the investment of the firm's resources in a way that will improve their position with respect to the enterprise. Such utility maximization is subject to what Williamson calls the "profit constraint", where reported profits are greater than or equal to the minimum profits demanded.¹²

The basic behavioral assumption of the model is the same as the basic rationality assumption, in regard to the advancement of self interest. Where a state of vigorous competition is lacking in the marketplace, the model yields implications that are different from the traditional profit maximization model.¹³ In other words, this model recognizes the results of the profit maximization hypothesis under conditions of pure

⁹ A. KOUTSOYIANNIS, *supra* note 8, at 349.

¹⁰ *Id.* at 348 (a survey of such inconclusive studies).

¹¹ O. WILLIAMSON, *supra* note 6, at 28-37.

¹² *Id.*; R. CYERT & J. MARCH, *A BEHAVIOURAL THEORY OF THE FIRM* ch. 9 (1963).

This is made clearer by Williamson's classification of profits as follows:

(1) Maximum profits, i.e. profits which the strictly profit-maximizing entity would have obtained by equating marginal revenue to marginal cost;

(2) Actual profits, i.e. maximum profits less the amount of excess expenditure on staff;

(3) Reported profits, i.e. maximum profits less the amount of management slack absorbed as cost (taxable profit); and

(4) Minimum required profit (after tax-profits), being the lowest level of profit required by management to continue to retain control. It is from this amount that dividends and internal growth funds are obtained.

O. WILLIAMSON, *supra* note 6, at 42.

¹³ O. WILLIAMSON, *supra* note 6, at 59.

competition.¹⁴ In his later works, Williamson suggests that most of the difficulties encountered by firms on these matters have been overcome by the adoption of M-form (Multi-form) structures as against U-form (Unitary form) structures. The latter claim is discussed below.

2.3. Marris' Growth Model

According to Marris, managerial capitalism causes managers to show a high preference for company growth achieved by such actions as developing new products, advertising, and finding new markets. Such growth is subject to the constraint of a takeover threat; if expansion is at the expense of profitability (thereby depressing share prices), raiders would find the company an attractive target. This tradeoff between growth and the likelihood of takeover is conditioned by management's concern for job security. Managers also show a preference to grow into positions of power within their own organizations and influence its growth rather than move on to other firms. Therefore, managers aim to maximize the *rate of growth* (change in size) of the firm rather than maximize its absolute size. For, if size in itself was their concern, they would move onto larger firms. Since salary, power, and prestige all result from policies of rapid growth, managements are likely to seek the growth of their own organizations as one of the best methods for satisfying such personal needs and ambitions.¹⁵ Consequently, management actions are conditioned by the following: (1) steady state growth, linking growth rates and share prices; (2) non-involvement with risky investments, and (3) prudent financial policy, all maximizing *rate of growth* as distinct from growth in absolute size.¹⁶

¹⁴ As Williamson states:

[I]n the absence of vigorous competition in the product market and where the separation of ownership from control is substantial, there is no compelling reason to assume that the firm is operated so as to maximize profit. On the contrary, such behavior would appear to require an unusual variety of rationality - and one not widely found in human affairs - namely, a complete detachment of individual interests from occupational decision making. Thus . . . where discretion in the decision making unit exists, this will ordinarily be exercised in a fashion that reflects the individual interest of the *decision-makers*.

Id. at 55.

¹⁵ Marris, *A Model of the Managerial Enterprise*, 77 Q. J. ECON. 185, 187-88 (1963).

¹⁶ *Id.* at 189-90. See generally R. MARRIS, *supra* note 7, for a general overview of definitions used here, including growth of the firm which will be defined as growth of the firm over a period of time during which most of the relevant economic variables (e.g., sales, profits, assets) grow at a constant rate. The firm chooses among many different growth rates. Prudent financial policy will be determined by three crucial financial ratios:

Marris' corporate growth theory is tied to his "valuation ratio."¹⁷ From this Marris "assumes" that, other things being equal, the firm is a likely target to a bidder who values it at a ratio higher than the market value¹⁸ and the value placed by other bidders.¹⁹ Marris' theory also implies that acquirers have higher valuation ratios than targets. Both assertions have been empirically tested by several researchers, notably Singh and Newbould.²⁰ Singh's evaluation is that the market for

(1) leverage or debt ratio -

$$\frac{\text{value of debts}}{\text{total assets}}$$

(2) liquidation ratio -

$$\frac{\text{liquid assets}}{\text{total assets}}$$

(3) retention ratio -

$$\frac{(\text{retained profits})}{\text{total profits}}$$

referred to collectively as the "financial security constraint".

¹⁷ R. MARRIS, *supra* note 7, at vii. "Book value: the original cost of an asset, less the proportion of original value deemed by the firm's accountants to have been lost through depreciation, adjusted for any change in the supply price of assets of this technical description and performance which may have occurred since it was installed." *Id.*

¹⁸ See D. KUEHN, TAKEOVERS AND THE THEORY OF THE FIRM 57 (1975).

¹⁹ R. MARRIS, *supra* note 7, at 31. The assertion takes two forms. In its strong form it has been interpreted to mean that unless a firm achieves the minimal valuation ratio it is almost bound to be acquired, though once such ratio is achieved, it is more or less safe from acquisition. In its weaker form, it has been taken as meaning the higher the valuation ratio of a firm, the lower the chance of its being acquired. The lower the valuation ratio, the less the acquirer will have to pay for the acquisition. See generally A. SINGH, TAKEOVERS THEIR RELEVANCE TO THE STOCK MARKET AND THE THEORY OF THE FIRM (1971) (exhaustive statistical analysis examining valuation ratios and other determinants).

²⁰ On the question whether acquiring firms "have higher valuation ratios than the acquired," Singh concluded that "the acquiring firms have higher, but not significantly (at the 5 percent level) higher valuation ratios than the acquired ones". Newbould is far stronger in his rejection. Out of a survey of 74 attempted mergers, the target had a higher valuation ratio than the average for its industry in 41 cases (55%); the victims in the remaining 33 cases had a lower-than-average valuation ratio for the industry. Of the 64 actual mergers, 33 firms (52%) had a valuation ratio higher than their target, the remaining 31 firms having a valuation ratio lower than their target. On whether there exists an inverse relationship between acquisition and low valuation ratios, Singh found that although the valuation ratio of the acquired firms were significantly less than that of the non-acquired firms, there was a very considerable degree of overlap between the two groups. G. NEWBOULD, MANAGEMENT AND MERGER ACTIVITY 104 (1970). According to the evidence, there was a relatively large number of acquired firms with above average valuation ratios, with a similarly large proportion of non-acquired firms with valuation ratios below the average for their respective industries. D. KUEHN, *supra* note 18, at 48.

Singh therefore states:

This evidence clearly refutes the valuation-ratio constraint in the strong form described below. It also suggests that the inverse relationship between the valuation ratio and the probability of takeover is likely to be

corporate control provides a rather weak constraint on managers and that as the firm increases in size, the constraint decreases.²¹ But there is still some constraint which tends to be more effective on smaller rather than larger firms. Consequently, the threat of takeover, far from restraining growth by acquisitions, actually encourages it.

Newbould's thesis goes further. He argues that the primary motivation for acquisitions is managerial self interest. Newbould found that rational business reasons including market dominance, defensive tactics and reinforcement accounted for over sixty percent of the mergers.²²

very weak. Thus the achievement of a relatively high valuation ratio, far from guaranteeing a firm against take-over may not even greatly reduce its chance of being acquired.

A. SINGH, *supra* note 19, at 23.

²¹ However, Kuehn's findings on both issues is supportive of Marris. Kuehn states:

Both at the industry level where it was found to be significant in a majority of industries and at the aggregate level in the analysis in the present chapter, the inverse relationship between the valuation ratio and the likelihood of takeover (or in the profit model, the positive relationship between the proportion surviving and the low valuation ratio) has emerged. The profit rate and the growth rate similarly emerge as indicators of whether or not the firm will be taken over. Separate analyses were undertaken for the valuation ratio and the financial indicators of performance, for, following Marris, it was expected that the impact of the firm's past performance and present state would be felt via the valuation ratio. It is for this reason he concentrates his attention on the valuation ratio as the primary constraint on managerial behaviour. Having established the existence of this constraint both in its weak form (as a probability function) and in a strong form (as a threshold value which varies normally between firms as in the profit transformation), a necessary condition of the growth maximization hypothesis with the valuation ratio constraint has been demonstrated.

D. KUEHN, *supra* note 18, at 125.

But see Singh, Book Review, 14 J. ECON. LIT. 505 (1976) [hereinafter Singh, *Book Review*]. Singh asserts that Kuehn has:

adopted a peculiar procedure for comparing the taken-over and non-taken-over companies, which seriously biases his results. For instead of comparing the characteristics of the two groups of firms *over the same time-period*, he compares the sizes of taken-over firms, in the *one year before take-over* with the average sizes of the surviving firms, *averaged over the entire 13-year period 1957-69 or over all available years*. Quite apart from other biases that this method would introduce, it would *ceteris paribus* tend to overstate the size of taken-over, relative to that of non-taken-over, firms for the simple reason that there was an enormous increase in company size over time and a disproportionate number of take-overs occurred during the merger.

Id. at 507.

See generally Singh, *Take-overs, Economic Natural Selection, and the Theory of the Firm: Evidence From the Post-war United Kingdom Experience*, 85 ECON. J., 497 (1975) [hereinafter Singh, *Take-Overs*] (take-over discipline was very weak in general, especially in very large firms).

²² Newbould's argument is based on responses from 38 companies to a question-

2.4. The Choice

None of the shortcomings highlighted above, however, point the

naire requesting ranking of reasons for the particular acquisitions. Newbould found:

(1)market dominance, *e.g.*, "the collective desire to acquire quick and certain shares of the market and to eliminate competition", to be the main reason (27%);

(2)defensive *e.g.*, "representing the collective intention to preserve existing market and industrial positions", a close second (21%);

(3)re-enforcement, *e.g.*, "a mixture of some firms deserving to be taken over and other firms seeking in particular firms opportunities for the management to work upon", third (16%).

On the basis of these groups the rankings are:

TABLE 7

	Marks	Percentage of total
Market dominance	102	27
Defensive	81	21
Re-enforcement	60	16
Diversification	34	9
Financial	33	9
Technological/Economic	29.5	8
Capacity (Siv,v)*	14	4
Eliminate inter-company transactions	10	3
Government influence	7.5	2
Industrial reorganization (Sii, iii)*	5	1
Institutional influence	2	
Ambition	2	
	380	

*These two have not been grouped together, for there was no suggestion from those reporting "capacity" reasons that it was other than a problem for their own firm.

G. NEWBOULD, *supra* note 20, at 138.

On the restraining effect of the valuation ratio, Newbould says:

The conclusion is that the valuation ratio, which is the best indication of management success and market recognition of the individual firm, is irrelevant to the incidence of mergers in 1967 and 1968.

The management of a firm cannot avoid (or hasten!) a merger situation by following strategies designed to include a consideration of the valuation ratio.

The valuation ratio has not been found able to offer any explanation of the incidence of mergers, either in indicating those firms which receive bids, those which make bids, or in explaining the incidence of merger activity over time. Perhaps this is another example of the excess rationality imputed by economists into the actions of management.

Id. at 105-107.

According to financial management and capital projects analysis, target acquisitions costs are no different than costs incurred in undertaking any other investment opportunity. The standard textbook practice is the discounted cash flow method (or a variant thereof). *Id.* at 81.

According to another writer:

[T]he valuation process is, in its fundamentals, no different for a prospective acquisition than for any other capital project. Whether a firm is considering replacing a new machine, constructing a new plant, or buying

way out of agency relationships as the advantages of the use of agents far outweigh any problems associated with that use. Agency extends the capacity of the principal far beyond what he can do on his own. The difficulty is to ensure primacy of the principal's interest. The owners face the familiar tradeoff decision between reducing the agency problem and increasing the monitoring costs to oversee the agents. The difficulty is explainable partly by reference to the modern corporation's governance structure and also by the problem of entropy. Management receives, evaluates and translates external opportunities and constraints into internal opportunities and constraints. Management induces performance and provides a sense of direction and control within the firm while at the same time evaluating the nature of performance on the inside against the demands from outside. But the organization must also struggle against actual or potential organizational and effort entropy. Unless there is persistent exercise of very strong controls (monitoring) of the tasks performed by management, it is likely that the performance would fall short of the owners' expectations.

the assets or shares of another firm, it is considering the investment of capital in the present in exchange for a "stream" of cash returns in the future. In all three projects its problem is to determine whether the returns are large enough to warrant the required capital outlay, or - essentially the same thing - what capital outlay is warranted by the returns the project promises.

Schwartz, *Merger Analysis as a Capital Budgeting Problem*, in *THE CORPORATE MERGER* 139 (W. Alberts & J. Segall eds. 1966).

This process views the acquisition decision as a form of outlays and estimated inflows resulting from use of the assets, and is calculated on the basis of a discounted cash flow. However, out of 38 firms surveyed by Newbould, none seemed to have used this method. Instead, the techniques used were: (1) asset value (8 firms); (2) current market price (7 firms); (3) price earnings ratio (5 firms); (4) relative value of target to bidding firm based on current profits/current market prices, and splitting the equity capital of the enlarged bidding firm in that ratio (5 firms); (5) multiple of profits (3 firms); (6) previous peak price (1 firm); (7) comparison with similar quoted company (1 firm); (8) mixture with emphasis on profitability/growth of profits/asset value (5 firms); (9) unknown by respondent (2 firms). G. NEWBOULD, *supra* note 20, at 82. Such divergence once again highlights the strong managerial motivations (which Newbould calls "management" costs) underlying acquisitions. To quote Newbould:

Management has never been observed to act in response to strict financial criteria, and in the case of a merger there are considerations which cannot be reduced to financial terms, and which may overrule financially correct actions.

For example, there is defensive strategy. If the management of a firm sees its market position being threatened, say by a merger between two competitors, it will be obvious if life is going to be more competitive and difficult; and how much financial analysis would it take to deter the management from taking expensive defensive action? What premium should be paid to acquire perhaps the only firm remaining in the market that can offer the necessary defensive potential?

Id. at 95.

To keep managers in line, therefore, owners incur monitoring costs. These take on a variety of forms and include incentive schemes, reporting requirements and bonding costs (contractual obligations). These devices are costly to the owners; the costs are a function of the degree of certainty with which information is sought.²³ Even if all of the agent's remuneration took the form of a stake in the firm's future, it will still not result in the firm's monitoring costs being zero as the agent will still receive only part of the proceeds of his endeavours. Furthermore, given tax considerations, compensation packages designed for agents by agents take on forms that are difficult to quantify even if they can be identified. In the face of this, the principal will have to incur inordinate monitoring costs in order to guarantee that the agent will make decisions which the principal would prefer. There is also the danger that "because the subjects are opportunistic human beings, they may well reduce, rather than improve, their performance if they feel over-monitored."²⁴

3. RESPONSES TO THE AGENCY PROBLEM: EXTERNAL CONSTRAINTS

3.1. *The Market for Corporate Control*

Manne, in a seminal article written in 1965, has referred to the market for corporate control as the only remaining *natural* device to assume efficient resource allocations; the others being the product market and the capital market.²⁵ Manne sees a high positive correlation

²³ See Marris & Mueller, *The Corporation, Competition and the Invisible Hand*, 18 J. ECON. LIT. 38 (1980).

²⁴ *Id.* The magnitude of such agency costs will, no doubt, vary from firm to firm and will depend on factors such as: (1) the tastes of managers; (2) the ease with which they can enforce their own preferences against value maximization; (3) the costs of monitoring and bonding activities; (4) the cost of measuring and evaluating the agent's performance; (5) the cost of devising and applying an index for compensating the manager which correlates with the owner's welfare; (6) the costs of devising and enforcing specific behavioural rules or policies; (7) the market for agents of that specialty; and (8) the market for the particular enterprise itself. Jensen & Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 328-29 (1976).

While far from being conclusive, the results obtained by Jensen and Meckling are nonetheless extremely useful for helping to understand that there are definite economic limits to the measures which should be taken to ensure that directors act in the interests of shareholders during a takeover bid. Shareholders invest in a company for profit (whether from dividends or capital gain). So, while some measures are clearly necessary to counter the Agency problem which necessarily arises once ownership and control become divided, it is also important to note that such measures are both costly to administer and difficult to enforce.

²⁵ Manne, *Mergers and the Market For Corporate Control* 73 J. POL. ECON. 110 (1965) [hereinafter Manne, *Mergers*]; see also Manne, *Cash Tender Offers For*

between corporate managerial efficiency and share price, with share prices of inefficiently managed companies declining relative to the share prices of other companies in the same industry or the economy as a whole.²⁶ Manne's ideas have been extended and aggressively restated by subsequent writers, notably Easterbrook and Fischel.²⁷ Stated briefly, their overall argument is that acquisitions and the threat of acquisitions promote efficiency (operational and allocational), and that regulation increases the costs of acquisition which results in fewer acquisitions and consequently, increased monitoring costs. Acquisitions, therefore, are viewed as a natural function of the market place manifesting itself through the mechanism of the market for corporate control. This line of reasoning views acquisitions as self-fulfilling in that they supposedly replace inefficient management with efficient management, and that they move assets from areas of low productivity to areas of high productivity. Not surprisingly, any interference with this natural market mechanism outside of those relating to fraud and misinformation (there being no positive obligations to disclose and a very narrow reading of fiduciary obligations) is viewed with disfavor.

Such an approach is not without its difficulties. First, it blurs the distinction between an efficient acquisition process and the end result. For, by implication, the argument assumes that regulation makes the takeover process and the end result inefficient. Secondly, the assertion that increased costs deter acquisitions, and are, therefore, *per se* bad refuses to concede any beneficial results that may flow from regulation. Thirdly, the argument that increased acquisitions will promote managerial efficiency (and hence reduce monitoring expenses) assumes, again, that the acquirer is efficient and that the acquisition will produce beneficial results. Fourthly, in its quest for increased acquisitions, the view disregards the welfare and aspirations of non-controlling shareholders. In other words, this viewpoint subordinates the issue of wealth distribution to the supposed phenomenon of wealth generating transactions.²⁸

Shares - A Reply to Chairman Cohen, 1967 DUKE L.J. 231 [hereinafter Manne, *Cash Tender Offers*].

²⁶ Manne, *Mergers*, *supra* note 25, at 112. Declining prices attract others to either partake in the perks of managerial office ("purchase of management compensation") or to attempt to better manage the declining entity. Manne disregards the former likelihood as being "too expensive generally" and concludes that "[o]nly the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords assurance of strong protection to the interests of vast numbers of small, non-controlling shareholders." *Id.* at 113.

²⁷ Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

²⁸ First, there is acceptance of the Efficient Market Hypothesis (at least in its

3.2. Capital Market Constraints

It also is argued that financial markets impose appropriate restric-

semi-strong form). From this it is argued that low share prices indicate poor management of the company which makes efficient management necessary to improve it. Secondly, the availability of this information is treated as providing the necessary impetus for efficiently managed companies to monitor the market with a view to making a takeover bid. Such bids will be forthcoming where the expected gains from the acquisition of control and replacement of inefficient management exceed the cost of acquisitions. Thirdly, the threat of takeover caused by the informational function acts as (1) a spur to incumbent management to keep share prices high by efficient performance and efficient use of the company's assets, and (2) where the bid succeeds, the acquired company will run more efficiently and remain so. The point made is that a "free" market for corporate control will act to ensure efficiency in respect of both the company taken over and the marketplace in general (i.e. efficient both operationally and allocationally) - the threat of takeover acts as a sanction against mismanagement, while the takeover itself acts as an efficient allocator of resources.

These assumptions are not without shortcomings. In the first point above, there is the attempt to equate the real value of the firm with the Efficient Market Hypothesis. In other words, it disregards non-public information. The real issue is not whether the Efficient Market Hypothesis is true or not, but whether the assumptions are necessarily fair. See generally Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal For Legislation*, 83 COLUM. L. REV. 268, 268-309 (1983) [hereinafter Lowenstein, *Hostile Takeovers*] (analyzing market efficiency, with particular attention to the Efficient Market Hypothesis, as it pertains to hostile takeovers).

The second assumption above views the takeover threat as an end in itself; inefficient management is replaced by efficient management followed by an efficient allocation of resources. It assumes that takeover decisions are in fact made on the basis of opportunity costs, that inefficiently managed companies are the targets, and that takeovers are value increasing. The evidence in the body of this paper, however, suggests the contrary. Furthermore, the decision to acquire may be no more than the desire to "manipulate reported earnings," or take advantage of undervalued assets, taxation advantages and the like. Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 731 (1985) [hereinafter Lowenstein, *Management Buyouts*].

The evidence also suggests that the takeover threat by itself, provides only a degree of discipline for small firms with below average profitability, and does not do so with respect to the larger firms. Large firms, by becoming larger still (via acquisitions), are in a position to avoid the acquisition threat presented by the failure to maximize profits. Lipton & Vlahakis, *Takeover Responses, 1984 Developments*, U.C.S.D. SEC. REG. INST. 13 (Nov. 1984). The fact that a company is a below average performer only places it in a wide category which is vulnerable to a takeover. The evidence indicates that in terms of a short term assessment (one year period), the chances of firms whose profitability lie between the second and ninth deciles are about the same. A. SINGH, *supra* note 19, at 140. With respect to long term profitability, movement above the median (fifth decile) reduces such vulnerability by approximately 50 percent. While this indicates that increased profitability may reduce vulnerability (i.e. that the threat of a takeover provides a measure of discipline), Singh points out that it must be considered alongside the size of the firm, for the larger the firm's size, the lesser its vulnerability to being taken over - as a form of progressive immunity sets in with each new acquisition. Faced with the choice of either increased profitability or growth as a safeguard against being taken over, firms would opt for the latter. The threat of a takeover is not in itself an adequate disciplinarian to non-profit maximizing management. The fact that a firm is an above average performer will not make it immune from takeover. The company may be an ideal target precisely because of its profitability and efficient management, as defensive acquisitions may be made by either profitable or not so profitable compa-

tions by denying access to capital to firms whose managements are en-

nies. *Id.* at 141.

Easterbrook and Fischel do recognize that some acquisitions may not produce gains and may be attributable to management "self-aggrandizement." However, they do not consider "this managerialist explanation of control shift" as being important in designing legal rules as the market penalizes buyers who pay too much by reason of the deal being unprofitable. Easterbrook & Fischel, *supra* note 27, at 707. This contention necessarily assumes the corporate control market to be both efficient and pervasive. Even if this was the case, the argument becomes irrelevant where the acquisition is prompted by defensive considerations or by a desire to engage in empire building. In any event, the discipline forthcoming (if it does) is after the event. Also, the evidence suggests that the transfer of a controlling interest (and with it the ability to control assets of the company far in excess of the controllers own investment) can always be made without any loss being incurred. *Id.*

There is evidence that regulation has increased the cost of tender offers. One estimate places the increased costs at between thirteen to twenty-seven percent. Smiley, *The Effect of The Williams Amendments and other Factors on Transaction Costs in Tender Offers*, 3 INDUS. ORG. REV. 145 (1975). The evidence suggests periodic upsurges and periods of relative calm attributable to factors inherent in the overall economy rather than the presence or absence of regulation. To cite, as evidence, the findings of one writer:

In the late 1960's the country experienced a wave of corporate combinations. . . . By 1969 the wave was beginning to ebb and from 1970-1975 mergers were at low tide. From 1976, however, both the number and absolute dollar volume of corporate combinations grew steadily to the point where the phenomenon hit its highest water mark ever - \$81 billion of transactions in 1981. Even adjusting for inflation, 1981 was the year of the greatest transfer of ownership via the merger mechanism heretofore experienced.

A Financial Perspective on Takeovers and Related Phenomena: Oversight Hearing on Corporate Takeovers before the House of Representatives Subcomm. on Monopolies and Commercial Law of the Comm. on the Judiciary, 97th Cong., 2d Sess. 49 (1982) (statement of Kenneth H. Miller, Managing Director, Strategic Services of Merrill Lynch White Weld Capital Markets Group). See generally Gort, *An Economic Disturbance Theory of Mergers*, 83 Q. J. ECON. 624 (1969) (discussing trends in merger activity as a result of economic disturbances).

More recently, another upsurge in the number of acquisitions has been reported. Thus rises and falls in the number of acquisitions can be explained just as much by reference to external factors such as the rise and decline in overall economic activity. Easterbrook's and Fischel's argument also assumes that lack of regulation will result in greater monitoring activity. The inference once again is that the acquisitions decision is made on a strict analysis of costs and benefits with the determining factor being the cost of satisfying the regulatory requirements rather than the entity to be acquired. Compared to the latter, the costs of satisfying regulatory demands is minimal. See Bebcuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 24 (1982) (endorsing regulatory requirements and contradicting the Easterbrook & Fischel view of regulation); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982);

Greater monitoring activity in the absence of regulation in itself assumes a competitive market for corporate control. However, if there is absent the requirement for offerors and targets to make disclosure, such competition seems to be unlikely. There is also reason to believe that the initial acquirer may not necessarily be the most efficient user of the assets acquired. Easterbrook and Fischel respond to this by claiming that there will be an eventual drift to the most efficient user. The point becomes self-defeating when viewed in terms of the costs involved. In the unlikely situation of the corpo-

gaged in excesses and/or self preservation:

The pricing of securities is the principal device by which the stock market performs its allocative function. By assigning higher prices to the securities of the firms with higher prospective earnings per unit of resources, and relatively lower prices to those of firms with low prospective profitability, the market can ensure that the more "efficient" firms have cheaper access to investment funds and are therefore able to make greater use of them.²⁹

The reality, however, is different. A large number of firms in the economy, especially the large manufacturing firms, make relatively little use of the market for raising new funds. Reasons for such reluctance include the transaction costs involved (underwriting, registration, information), outside scrutiny, disclosure to competitors, drop in value of securities following a new issue, uncertainty, the need for the market to concur with the expectations of the company, and the influence of the tax system.³⁰ Most large firms, therefore, attempt to be independent of

rate control market being competitive in the absence of regulation, there will be an unnecessary duplication of expenses regarding search, compliance, etc. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

Easterbrook and Fischel therefore, seem to considerably overstate both the need for and effectiveness of monitoring by bidders and the adverse effects of regulations on monitoring by prospective bidders. In accordance with their claims they also deliberately ignore any beneficial effects of regulation on control transactions. Arguments for non-regulation solely to preserve claims of benefits by monitoring are clearly misplaced.

²⁹ A. SINGH, *supra* note 19, at 2-3.

³⁰ To quote a recent text on factors influencing management decision making:

Those who argue that management strives to maximize shareholder wealth have also argued that management's strategic decisions are subject to the discipline of the capital market. From their perspective management's choices are guided by the corporate rate of return on investment compared to the cost of that capital in the public markets. But we have found that the top managers in these large, mature companies seek to minimize their dependence on the external capital market. They work to make their companies financially self-sustaining. Thus their goals reflect the characteristics of an internal capital market in which the demand for funds reflected in growth objectives must be balanced against the available supply provided primarily by retained earnings and secondarily by that borrowing available on a truly arm's length basis.

G. DONALDSON & J. LORSCH, *DECISION MAKING AT THE TOP*, 7 (1983).
And again:

The reality of limited financial resources, for even the largest industrial corporations, stems from senior management's fundamental mistrust of the capital markets, both debt and equity. In particular, these experienced managers are loathe to rely on the capital markets as the primary source of the funds essential to achieve vital corporate objectives. Such funds must be available at a time of management's choosing, on terms it considers acceptable, in the amount it requires. However, managers' expe-

these external restraints and opt to rely on funds that are internally generated.³¹

The need for external funds also may be avoided by resort to either a friendly merger with another firm of similar size and profitability, by a share exchange with a smaller firm, or the acquisition of a cash rich firm. Furthermore, management can generally raise the funds it considers necessary, because, at least among the larger firms (where ownership is scattered), shareholders will not be in a position to resist any such expansion.³² In many companies, "the sophisticated control of credit or capital expenditures simply does not extend to acquisitions",³³ and the capital market itself does not impose controls on borrowing for acquisitions in any significant way. As Meeks pointed out, the "control mechanism allocates the funds for expansion according to the firms' current profitability on existing assets, whereas the 'ideal system' would allocate on the basis of the future profitability of the new project."³⁴ Evidence indicates that while a form of "crude control" may apply to growth by new investment it could only operate "feebly for growth by merger."³⁵ Meeks concludes:

A major proportion of growth by acquisition (but not of

rience has taught them that investors' judgments and expectations are often out of phase with their own judgments, expectations, and needs. Just when the company's vital financial and competitive interests are at stake, the market's terms may be wholly unacceptable. While the capital market window may never be literally closed, for practical purposes it remains shut because these managers are unwilling to step up to it.

Evidence of this unwillingness can be seen quite clearly in the record of equity financing undertaken by our twelve companies. In the entire group, top management chose to issue stock for cash only twice during the decade of the study. These issues, one in each of two companies, accounted for approximately \$100 million in new funds, or about half of 1 percent of the \$17.4 billion of new funds added in all companies. Counting the repurchase of equity, the net addition of new equity was zero. Moreover, these managers did not include new equity in the list of variables they considered when they planned for mainstream corporate funding programs. The conclusion is inescapable: financial goal setting and planning for the companies' major long-term revenue sources took place within an environment of limited financial resources.

Id. at 51-52.

³¹ J. GALBRAITH, *THE NEW INDUSTRIAL STATE*, 39-40 (1967) (providing background information regarding firm behavior and the preference for reducing external constraints).

³² A. SINGH, *supra* note 19, at 5.

³³ O'Herlihy, *Real Growth from Acquisitions: The Rules For A Dangerous Game*, *THE DIRECTOR*, Sept. 1971, at 371.

³⁴ G. MEEKS, *DISAPPOINTING MARRIAGE: A STUDY OF THE GAINS FROM MERGER* 47 (1977).

³⁵ Baumol, Heim, Malkiel, & Quandt, *Earnings, Retention, New Capital and Growth of the Firm*, 52 *REV. ECON. & STATISTICS* 345 (1970).

new investment) was typically financed from external sources; and whereas a strong positive association was found between profitability and the rate of growth by new investment, that between profitability and the rate of growth by takeover was very much more weak.

But the ability of companies with mediocre profit performance to grow rapidly [in size] by takeover, coupled with the evidence of chapter 3 on the disappointing outcome of the typical merger, provokes considerable doubts about the effectiveness of market controls over acquisition and reinforces the case for tighter restrictions and additional appraisal by the State.³⁶

³⁶ G. MEEKS, *supra* note 34, at 60.

The U. S. position is similar. Baumol sums up as follows:

We have examined arguments which might lead us to expect that security prices would be tied very closely to company earnings prospects and yet other lines of reasoning which imply that the relationship would be haphazard and depend largely on the fortunes of speculation. We have seen that the stock market is not given the opportunity to impose its discipline on the bulk of American corporate enterprise in its role as a capital market, for most firms come but rarely to seek their funds at the Exchange. . . .

Baumol, *supra* note 35, at 348.

All in all, one cannot escape the impression that, at best, the allocative function is performed rather imperfectly as measured by the criteria of the welfare economist. The oligopolistic position of those who operate the market, the brokers, the floor traders and the specialists; the random patterns which characterize the behavior of stock prices; the apparent unresponsiveness of supply to price changes; and management's efforts to avoid the market as a source of funds, all raise some questions about the perfection of the regulatory operations of the market. W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY*, 82-83 (1965).

And O. Williamson, says:

The reasons why traditional control of management performance by the capital market is relatively crude are that internal conditions in the firm are not widely known or easy to discover (information impactedness) and that those seeking to gain control of the firm (takeover agents) might well take opportunistic advantage of the shareholders' bounded rationality. Information impactedness means that outsiders cannot make confident judgments that the firm has departed from profit maximizing standards, except with difficulty. The firm is a complex organization and its performance is a joint consequence of exogenous economic events, rival behavior, and internal decisions. Causal inferences are correspondingly difficult to make, and, hence, opportunism is costly to detect. Moreover, once detected, convincing interested stockholders that a displacement effort ought to be supported encounters problems. Inasmuch as time and the analytical capacity of stockholders are not free goods (which is to say that the limits imposed by bounded rationality must be respected), the would-be takeover agent cannot simply display all of his evidence and expect stockholders to evaluate it and reach the "appropriate" conclusion. Rather, any appeal to the stockholders must be made in terms of highly digested interpretations of the facts. Although this helps to overcome the stockholder's bounded

4. RESPONSES TO THE AGENCY PROBLEM: INTERNAL CONSTRAINTS

Organizational theorists such as Williamson,³⁷ and writers such as Fama and Jensen³⁸ highlight certain structural constraints which have evolved within organizations, which have helped reduce the agency problem, and which have achieved other objectives as well.

4.1. *Williamson's M-Form Model*

In his later works, Williamson suggests that most of the monitoring difficulties encountered by firms have been overcome by the firms adopting the M-Form structures in lieu of the previous U-form structures.³⁹

The principal operating units within the U-form are its various operational divisions; sales, finance, manufacturing, and engineering. Williamson depicts this type of structure as being the "natural" form for organizing multifunctional activities, and as the form commonly prevailing amongst moderate sized enterprises. Williamson states that even the M-form enterprise preserves the U-form at the lower levels of its hierarchy. The U-form solves division of labor problems efficiently by incorporating provisions for an effective and strategic decision-making and control apparatus. Nevertheless, it encounters obstacles with respect to the following: (1) the difficulty of control which emerges with expansion; and (2) the general problem of utility maximization, including the expense-preference inclinations of the functional divisions. The M-form structure theoretically overcomes these shortcomings by virtue of its built-in quasi-autonomous operating divisions, each division of

rationality problem, it poses another: How is the interested stockholder (or his agent) to distinguish between bona fide and opportunistic takeover agents?

O. WILLIAMSON, *supra* note 6, at 31.

The upshot of these remarks is that the transaction costs associated with *traditional* capital market processes for policing management, of the sort described by Peterson are considerable. Correspondingly, the range of discretionary behavior open to incumbent managements is rather wider than Peterson and other supporters of the fiction of the frictionless capital market concede. Williamson, *The Modern Corporation as an Efficiency Instrument*, in GOVERNMENT CONTROLS AND THE FREE MARKET 184-85 (S. Pejovich ed. 1976).

³⁷ O. WILLIAMSON, *supra* note 6.

³⁸ Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

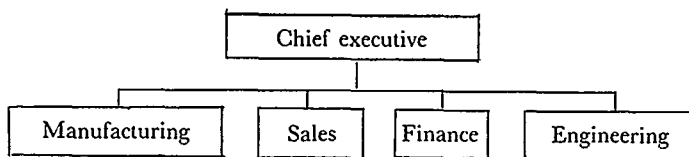
³⁹ Williamson, *Managerial Discretion, Organization Form, and the Multi-Division Hypothesis*, in THE CORPORATE ECONOMY 345 (R. Marris & A. Wood eds. 1971) [hereinafter Williamson, *Multi-Division Hypothesis*]; O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 132-54 (1975) [hereinafter O. WILLIAMSON, MARKETS AND HIERARCHIES].

The two structural forms look as follows:

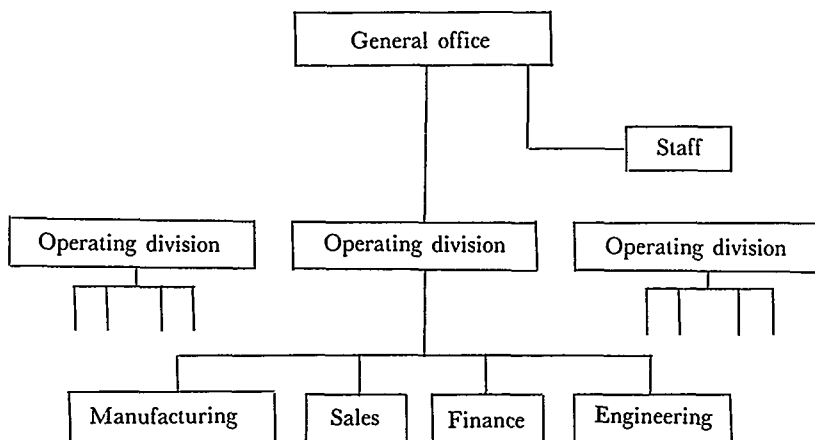
which performs all of the functions for each single product. Each of these operating divisions may itself be divided along functional lines.⁴⁰

The resulting structure, says Williamson, displays elements of both rationality and synergy: the whole is greater (more effective, more efficient) than the sum of the parts. Apparently, these factors have not had a noticeable impact on the modern theory of the firm. Williamson

TABLE 8
UNITARY FORM



MULTI DIVISION FORM



Id. 134, 138.

⁴⁰ Williamson claims that large firms, quite generally, have undergone a reorganization which follow M-form lines. Under this form of structure:

(1) The responsibility for operating decisions is assigned to more or less self contained operating divisions (U-forms);

(2) The elite staff attached to the general office perform both advisory and auditing functions. These twin functions give the effect of apparently increased control over operating-division behavior;

(3) The general office is principally concerned with strategy decisions involving planning, appraisal, and control, including the allocation of resources among the other (competing) operating divisions; and

(4) The separation of the general office from the various divisions compels the executives to be concerned with the overall performance of the organization rather than with the affairs of one functional division.

O. WILLIAMSON, *MARKETS AND HIERARCHIES*, *supra* note 39, at 138.

attributes this lack of impact to the neglect in recognizing organizational form, and on the exclusive reliance upon the notion of profit maximization. According to Williamson, the character of the firm is greatly determined by market circumstances, internal efficiency, the strategic decision-making process, and the internal compliance processes. Williamson posits that organizational form has an immediate effect on the last three and an eventual effect on market circumstances.⁴¹

The operating divisions within the M-form have many of the attributes of independent firms, and are referred to by Williamson as "quasi-firms".⁴² Each of these firms has a U-form structure. At this point of analysis, the question of managerial utility maximization emerges once again. Williamson maintains that direct intervention (where appropriate) by the general office and its elite staff with respect to internal resource allocation and to personnel, and to the auditing thereof, would effectively impede the operating divisions from performing appropriately.⁴³

However, this perception pertains only to the character of the firm's long-term performance. With respect to short-term performance, where the focus is on individual behavior within the firm rather than on the entire firm as the unit of analysis, Williamson conceives the managerial discretion models to be more appropriate.⁴⁴

⁴¹ Internal efficiency (or decrease in "control-loss") in the M-form is achieved by increased communication, by an increase in the ease of utilizing resources in a coordinate way, and by the infusion of a form of quasi-autonomy, at low cost, into the operating divisions. Williamson, *Multi-Division Hypothesis*, *supra* note 39, at 356-57. The strategic decision-making function is achieved by (1) assigning this function to a team of top executive generalists who are removed from operating responsibilities, and (2) supporting this group of general officers with an elite staff capable of performing the in-depth analyses necessary to discharge the strategic overseer task effectively. *Id.* at 359.

⁴² *Id.* at 361. Williamson attributes the first use of "quasi-firms" to Heflebower, *Observations on Decentralization in Large Enterprises*, J. INDUS. ECON., Nov. 1966, at 7, 7-22.

⁴³ Williamson, *Multi-Division Hypothesis*, *supra* note 39, at 362.

One concludes, therefore, that not only does the structure of the M-form organization yield internal efficiency and high-level goal-pursuit outcomes different from that which an equivalent U-form enterprise would display, but, in addition, the M-form structure facilitates the exercise of the internal compliance machinery in especially effective ways. That the preferences of an assertive general office in an M-form corporation should (up to a first approximation) prevail seems at least plausible. *Id.* at 366.

⁴⁴ *Id.* at 368.

Williamson also regards the M-form as a response to the failure of the capital market to regulate the firm. This is so for the following reasons: (1) Unlike the capital market, the M-form is an internal rather than external control mechanism; (2) it can make fine-tuning as well as discrete adjustments, i.e., because it is an internal mechanism, it can intervene early in a selective, preventative way as well as perform *ex post* corrective adjustments; and (3) the costs of intervention by the general office are low.

4.2. *The Modified Neo-Classical Response*

More recently, writers such as Alchian, Demsetz, Jensen, Meckling, and Fama have developed a model theory which, while rejecting the classical model of the firm, attributes classical forms of economic behavior to agents within the firm. This view sees the firm as consisting of a set of contracts among factors of production with each factor motivated by its own self-interest. In an article published in 1972, Alchian and Demsetz identify the classical firm

as a contractual structure with: 1) joint input production; 2) several input owners; 3) one party who is common to all the contracts of the joint inputs; 4) who has rights to negotiate any input's contract independently of contracts with other input owners; 5) who holds the residual claim; and 6) who has the right to sell his central contractual residual status. The

From this, the argument is extended to capital market displacement efforts. *Ceteris paribus*, Williamson says, displacement is more likely the greater the unavailed profit opportunities in the target firms and the lower the costs of effecting displacement. In relation to the U-form, the M-form enhances the attractiveness of making a displacement effort in both respects. In a more recent article, Williamson places the M-form in the context of the market for corporate control. *Id.* at 370-71. He there states:

To be sure, managerial preferences (for salary and perquisites) and stockholder preferences (for profits) do not become perfectly consonant as a result of conglomerate organization and the associated activation of the capital market. The continuing tension between management and stockholder interests is evident in the numerous efforts that incumbent managements have taken to protect target firms against takeover. . . .

The relief and alleviation to which I refer [following the adoption of the M-form] do not, of course, mean that continuing concern over corporate control is unwarranted. Additionally, the appearance of takeover and the resulting activation of a market for corporate control is, while important, easily exaggerated. After all, the corporate form was not threatened with demise in the pretakeover era. Remarks by takeover enthusiasts that the corporation owes its salvation to this device thus need to be discounted. . . . [T]here is reason to believe that the invention and diffusion of the M-form structure and its conglomerate variant have served to attenuate aspects of the managerial discretion problem. But mitigation and elimination are not the same. Although the hierarchical logic of the M-form structure is great, there is no reason to believe that the evolution of corporate control techniques has reached an end.

Williamson, *Organization Form, Residual Claimants and Corporate Control*, 26 J.L. & ECON. 351, 363-366 (1983) (citing E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* 234-76 (1973) and Cary, *Corporate Devices Used to Insulate Management from Attack*, 39 ANTITRUST L.J. 318 (1969-70)).

See also Lowenstein, *Management Buyouts*, *supra* note 28, at 754. The M-Form theory of conglomerate organization, that the separation of general management from operating division yields important benefits, once seemed attractive, at least in academic circles. It is now giving way to a different view: that people work best when wearing one hat instead of four and when decision-making is not encumbered by layers of executives in search of a function.

central agent is called the firm's *owner* and the *employer*. No authoritarian control is involved; the arrangement is simply a contractual structure subject to continuous renegotiation with the central agent. The contractual structure arises as a means of enhancing efficient organization of team production. In particular, the ability to detect shirking among owners of jointly used inputs in team production is enhanced (detection costs are reduced) by this arrangement and the discipline (by revision of contracts) of input owners is made more economic.(emphasis added)⁴⁵

⁴⁵ Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794 (1972). They go on to state:

As a consequence of the flow of information to the central party (employer), the firm takes on the characteristic of an efficient market in that information about the productive characteristics of a large set of specific inputs is now more cheaply available. Better recombinations or new uses of resources can be more efficiently ascertained than by the conventional search through the general market. In this sense inputs compete with each other within and via a firm rather than solely across markets as conventionally conceived. Emphasis on interfirm competition obscures intrafirm competition among inputs. Conceiving competition as the *revelation and exchange* of knowledge or information about qualities, potential uses of different inputs in different potential applications indicates that the firm is a device for enhancing competition among sets of input resources as well as a device for more efficiently rewarding the inputs. In contrast to markets and cities which can be viewed as publicly or nonowned market places, the firm can be considered a privately owned market; if so, we could consider the firm and the ordinary market as competing types of markets, competition between private proprietary markets and public or communal markets.

Id. at 795.

These views are carried further by Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON., 288 (1980). In a later article Fama extends the frame of reference to the larger modern corporation by separating the functions of management from risk bearing, and by substituting the reference to employer and entrepreneur with the term management. The firm is viewed as being disciplined by the product market (forcing it to devise mechanisms to efficiently monitor the performance of the entire team and its individual members) and the managerial labor market (both within and outside of the firm). Discipline in the latter instance is enforced by the managers themselves (horizontally and vertically) and by the employment of outside directors. The firm's security holders are also viewed as providing important but indirect assistance to the managerial labor market. It is the latter factor which distinguishes it from the views expressed by Alchian and Demsetz, and Jensen and Meckling who make the control of management the province of the firm's risk bearers and Manne who relies on the market for corporate control. See Jensen & Meckling, *supra* note 24, at 305-60. On this point Fama says:

When management and risk bearing are viewed as naturally separate factors of production, looking at the market for risk bearing from the viewpoint of portfolio theory tells us that risk bearers are likely to spread their wealth across many firms and so not be interested in directly controlling the management of any individual firm. Thus, models of the firm, like those of Alchian-Demsetz and Jensen-Meckling, in which the control

In a more recent article, authors Fama and Jensen draw attention to the internal constraints involved in handling the agency problem. They view the decision-making in the modern corporation as a four step process: (1) the *initiation* of proposals; (2) *ratification* of the decision initiatives chosen to be implemented; (3) *implementation* thereof; and (4) *monitoring* and rewarding the performance of decision agents.⁴⁶ Of these, initiation and implementation stages fall within the province of management while the ratification and monitoring stages fall within the province of control. According to the authors, devices for separating decision management from decision control include: (1) decision hierarchies in which higher level agents first ratify and then monitor the decision initiatives of lower level agents; (2) boards of directors that make and monitor the organization's most important decisions, and hire, fire, and compensate top-level decision managers; and (3) incentive structures that encourage mutual monitoring among decision agents.

The authors further claim that the multiple-member nature of the present day board of directors makes the possibility of collusion between top level decision-management and control-agents less likely to occur. Nevertheless, the agency problem and the problem of agency costs persists in the real world because "complete, fully contingent, costlessly enforceable contracts do not exist and because contractual breaches are often difficult to prove to a third party enforcer such as a court."⁴⁷ The authors also fail to explain why the separation of residual claimant (ownership) and management appear to be positively related to the size of the organization and is not a universally applicable solution.⁴⁸ Their propositions that (1) separation of ownership from control in the small organization produces smaller risk sharing benefits

of management falls primarily on the risk bearers, are not likely to allay the fears of those concerned with the apparent incentive problems created by the separation of security ownership and control. Likewise, Manne's approach, in which the control of management relies primarily on the expensive mechanism of an outside takeover, offers little comfort. The viability of the large corporation with diffuse security ownership is better explained in terms of a model where the primary disciplining of managers comes through managerial labor markets, both within and outside of the firm, with assistance from the panoply of internal and external monitoring devices that evolve to stimulate the ongoing efficiency of the corporate form, and with the market for outside takeovers providing discipline of last resort.

Fama, *supra*, at 295.

⁴⁶ Fama, *supra* note 45, at 303.

⁴⁷ Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J. L. & ECON. 367, 368-71 (1983).

⁴⁸ See *id.* at 371.

in relation to the agency costs; and (2) that the "total risk" of managers is correlated with organizational size, have also been challenged.⁴⁹

In summary, two opposing views seek to explain the theory of the firm: (1) the neo-classicists who view acquisitions as yet another profit maximizing decision, and (2) the managerialists who view acquisitions as no more than maximizing management utility. Motivations consistent with the neo-classical view⁵⁰ include: financial motivations such as redeployment of excess cash, leverage, diversification and risk reduction; synergy motivations which include gains from economies of scale and the achievement of monopoly power; exploitation of information such as undervalued shares, or of alternative efficient operating strategies; and the replacement of inefficient management. They support their claim by reference to the product market, the securities market, the capital market, the managerial employment market, internal monitoring, and the market for corporate control.

Managerialists, on the other hand, contend that management acts to promote its own utility. According to this view, in addition to achieving certain satisfactory levels of profit, managers are in a position to and do maximize their own self interest. Market constraints are effective only to a point. More importantly, size in itself offers protection. Thus, if the neo-classical viewpoint is correct, this will be evidenced by the comparatively lower levels of profit for the acquired firms in comparison to those expected in the industry. Further evidence would be demonstrated by: the non-acquired firms and the offeror being more profitable; smaller firms merging more often than larger firms (unless all of the firms in the industry are below minimum efficient size);⁵¹ and, most importantly, of the acquired firm (or combined enterprise) being run more efficiently and profitably. Conversely, if the managerialist viewpoint is correct the larger body of evidence will suggest the contrary. The evidence will be evaluated in the next section.

5. RESULTS OF ACQUISITIONS: THE EMPIRICAL EVIDENCE

5.1. *A Profile of Offeror and Target Firms*⁵²

Offeror firms are larger and more dynamic than the target and

⁴⁹ See *id.*; see also Arrow, *The Role of Securities in the Optimal Allocation of Risk Bearing*, 31 REV. ECON. STUD. 91 (1964).

⁵⁰ Halpern, *Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions*, 38 J. FIN. 297, 306-12 (1983).

⁵¹ A. COSH, A. HUGHES, & A. SINGH, *THE DETERMINANTS AND EFFECTS OF MERGERS* 55 (D. Mueller ed. 1980).

⁵² The discussion in this section is based on standard information available in texts such as G. MEEKS, *supra* note 34; A. COSH, A. HUGHES, & A. SINGH, *supra*

other non-acquiring firms. Apart from a higher rate of growth, they have the attributes one associates with "growth-minded" firms, *e.g.*, higher retention rates. The data also show that it is relatively easier to distinguish this particular group of firms from the rest than it is to separate the acquired firms from the acquiring firms. Offeror firms have, for the short term (*e.g.*, the two year period *preceding* the takeover), significantly better profitability and growth records than target firms. On the average, they also are somewhat less liquid, more highly geared, and tend to retain a significantly greater proportion of their profits than the acquired firms. The same is true for the long term (*e.g.*, the six year period preceding the takeover) except that in this case profitability is secondary in importance to growth, retention ratio, and liquidity. Offeror firms, generally, have higher (though not significantly higher) valuation ratios than their targets. The typical target, on the other hand, is only an average performer in terms of profitability and has been less profitable than the offeror in the period prior to merger.

5.2. Characteristics of Firms Taken Over

Studies conducted by several researchers, including Buckley, Kuehn, Newbould, Singh, Tzoannos and Samuels, examined the characteristics of firms taken-over in the U.K. These writers have adopted certain analytic criteria such as profitability, dividend performance, valuation ratio, price-earnings ratio, gearing, liquidity, and growth in net assets.⁵³

Not every investigator, however, looked at all of the above mentioned characteristics. Thus, according to Buckley, target companies frequently possessed low valuation ratios, declining or static earnings,

note 51; A. SINGH, *supra* note 19, at 153-58.

⁵³ M. Firth, *supra* note 2, at 50.

Findings of these studies are summarized below:

TABLE 9

	Buckley	Firth	Hayes & Taussig	Kuehn	Newbould	Singh	Tzoannos & Samuels
Profitability	Low	Low & Average		Low		Low	
Dividend Performance		Average	Low				
Valuation Ratio	Low	High		Low	Average	Low	
Price-Earnings Ratio	Low	Average	Low		Low		
Gearing	Low	Average				Average	High
Liquidity	Average	Average	Low	Low		Average	Average
Growth in Net Assets				Low		Low	

and low price-earnings ratios when compared to the respective industrial average. Buckley noted a "slight tendency towards undergearing." According to Kuehn, targets "tended to have low valuation ratios, low profitability and low growth [with] lowish liquidity . . . while the dividend pay-out policy appeared to have no impact."⁵⁴ Kuehn found the valuation ratio to be the major variable in determining the likelihood of a takeover. He also found that bidders tended to have lower profitability than that of the industry average, but higher valuation ratios than those of the industry average.⁵⁵ Newbould's study, accomplished by means of a case study questionnaire, demonstrated a low price-earnings ratio for the target when compared to the ratio for the offeror. In contrast to other studies, however, Newbould found that targets did not have a low valuation ratio in comparison to that of acquired over companies.⁵⁶

Singh found that targets tended to have low profitability, low growth, and low valuation ratios when compared to acquired companies. Singh also found that profitability, not the valuation ratio, was the predominant variable influencing takeovers, and that offerors had a significantly higher level of growth than did target companies.⁵⁷ Finally, Tzoannos and Samuels (who compared their investigations of thirty six randomly selected mergers to a control group of thirty two companies) found that:

[T]he characteristics possessed by those companies that were taken over, which differentiated them from the companies not taken over, were as follows: a higher absolute level of capital gearing, a higher rate of increase in the capital gearing, a slower increase in profits, a lower price-earnings ratio, a slower rate of increase in dividends and a greater variation over time in the rate of dividends.

The characteristics of the companies that were active in taking over other companies were an above average downward trend in capital gearing, a lower absolute level of capital gearing, a higher than average increase in profits to capital employed and a higher than average increase in the trend of dividends.⁵⁸

For the U.S., Hayes and Taussig report similar findings in their

⁵⁴ M. FIRTH, *supra* note 2, at 51; Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135 (1967).

⁵⁵ M. FIRTH, *supra* note 2, at 45.

⁵⁶ As adapted from the table appearing in Firth. *Id.* at 50.

⁵⁷ *Id.* at 52.

⁵⁸ *Id.*

study of cash take-over bids for the period 1957-66.⁵⁹ They examined fifty cash tender offers at random and compared them with a control group of fifty companies randomly chosen. Acquired firms had high liquidity, poor earnings and a declining dividend policy. Stevens conducted another study,⁶⁰ which compared forty companies with a controlled group of another forty companies, and revealed similar findings. These studies tended to suggest that most targets were potentially failing firms and that there was merit in mergers as an efficient alternative to bankruptcy.⁶¹ Subsequent studies evaluated by Boyle,⁶² and by Mueller,⁶³ differ from this. Boyle studied 698 of the 1,275 acquired firms in large acquisitions over the period of 1948-1968. He found that few were suffering losses, and, on the average, acquired firms were only slightly less profitable than all firms. Boyle also found that conglomerates acquired firms with a higher profitability record (roughly equal to the profitability of the average over all manufacturing firms in the acquired firm's industry) than those firms acquired by firms engaged in horizontal and vertical integration.⁶⁴ Boyle's findings have received support from subsequent studies.⁶⁵ Compared to the U.K., therefore, it is clear that target firms in the U.S., though not as profitable as their acquiring firm, were more profitable than their industry average.⁶⁶

⁵⁹ According to Firth, however, the difference is explainable in terms of the later date relative to the takeover announcement that Hayes and Taussig used to collect their data compared to those dates used by Kuehn and Singh, and by the change in characteristics that target may have been either prepared to accept or forced to accept. *Id.* at 53; Hayes & Taussig, *supra* note 54, at 135-48.

⁶⁰ Tzoannos & Samuels, *Mergers and Takeovers: The Financial Characteristics of Companies Involved*, 4 J. BUS. FIN. 5, 7-8, 15 (1972); Stevens, *Financial Characteristics of Merged Firms: A Multivariate Analysis*, J. FIN. & QUANT. ANAL., Mar. 1973, at 149 (supports general proposition that most targets are distinguishable from non-target firms on the sole basis of financial characteristic analysis).

⁶¹ P. STEINER, *MERGERS, MOTIVES, EFFECTS, POLICIES* 185 (1975); see Hayes & Taussig, *supra* note 54, at 135-48; see also Stevens, *supra* note 60.

⁶² Stevens, *supra* note 60, at 149; Boyle, *Pre-Merger Growth and Profit Characteristics of Large Conglomerate Mergers in the United States: 1948-1968*, 44 ST. JOHN'S L. REV. 152, 152-70 (Special Ed. 1970).

⁶³ Mueller, *The United States, 1962-1972*, in *THE DETERMINANTS AND EFFECTS OF MERGERS*, 271-98 (D. Mueller ed. 1980); see also Monroe & Simkowitz, *Investment Characteristics of Conglomerate Targets: A Discriminant Analysis*, S.J. BUS., Nov. 1971, at 1-16 (analyzed targets taken over by conglomerate in 1968).

⁶⁴ See P. STEINER, *supra* note 61, at 185.

⁶⁵ Boyle, *supra* note 62, at 152-70.

⁶⁶ Mueller takes the view further. He states:

The companies that were acquired between 1962 and 1972 were smaller than the average firm in their industry, but indistinguishable in all other respects from size-matched non acquired firms. These findings are similar to those of Melicher and Rush. Melicher & Rush, *Evidence on the Acquisition - Related Performance of Conglomerate Firms*, 29 J. FIN. (1974).

5.3. *The Impact of a Bid on Bidder and Target Stock*

Evidence suggests that stockholders of bidding firms earn positive abnormal returns⁶⁷ prior to the announcement of an acquisition.⁶⁸ Bidders' abnormal returns are positively related to firm size, *e.g.*, given the larger size of the bidder, the larger the target the greater the return.⁶⁹ The precise effect of a bid announcement on bidder stock in the U.S. is uncertain. One view is that it results in "small, generally insignificant, but positive returns."⁷⁰ The other view is that bidder stock loses a small, insignificant amount of value.⁷¹ Bidders in successful tender offers gain significantly. However, this gain is substantially lower than that enjoyed by the acquired company.⁷² Unsuccessful bidder stock retains its increased value, more or less,⁷³ until the target is acquired by

They differ somewhat from those of Stevens. Stevens found that acquired firms were less levered and more liquid than nonacquired companies.

Mueller, *supra* note 63, at 287.

Thus, Steiner cites (1) the 1972 FTC Report studying the 1960-1968 acquisitions of nine leading conglomerate acquirers, which found that the great majority of target companies earned profits in the period before acquisition even though somewhat below average for their industries, and (2) Denis Binder, *An Empirical Study of Contested Tender Offers: 1970-69*, (S.J.D. Thesis, Law School, University of Michigan, 1973), studying targets in contested tender offers found the targets to be generally profitable throughout the decade. It may therefore be argued that only conglomerates set out to acquire successful targets. P. STEINER, *supra* note 61, at 185-86. *See also* Mueller, *The Effects of Conglomerate Mergers*, 1 J. BANKING & FIN. 315, 327 (1977).

⁶⁷ Mueller, *supra* note 63, at 296.

⁶⁸ *See* Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51 (1983); *see also* Schipper & Thompson, *Evidence on the Capitalized Value of Merger Activity for Acquiring Firms*, 11 J. FIN. ECON. 85 (1983) (positive from a period 30 months before announcement with most gains - about 13% - during last 12 months. Latter gains attributed to 'leakage'); Malatesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155 (1983) (approximately - 1% over the months preceding merger announcement); Dodd & Ruback, *Tender Offers and Stockholder Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351 (1977) (positive returns over the 12 months preceding the tender offers); Mandelker, *The Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303 (1974) (small and positive returns over the 30 months preceding the announcement).

⁶⁹ *But see* Asquith, *supra* note 68, at 58 (target firm's residuals decline on average prior to the merger bid, while the bidding firm's residuals increase on average).

⁷⁰ *Id.* at 81.

⁷¹ *See* Langeteig, *An Application of a Three-factor Performance Index to Measure Stockholder Gains from Merger*, 6 J. FIN. ECON. 365, 381 (1978) (slightly negative returns over the six months before the event, but not statistically significant).

⁷² Asquith, Bruner, & Mullins, *The Gains to Bidding Firms from Merger*, 11 J. FIN. ECON. 121, 138 (1983). The authors estimate that on average, a bid for a target firm half the bidding firm's size produces a cumulative excess return 1.8% greater than a bid for a target one-tenth the bidder's size.

⁷³ *See id.* at 138.

The unsuccessful target firms' average 2-day excess return for the day a merger is bid is -5.9% . . . [s]uccessful target firms gain 1.3% on their merger day and . . . unsuccessful target firms lose -6.4% on their outcome day.

another, at which point the unsuccessful bidder's stock registers a decline in value.⁷⁴ In the latter instance, the market perceives the unsuccessful bidder as having lost an opportunity to acquire a valuable asset and the successful bidder as having acquired that benefit.⁷⁵ In the long term, however, the stock of all bidding firms generally shows a decline in its abnormal returns.⁷⁶ The evidence in the U.K. shows that, on the average, acquiring firms suffered falls in their share prices upon the announcement of a bid.

Although there is disagreement concerning the financial returns of targets prior to the announcement of an offer,⁷⁷ there is, nevertheless, consistent evidence that the excess returns on the day of the announcement are considerable.⁷⁸ The announcement of a tender offer causes an immediate rise in target share prices.⁷⁹ Where a rival bid is made, target shares rise even higher.⁸⁰ If no rival bid is made and the original bid fails, target share prices will, over the next two years, revert to their pre-offer price.⁸¹ The higher price is sustained, during the interim due to the possibility of further bids.⁸²

Id.

⁷⁴ *Id.*; Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980) ("evidence of small, but significant negative abnormal returns at the date of the first public announcement . . ."). Thus, Malatesta observes: "[b]ecause the results of previous studies are contradictory, it is difficult to draw conclusions concerning the hypothesis. Malatesta, *supra* note 68, at 158.

⁷⁵ Jensen & Ruback, *The Market for Corporate Control; The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (abnormal gains of target in successful tender offer, 30%; bidder, 4%; unsuccessful target, -3%; unsuccessful bidder, -1%); Dodd & Ruback, *supra* note 68 (abnormal gains of unsuccessful bidder, 0.6%; successful bidder, 2.83%; successful target, 20.58%; and unsuccessful target, 18.96%).

⁷⁶ Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers*, 11 J. FIN. ECON. 183, 198-206 (1983).

⁷⁷ *Id.* at 204.

⁷⁸ *Id.*

⁷⁹ Asquith, *supra* note 68, at 81; Jensen & Ruback, *supra* note 75, at 12.

⁸⁰ Dodd & Ruback, *supra* note 68 (normal returns for the 60 months preceding); Asquith, *supra* note 68 (all target firms realize negative average excess returns in the period prior to the announcement date); Malatesta, *supra* note 68 (evidence that during periods well before a merger acquired firm shareholders suffer losses while acquiring firm's shares earn positive abnormal returns).

⁸¹ See Asquith, *supra* note 68, at 81; Bradley, Desai, & Kim, *supra* note 76, at 189-98, 205. *But see* Dodd & Ruback, *supra* note 68 (abnormal returns of target dominate beside abnormal returns of bidder); Asquith, Bruner & Mullins, *supra* note 72 (positive stock price reaction for bidders and a much larger positive reaction for targets); Malatesta, *supra* note 68 (acquired firms earn abnormally large returns of a statistically and economically significant magnitude, while acquiring firms earn small, generally insignificant, but positive returns).

⁸² Bradley, Desai & Kim, *supra* note 76. The studies focus on the average impact of acquisitions, e.g., "they compute the average abnormal stock returns associated with acquisitions for a sample of participating firms." *Id.* The impact of individual acquisitions has to be separately determined. Also, the focus on such studies is limited to stock price information picked at one or two information release dates, e.g., the announcement of the bid or the outcome dates. They do not examine responses to the continuous inflow of market information at several dates. However, evidence for the long term

At least three competing hypotheses seek to explain such rise and decline in stock prices. According to the *information hypothesis*, the rise in target share price is due to the new information released about the target. However, this does not explain the eventual fallback to the pre-offer price where the offer is unsuccessful and no rival bids are received. There is another aspect to this information theory, which is that bidders act in response to inside information. Thus, according to Ruback,⁸³ in the Conoco takeover, it was the possession of inside information that led DuPont to persist in its bid even though its own share values had registered a decline upon the announcement of the offer. Likewise, information about the bidders' own value might help explain the difference in bidder returns in tender offers and merger proposals. The evidence indicates that bidders in successful tender offers earn small positive returns and that successful merger bidders earn approximately zero returns. Tender offers are frequently cash offers, and mergers are usually stock and other security exchange offers. Therefore, astute market participants will interpret a cash offer as good news and a stock offer as bad news about the bidders' value and incorporate this information into bidder stock prices along with the estimated value of the acquisition. This argument implies that returns to bidders in cash tender offers will be higher than in mergers, if other aspects of the deals are approximately equivalent.

According to the *synergy hypothesis*, the price rise recognized the potential combination's synergy, with the moving cause being the peculiar attributes of the target. It is this factor that disadvantages the unsuccessful bidder and causes the decline in its stock price. Synergy includes gains from vertical integration, the realization of economies of scale, and gains from monopolizing output markets.⁸⁴

Under the *improved management hypothesis*, target share values are enhanced by being rid of inefficient management. The assumption is that would be acquirers maximize value while potential target firms are controlled by inefficient management.⁸⁵ A further hypothesis seeks to explain a motive for acquisition by bidding firms. Bidder management seeks, by acquisition, to maximize their firm size. The implication is that firms engage in acquisition even when the marginal cost of ac-

shows that both in the U.S. and the U.K., the decline is small and statistically insignificant for the first 80 days following the outcome but then declines swiftly over the next 160 days. *Id.*; see Asquith, *supra* note 68, at 74-75. A comparative decline in returns for acquiring company shareholders sets in relative to their matched control group firms for the period following three years after the merger. Jensen & Ruback, *supra* note 68; A. COSH, A. HUGHES & A. SINGH, *supra* note 51.

⁸³ Ruback, *The Conoco Takeover and Shareholder Returns*, 24 SLOAN MGMT. REV. 13 (1983).

⁸⁴ Mueller, *supra* note 63, at 293, 310.

⁸⁵ *Id.* at 310; A. COSH, A. HUGHES & A. SINGH, *supra* note 51, at 267.

quisition is higher than the marginal increase in the value of the firm.⁸⁶

5.4. Performance Subsequent to Acquisition

The performance of firms subsequent to acquisition is the next major issue. Where the combined post-merger performance of the firms is found to be superior, this factor will compensate for inadequate constraints of the capital market.⁸⁷ Early research on the subject showed strong evidence to the contrary; acquisition decreased performance, or at best, made no difference to performance. In examining the research, only two of the studies suggest that acquisition may lead to improved performance, six noted no difference, while seven found decreased performance.⁸⁸ In addition, two empirical studies — one in the U.S. by Kitching⁸⁹ and the other in the U.K. by Newbould⁹⁰ — based on questionnaires and follow up interviews gave similar results. According to

⁸⁶ Ruback, *supra* note 83.

⁸⁷ *Id.* at 20.

⁸⁸ See Malatesta, *supra* note 68, at 157. For evidence that merger programs are consistent with value-maximizing behaviour of bidder management, see Asquith, Bruner & Mullins, *supra* note 72. *But see* Jensen & Ruback, *supra* note 75, at 9 (“takeover gains apparently come from the realization of increased efficiencies or synergies, but the evidence is not sufficient to identify their exact sources.”) (“there is currently no evidence that directly links these negative pre-merger returns [of targets] to inefficiency.”); Eckbo, *Horizontal Mergers, Collusion, and Stockholder Wealth*, 11 J. FIN. ECON. 241 (1983) (evidence indicates that the gains are more general extending to rivals in the industry as well as to the specific target firm, and removal of inefficient target management is unlikely to be an industry-wide phenomenon).

It would be surprising to find that all the gains reflected in the table are due to a single phenomenon such as elimination of inefficient target management. Some of the gains are also likely to result from other synergies in combining two or more independent organizations, and discovery of the precise nature of these synergies is a complicated task. These results suggest it is difficult to identify the source of the gains from takeovers -- even in the context of a single takeover. See table 10 on pages 100 and 101.

⁸⁹ Mandelker, *supra* note 68, at 304. According to the evidence of Schipper and Thompson, at least the less extreme proposal that managers seek to acquire more firms than is optimal at the margin is tenable.

⁹⁰ The arguments commonly made for unification are: (1) that where excess capacity exists in an industry, output might be concentrated in existing least-cost plants; (2) the reduction in market uncertainty following unification acts as a stimulus to new lower cost equipment; (3) potential economies of scale; and (4) more efficient management of existing assets. According to Meeks, U.K. studies reveal almost without exception, that there exists “either no systematic relationship or else a weak inverse relationship between size and profitability . . . these results sit oddly with evidence of potential economies of scale . . . evidence has appeared of some symptoms of ailments which might afflict large organizations - however promising their performance might be in engineering terms. It appears that bigger plants suffer worse strike records, and there is evidence that they also suffer more accidents per man and enjoy less favorable utilizations of their labor force on account of absenteeism and sickness.” G. MEEKS, *supra* note 34, at 30-31.

The point is reiterated by W. PENROSE, *THE THEORY OF THE GROWTH OF THE FIRMS* (1959), that “beyond a certain point increases in a company’s growth costs are reckoned to stem chiefly from the difficulties of assimilating additions to the management team. They are incurred in expansion by new investment and by takeover alike” *Id.* at 212; *see* R. MARRIS, *supra* note 7, at 114-18.

Kitching's study, management rated 22 out of 69 acquisitions as failures. Of the successful ones, the greatest scope for improved performance was in the areas of finance (amount and cost of capital) followed in order of importance by marketing, research and development, and production. This is an ordering in almost exact reversal of the asserted benefits of acquisition.

Newbould's study of 38 firms revealed a generally unimpressive record for mergers. Zero or negligible effects were reported by 27 acquiring firms on post-merger asset disposal, by 25 firms on plant closure, by 26 firms on sales and by 30 firms on exports.⁹¹ A case study treatment of mergers in particular markets by Hart, Utton and Walshe also reveals the existence of managerial diseconomies following merger.⁹²

Based on these studies, Singh concluded that although the evidence indicated that the more dynamic and efficient firms tend to acquire the relatively weak and inefficient ones, the evidence also indicates "subsequent retrogression with respect to profitability" with respect to both combined assets of the amalgamating firms, and the assets of the acquiring firms before takeover.⁹³ The strong inference, though not

⁹¹ Adapted from Tables appearing in G. MEEKS, *supra* note 34, at 88; Utton, *On Measuring the Effects of Industrial Mergers*, 21 SCOT. J. POL. ECON. 13, 18 (1974).

⁹² Kitching, *Why Do Mergers Miscarry?*, 45 HARV. BUS. REV. 84 (1967).

⁹³ G. NEWBOULD, *supra* note 20.

The same conclusion was reached by others such as Meeks and Newbould. For the U.S., in a study by Lev and Mandelker it is stated:

We can therefore conclude that merger results in the expected once-and-for-all increase in assets, sales and operating income, but does not contribute to the acquiring firm's growth rate in subsequent years. Indeed, the data suggests that these firms experience a decrease in growth rate in the postmerger period compared with non-merging firms - perhaps a 'shake-down' or 'digestion' effect.

Id. at 161-75.

TABLE 10
SUMMARY OF FINDINGS OF THE RELATIONSHIP BETWEEN UNIFICATION AND PERFORMANCE
[Adapted from the Table appearing in MEEKS at 88 and UTTON at 18]

Researcher	Period	Sample Size	Yardstick	Performance measure	Verdict	Summary of results
A. The Early Consolidation Movement						
Dewing	1893-1912 (USA)	35			Worsened performance	Post consolidation earnings below those prior to consolidation
National Industrial Conference Board	1900-1913 (USA)	48			No difference	No evidence that as a whole consolidations were notably or increasingly profitable
Livermore	1901-1932 (USA)	328			No difference	45 per cent of consolidations clearly successful.
Nelson	1899-1910 (USA)	13			No difference	Consolidation common stockholders had marginally lower earnings than average earnings on preferred stock
B. Recent Mergers (USA)						
Lev and Mandelker	1947-68 (USA)	69	Matched sample (with respect to size and industry)	Rates of return on total and on equity assets. Dividends plus share price appreciation	Indecisive Favourable	Net income to total assets significantly higher for merging firms.
Kelly	1946-60 (USA)	22	Matched sample (with respect to size and industry)	Change in share price. Change in price-earnings ratio. Change in earnings per share.	Indecisive Favourable Unfavourable	Profits and profits margins the same for internally and externally expanding firms.
Hogarty	1953-64 (USA)	43	Industry average	Dividends plus share price increase. Change in earnings per share.	Unfavourable Indecisive	Investment performance of heavily merging firms significantly worse than average performance of firms in the same industry.

Lorie and Halpern	1955-67 (USA)	115	Market index	Victim shareholders' capital appreciation	Favourable	Average rates of return for conglomerate mergers higher 1 and 2 years after merger than average return for large companies	
Reid	1951-61 (USA)	478	Tested for individual industries	Relation to acquisition of: change in share price; change in earnings per unit of opening assets; change in earnings per unit of opening sales	Negative Negative Negative	Non merging firms more profitable than all types of merging firms	
Reid	1960-68 (USA)	59			Negative	Conglomerate profitability below that of other firms.	
C. Recent Mergers (UK)							
Singh	1954-60 (UK)	77	Participants' earlier profitability, in relation to industry	Rate of return on net assets	Unfavourable	Majority of firms had post merger decline in relative profitability performance.	
Upton	1961-70 (UK)	39	Matched sample (with respect to size)	Rate of return on net assets	Unfavourable	Merged firms profitability is lower than those of internal growth firms Comparison of performance by groups.	
Meeks	1964-72	233	Participants' earlier profitability in relation to industry	Profitability with appropriate adjustment for accounting bias and changes in company's environment.	Negative	Decline in profitability reflecting a fall in efficiency. Decline heightened where merger results in increased market power.	

proven, is that "it is on balance very unlikely that the reshuffling of economic resources which takes place as a result of the takeover process leads to any more profitable utilization of these resources. The weight of the evidence indicates that the takeover process is at best neutral in this respect."⁹⁴ More recent evidence, however, shows a changing picture for the U.K. As found by Cosh, Hughes and Singh, for the period 1967-69:

[T]he most interesting point to emerge from these results is that the post-merger profitability of merging firms is not lower than that of control group firms. Earlier in the chapter it was found that although the pre-merger profitability of acquiring firms was about the same as that of the matched control group firms, the profitability record of acquired firms before acquisition was distinctly less favourable than that of their matched control group, which suggests that the post-merger performance of merging firms may have improved somewhat relative to that of control group firms.(citation omitted)

These writers also found that acquiring companies grew faster than control group companies after merger.⁹⁵

The U.S. position is less encouraging. Mueller says that "merging firms probably did somewhat worse than their base industries following merger relative to their performance before merger. At best one might argue that they did about as well."⁹⁶ Mueller also found that: (1) the actual profitability of the merged firm was far below its projected profitability; (2) merging companies experienced a greater slowdown in growth rates than their control group firms; (3) mergers led to an unmistakable deterioration in the operating performance of the merging companies; (4) this deterioration led to merging companies' experiencing a greater slowdown in growth rates than their control group firms and in a deterioration in the relative performance of their common shares.⁹⁷ Despite the difference compared to the U.K. position, the findings of Mueller show a marked improvement from that of researchers such as Reid (1951-68), and Hogarty (1953-64) whose findings showed mergers produced an altogether negative result.

⁹⁴ P. HART, M. UTTON & G. WALSHE, *MERGERS AND CONCENTRATION IN BRITISH INDUSTRY* 101 (1973).

⁹⁵ A. SINGH, *supra* note 19, at 166.

⁹⁶ Mueller, *supra* note 63; cf. Lev & Mandelker, *The Microeconomic Consequences of Corporate Mergers*, 45 J. BUS. 97 (1972) ("these firms experience a decrease in growth rate in the postmerger period compared with nonmerging firms").

⁹⁷ A. COSH, A. HUGHES & A. SINGH, *supra* note 51.

The evidence may be summarized as follows:

- (1) Acquiring firms are larger, more dynamic, and have performance records beyond their industry averages;⁹⁸
- (2) Acquired firms are smaller and not dynamic. U.K. evidence shows them to be less profitable than their industry average while U.S. evidence suggests that they were higher;⁹⁹
- (3) U.K. evidence shows that growth and profitability performance of merging firms did not deteriorate following the merger. U.S. evidence shows both a reduction in profitability and a slowdown in the rate of growth in size;¹⁰⁰
- (4) The profitability of acquisitions subsequent to 1968 in the U.K. and the U.S. was as good if not better than acquisitions made prior to 1968.¹⁰¹

Two matters should be highlighted. The first is that in both the U.S. and the U.K., the results of acquisitions subsequent to 1968 were as good as, if not better than, the results flowing from mergers prior to that period. This result is worthy of note if one can remember that (1) regulations governing tender offers came into effect in both the U.S. and the U.K. as recently as 1968, and (2) the effect of such regulation has been to increase the costs of acquisition as a result of the disclosure requirements and the equal treatment provisions.¹⁰² The second matter to note is that even though target firms in the U.K. have tended to perform more poorly than target firms in the U.S., the overall results from acquisitions in the U.K. are far more favourable than for the U.S. This feature is important because earlier studies for both the U.K. and the U.S. showed acquired firms to be poor performers with mergers resulting in an overall decline in performance in both countries.¹⁰³

⁹⁸ *Id.* at 58.

⁹⁹ *Id.*

¹⁰⁰ Mueller, *supra* note 63, at 288-90.

¹⁰¹ *Id.*

¹⁰² *Id.* at 288-97.

¹⁰³ A possible explanation for such results lies with the regulatory system that has evolved in these jurisdictions. Thus, while regulation may have increased the cost of acquisition, the auctioning process it sets in motion seems to have ensured greater compatibility between acquiring and acquired firms. The increased benefits flowing from the latter appears to have offset the additional expenses imposed by regulation. The explanation for the second difference highlighted would appear to lie in the different emphasis placed by the two codes. See Sappideen, *Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United States, the United Kingdom and Australia*, 8 J. COMP. BUS. & CAPITAL MARKET L. _____ (1986), while the regulatory schemes of both countries aspire to provide target shareholders with the twin benefits of adequate information and equal treatment, the U.K. requirements go further in one vital respect. It does not permit, save in special circumstances, a bid for less than all of target's shares. This difference in approach possibly explains the different outcomes in the two jurisdictions since 1968 — the year when the City Code and

6. CONCLUSION

The empirical evidence flowing from mergers, particularly for the U.S., does not show much by way of social gains. The evidence suggests that acquisitions achieve no more than a redistribution of benefits amongst shareholders with zero sum gain achieved overall. What appears to be required, therefore, is not more acquisitions but acquisitions that increase net gains and the creation of a framework to achieve this

Panel came into formal operation in the U.K., and the Williams Amendments came to be enacted in the U.S. Thus, studies for the period of 1954-60 even for the U.K. showed merger performance levels to be "at best neutral." The later study by Cosh, Hughes and Singh for the period 1967-69, shows a marked improvement. A. COSH, A. HUGHES & A. SINGH, *supra* note 51, at 267.

The U.S. position with respect to partial bids has moved further in the opposite direction since 1968. The U.S. regulatory scheme has come around to accommodating privately negotiated acquisitions and front-end loaded two-tiered tender offers. The stampeding effect of these practices (on target shareholders) permits the offeror to focus primarily on the costs connected with the first stage of the acquisition only, *viz.* the acquisition of control. The outstanding balance is acquired at bargain prices. As a countervailing measure, directors set up as many defensive obstacles as they possibly can. While precise figures are not available, it is obvious that the battle lines add up to the costs of acquisition. In the U.K. by contrast, target directors are prohibited from setting up defensive barriers. In fact, target directors are expressly required to further the interests of target shareholders. The inference, therefore, is that acquisitions in the U.K. tend to be allocationally (and therefore also operationally) more efficient than in the U.S.

Evidence of inefficiency in U.S. practice is also found in the type of mergers taking place. Because of the antitrust restrictions on horizontal and to some extent vertical mergers, conglomerate mergers are the prevailing form. A. COSH, A. HUGHES & A. SINGH, *supra* note 51. The poor performance results flowing from such mergers show that profits may not have been the underlying motive. Opinion on whether conglomerate mergers are efficient is divided. Mueller, *supra* note 63 (no efficiency gains or profit gains); G. BENSTON, *CONGLOMERATE MERGERS* (1980) (efficient gains made). The creation of antitrust problems for the individual offeror is a favorite defence strategy. The overall economic impact of such "monolithic" capitalism is considered by other writers. See S. RHOADES, *supra* note 4.

Empirical evidence shows substantial differences in rates of return on retained earnings across industries and firms. Fraumeni & Jorgenson, *Rates of Return by Industrial Sector in the United States 1948-1976*, 70 AM. ECON. REV., 326 (1980). More to the point are the findings of Baumol, *et. al.* These writers noted extremely low marginal rates of return on the earnings ploughed back by firms (3.0 to 4.6%) compared to the employment of new debt (4.2 to 14%) and consistent new equity financing (14.5 to 20.8%). Thus the highest returns flowed from new equity financing. Baumol, Heim, Malkiel & Quandt, *Earnings, Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STATISTICS 345, 353-55 (1970). Such evidence, once again, is hard to reconcile with the assumptions of neo-classical theory. (Neo-classical theory assumes that managers maximize the present value of the firm by investing to the point where the marginal return on investment equals the firm's cost of capital, which in turn equals the return the firm's shareholders can earn on shares of comparable risk of other firms.) See Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); Modigliani & Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433 (1963); Mueller, *Further Reflections on the Invisible Hand Theorem*, in *ECONOMICS IN DISARRAY* 178 (P. Wiles & G. Routh eds. 1984).

objective.

Traditional corporation law concerns itself with defense strategies adopted by target directors to ward off the acquisition threat. While this is an important consideration, it ignores the equally important consideration of the motives of the acquirer. Agency theory shows that the acquirer's motives and the results of acquisition are factors which are just as important, if not more important, in determining issues of policy. The provisions of the City Code¹⁰⁴ show an appreciation of this. Making the target shareholder the focus of attention imposes obligations on both target management and the offeror company. Thus, U.K. target management is restrained from acting like its U.S. counterparts, while offerors are deprived of the chance of acquiring control by unfairly pressuring target shareholders. Such restraint appears to have ensured a greater degree of compatibility in corporate control transfers. It also eliminates the inequities flowing from sale of control transactions, freezouts, and the two-tiered front-end loaded tender offer to name just a few.¹⁰⁵

Acquisitions, therefore, appear to be a manifestation of managerial

¹⁰⁴ Panel on Takeovers and Mergers, City Code on Takeovers and Mergers (1968).

¹⁰⁵ See S. RHOADES, *supra* note 4:

Once it is recognized that the desire for personal power is a primary motivator of businessmen, the large body of evidence showing that mergers generally do not result in higher efficiency begins to make sense — many of the mergers are primarily motivated by neither efficiency nor profits. Consequently, antitrust legislation that would sharply curtail merger activity would neither stifle invention and innovation nor reduce economic efficiency. The opposite would more likely be true. To preserve competitive capitalism and the pluralistic sociopolitical system that is consistent with it, the power drive of businessmen must be constrained. I propose constraints along the following lines:

A. No company, regardless of size, would be allowed to acquire or merge with more than one other company during a single calendar year.

B. No company, regardless of size, that is among the top quarter of the number of firms in an industry or accounts for 20 percent or more of industry sales would be allowed to acquire a firm that is among the top quarter of the number of firms in another industry or accounts for 20 percent or more of its industry's sales. (For example, a top maker of hair tonic could not acquire a top maker of toothpaste.)

Point A is the essential feature of this proposal. Point B is intended to prevent firms that occupy leading positions in one industry from expanding into another industry by acquiring one of the leading positions. Presumably the prohibition in B above would apply also to acquisitions within one's own industry.

Id. at 146.

See also, Lowenstein, *Hostile Take-overs*, *supra* note 28, at 318 (Lowenstein proposes, in part, that the offer, unless approved by the board of the target company, be left open for a period of six months from the date it is made); Lipton & Vlahakis, *supra* note 28; S. RHODES, *supra* note 4.

ambition rather than a product of the evaluation of opportunity costs. For example, the evidence that target shareholders receive abnormal gains while offeror shareholders do not lose (at best) in the face of a tender offer raises the question as to why target managements resort to defensive tactics and offeror managements engage in acquisitions. Similarly, the lack of evidence of greater profitability flowing from acquisitions compared to internal expansion, raises the question as to why firms engage in such wasteful action. While the management team of a successful acquirer reaps benefits, the management team of the acquired company also has its share of the loot through "golden parachute" agreements. More importantly, there is another form of compensation for management of both target and offeror. As the study by Asquith shows, the increased share prices of target (and to some extent of the offeror) are registered long before an event takes place or is even announced.¹⁰⁶ The managements of target and offeror have clear knowledge of the impending event, and it is they who stand to gain from the event regardless of the outcome.¹⁰⁷ Management, therefore, "appears to be the only consistent gainer from merger activity."¹⁰⁸

Marris and Mueller sum up the position thus:

The strongest prediction of the neo-classical theory is . . . that mergers increase the welfare of stockholders. This hypothesis has not been confirmed By contrast, the managerial prediction that mergers will take place when firms have the resources and discretion to consummate them, whether they are profitable or not, and even when the share performance of the acquiring firms may suffer, seems as consistent with the evidence as any.¹⁰⁹

¹⁰⁶ Asquith, *supra* note 68.

¹⁰⁷ Mueller, *supra* note 63.

¹⁰⁸ G. NEWBOULD, *supra* note 20, at 193.

¹⁰⁹ Marris & Mueller, *supra* note 23, at 45.

Although the managerial theory tells us something about the characteristics of acquiring firms in mergers . . . it says nothing about the characteristics of the companies they acquire. . . . Although the cheaper firms tend to be the ones taken, we do not at present have a clear idea of what makes them cheap. Furthermore, given that a number of firms are at a particular time cheap, we do not know which ones will be taken over and which survive.

Id. at 48.