1988

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Recommended Citation
John C. Coffee Jr., Joseph A. Grundfest, Roberta Romano & Murray L. Weidenbaum, *Corporate Takeovers: Who Wins; Who Loses; Who Should Regulate*, 12(1) REGULATION 23 (1988).
Available at: https://scholarship.law.columbia.edu/faculty_scholarship/3844

Corporate Takeovers

Who Wins; Who Loses; Who Should Regulate?

John C. Coffee, Jr., Joseph A. Grundfest, Roberta Romano, and Murray L. Weidenbaum

On December 3, 1987, during its 11th Annual Policy Conference in Washington, DC, the American Enterprise Institute convened a panel discussion on "Corporate Takeovers and Insider Trading: Who Should Regulate?" The panelists were John C. Coffee, Jr., professor of law at Columbia University; Joseph A. Grundfest, commissioner at the Securities and Exchange Commission; Roberta Romano, professor of law at Yale Law School; and Murray L. Weidenbaum, Mallinckrodt Distinguished University Professor and director of the Center for the Study of American Business at Washington University. The panel was moderated by Christopher C. DeMuth, president of AEI. The following discussion is drawn from these proceedings.

PROF. WEIDENBAUM: How should we regard takeovers? The prevailing view in the scholarly literature is that takeovers of major American corporations yield positive results because the shareholders usually benefit. I disagree.

Most economic studies of takeovers fail to answer, or even to ask, whether the new company performs better than did the separate parts. Those few that have tried to answer this question have concluded that takeovers are harmful.

Most scholarly studies focus on what happens to the market value of the target companies. Not surprisingly, the price of the target company's stock invariably rises during the takeover battle. On reflection, would we expect anything else? After all, what serious raider would try to acquire stock by offering less than the market price?

But the prevailing view in the economics literature goes beyond a restatement of the obvious. It also makes an heroic assumption: that the value of the target company rises because the new management is likely to manage more effectively than the old. Unfortunately this assumption is often mistaken for irrefutable fact. Why is it irrefutable? Not because empirical studies demonstrate the point. There is little evidence that tenderers have managed the businesses they acquired any more profitably than their peers or their predecessors. Rather, the presumption of greater productivity is supposedly irrefutable because it is the only conclusion consistent with the efficient-market hypothesis.

It is premature to conclude that stockholders generally benefit from takeovers. After all, for each seller there is a buyer. What happens to the stock of the firm that does the taking over? The answer to this question is downplayed in the takeover literature because the stock price of the acquiring firm usually declines after the merger is announced—sometimes substantially (between 5 and 42 percent) and sometimes imperceptibly (3 percent or less). All sorts of apologies are made for this inconvenient conclusion. Inevitably, some question the statistical methodology used, although it is the same as that used for the enthusiastically embraced findings that the share prices of target firms rise. In fact, the two sets of findings come from the very same researchers in the very same studies.

The widely held belief that shareholders generally benefit from takeovers does not withstand close scrutiny. There are winners and losers. But the results are counterintuitive: the owners of the "winning" firm—the buyers—lose; the owners of the "losing" firm—the sellers—win.

Furthermore, it is not clear that the takeover process benefits society. Of the studies that show the dollar amounts of the gains and losses to both groups of shareholders, several show net gains, and several show net losses. But few of these results are statistically different from zero. Thus one need not quarrel with the efficient-market hypothesis or with "event studies" to conclude that little net social benefit seems to accrue from the entire takeover process.

Many members of Congress are concerned over what they view as a rising trend of hostile mergers. Representative Peter Rodino, chairman of the House Judiciary Committee, for example, stated, "I think it is time for Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top managements for control of corporate assets."

But if we have learned anything from the long history of government regulation of business, it is that when Uncle Sam intervenes in internal business decision making, he usually does more harm than good. Regulation is likely to generate serious and often unexpected side effects—the "government failure" that so frequently accompanies attempts to deal with "market failure."

My preference is neither for new laws nor for a do-nothing approach. The proper answer to corporate takeovers can be found in the corporation itself.

In addition to "takeover artists" and "entrenched managers," there is a third private-sector force battling for corporate control, the firms' own boards of directors. These boards are elected to represent the shareholders. Their most important, but rarely performed, duty is to say no. The board of a bidding firm should oppose a prospective merger that would, over the long run, dilute the earnings of existing shareholders and, in the short run, reduce the market value of their shareholdings. Similarly the board of a target firm must decide when an offer for the corporation's shares is sufficiently attractive to accept over the protestation of the existing management.

If the raiders are opportunists, then management and boards of directors have given them the opportunity. The record is clear: if the board will not make the difficult choices that enhance the value of the corporation, the takeover artists will. Takeover mania is not a cause but a symptom of the unmet challenge. The complaisant director has not totally vanished from the boardroom. However, the increasing frequency of shareholder derivative suits to challenge board decisions makes future decisions less likely to be based on management's preferences.

PROF. COFFEE: Murray Weidenbaum has raised a valid point about takeover gains. He is concerned that takeovers may represent little more than wealth transfers from bidder shareholders to target shareholders, with no net increase in wealth. He points to studies by others that suggest that bidders lose significantly, and that since bidders are often much larger than target firms, there are likely to be net losses.

This is arguable. In fact, it has been argued for some time. But it is also susceptible to empirical resolution. We need data not only on the aggregate gains or losses to bidders or targets, but also on the gains or losses to matched pairs of bidders and targets. These data have only recently become available. In a recent study Michael Bradley, Anand Desai, and E. Han Kim of the University of Michigan Business School examine the combined wealth effects for all takeovers in which the bidder and the target were publicly held and for which data on stock prices were available. This is a set of 236 matched pairs between 1962 and 1984.

Bradley, Desai, and Kim find that over the entire period, the combined value of target and bidder firms increased by about 7.5 percent. In three out of four cases, the gains exceeded the losses. This leaves one out of four cases in which the net impact of the takeover was negative, meaning the shareholders of the bidder lost more than the shareholders of the target gained. The average dollar gain per takeover over the whole period was $117 million.

Even more interesting than the aggregate data is the breakdown into time periods. During the 1960s, acquiring firms made statistically significant gains from takeovers. During the 1970s, however, they made no statistically significant gains or losses.

What has happened in the 1980s? From 1981 to 1984, for the 52 matched pairs, the combined value of bidder and target firms increased by 8 percent, or $219 million per takeover. This higher average gain reflects the larger size of targets. The most interesting finding is that bidders are incurring statistically significant losses: about 3 percent of their market value, or about $27 million per takeover.

The evidence is clear. That bidders currently lose from takeovers is not a myth. In only about 35 percent of the cases do bidders break even or do better. In nearly two-thirds of the cases, bidders' stock tends to go down. Still, over the entire period, the net effect of takeovers is strongly positive. Although some shareholders lose, on average, takeovers help shareholders.

I think it is a mistake to focus on bidder shareholders versus target shareholders. Shareholders hold diversified portfolios. They do not know whether they are going to hold stock in a target or in a bidder; because they are diversified, they know that, on balance, they will do well.

Isn't it curious that the new state statutes give target shareholders more protection, when the only victim is the bidder shareholder?

The pattern of gains and losses is also very unstable. One would not expect the world to remain in one position forever, with bidders regularly losing two-thirds of the time, and target shareholders regularly reaping very large gains. One would expect the world to change in many ways, possibly with takeover pressure beginning to focus on unsuccessful bidders.

Moreover, if bidders lose, so what? Loss is a basic fact of entrepreneurial life. Four out of five new restaurants that open in Manhattan this year will probably fail within two years; yet we do not ban new restaurants. We generally believe that social gain accrues when people take entrepreneurial risks, even if some individuals incur losses. The same applies to takeovers. And isn't it curious that the new state statutes give *target* shareholders more protection, when the only victim is the *bidder* shareholder?

Let me move from what we know about takeovers to what we do not know. We do not know what motivates bidders. The source of takeover gains has long been a mystery. Certainly some managerial theories about perverse incentives seem plausible. But there is a new debate brewing among economists. Financial economists, on the one hand, do stock price studies, and they invariably find that, on balance, target stocks rise. Industrial organization economists, on the other hand, study the assets of the target firm, one to three years after a takeover. They find no evidence that target assets are better managed after takeovers. Their findings are strongly inconsistent with the view that bad managers are being replaced by better managers.

So we have a puzzle. Shareholders clearly gain, yet there is no evidence that the assets are better managed. Although there are many problems with defining the criteria for better management, we can conclude that shareholder gains do not necessarily translate into social gains.

It is possible that other people are losing. The most likely candidates—aside from creditors, who can protect themselves—are probably managers, particularly middle managers who are not usually the beneficiaries of golden parachutes. I am not arguing for legislative protection, but I probably am arguing for greater tolerance for self-help remedies, such as the newly popular tin parachute. This is a direct self-help response to the problems that arise in this rather unstable world.

Another such response is the leveraged buyout. I believe that the leveraged buyout will become more and more frequent, and that increasingly hostile takeovers will be the precipitating force. What seems to be moving takeovers in the last five years is negative synergy, that is, the creation of value from breaking up conglomerate firms.

PROF. WEIDENBAUM: Jack Coffee is letting off the hook too easily the prevailing finance literature on takeovers, exemplified by Michael Jensen's widely cited article in *The Harvard Business Review*. This article, and others in its tradition, refer to event studies as science, and to everything else as fiction. The data showing that target shareholders gain are said to be sound. The data showing that bidder shareholders lose are said to need further examination. They then firmly conclude that the economy benefits because takeovers are good for shareholders.

This has been the prevailing view in the economic finance literature. I am glad to see it becoming more reasonable, but let us not let those guys wiggle off the hook so easily.

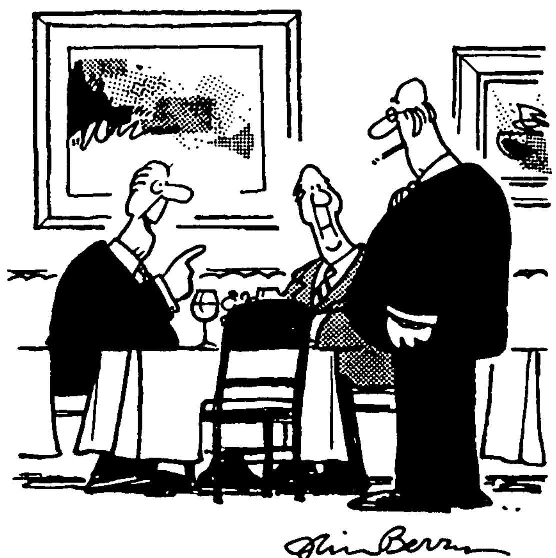
MR. GRUNDFEST: As an attorney and an economist, I would like to come to Jack Coffee's defense. We do not observe strong gains among bidders the way we do among targets. However, there are some fascinating patterns in the data. They suggest that market processes work in an evolutionary fashion to discipline acquisitors who engage in transactions that fail to add value in the marketplace.

Researchers at the Securities and Exchange Commission have discovered that aggregate data describing bidder returns mask significant differences within the population of bidders. In other words, while the average stock price effect on bidders' shares is close to zero, there are bidders with statistically significant negative returns and bidders with statistically significant positive returns. The bad bidders, those whose stock prices fall as a consequence of acquisition announcements, often become good targets themselves as the market later tries to undo their nonproductive acquisitions. These failed acquisitions often involve conglomerate strategies in which the buyer adds little, if any, operating value to the target firm. The market's subsequent attempts to discipline these transactions are often criticized as bust-up transactions even though they add economic value by creating more rational corporate forms involving less so-called conglomerate overhead.

Mergers and acquisitions are risky propositions. There is a Schumpeterian process at work as the market throws out the failures and tries to reward the successes. The problem with much of the legislation in the takeover area is that it would stop the operation of this evolutionary process. We would be trying to protect the failures, and at a very high price.

PROF. WEIDENBAUM: We agree on the public policy implications. No quarrel there.

PROF. ROMANO: Let me add a further wrinkle on the issue Murray Weidenbaum raises concerning the shareholders of acquisitors. A number of studies have found insignificant returns for bidders. This is not completely surprising. Competition among bidders reduces rents. Unless there were some unique synergies for a bidding firm, one would not expect a large positive return. More troubling is a finding of negative returns. Jensen argues—and I agree—that accounting data, which are used in the industrial organization literature, are unreliable. Accounting data can be a very poor measure of economically relevant information. Such data, for example, showed railroad companies doing well before they went into bankruptcy. So I understand the desire to use market price data as opposed to just accounting returns.



"Say, isn't your company owned by the SAME COMPANY that owns mine?"

With respect to Murray's argument about boards, boards may not always be able to do what a bidder can. An interesting study by Randall Mørck at the University of Alberta, and Andrei Shleifer and Robert Vishny at the University of Chicago's Graduate School of Business bears on this. They found that when boards fire managers, the firms were doing poorly relative to their own healthy industry. But the targets of hostile takeovers are in industries that are doing poorly relative to the market.

I do not know how much to make of this, but it would suggest that boards can tell if their company is doing well compared to their competition. When the whole industry is doing poorly, a hostile bidder may be more effective than the board at breaking existing contracts with the work force, and taking other steps necessary to revive the firm.

I do not understand why management cannot do that itself, so I have mixed feelings about such a thesis. But even if we accept that view it is still possible to agree with Murray that boards can be better monitors of what management is doing.

PROF. COFFEE: We have hard data on bidders incurring significant negative stock reactions. This cannot go on forever. Bidders themselves may become the targets of hostile takeovers, a self-corrective response. Alternatively, boards may see a few vivid lessons and become more aggressive. I do not dispute anything that Murray said about directors being more aggressive. But that is an hortatory prescription, and I am not optimistic about it having a meaningful impact.

Why are bidder returns dropping to a negative level? Partly because, as Roberta Romano mentioned, we have a much more competitive market for corporate control. Most takeovers today result in multiple bids which compete away the rents.

But this would lead only to insignificant returns. What we may have here is a possibility raised by Professor Richard Roll, the hubris hypothesis, also called "the winner's curse." The person who wins an auction may well be cursed because he paid more than everyone else was willing to pay. He may have paid more because he had unique synergy gains available only to him, but he may just have been too optimistic.

One other point. Bidders that are incurring losses tend to be large corporate bidders. But bidders that break up firms and sell them off have not had losses. Ronald Perelman, for example, after taking over Revlon, broke up the company, paid off the junk bonds, and wound up with 40 percent of the assets absolutely free. This kind of negative synergy takeover is likely to continue. It will probably also precipitate more leveraged buyouts, because what bidders can do, managements can also do once they are under the gun.

One last point. It would be interesting to look at differences between the American and the English systems. In England, when Hanson Trust finances a takeover, it does not use junk bonds, but typically makes a subscription offering. English bidders in takeovers offer their own stock or use cash. That introduces some market discipline: if the market thinks the bidder is paying too much, or has a history of making overpriced acquisitions, the subscription offering will flop.

This equity subscription process has been very successful. English takeovers may have produced less of a winner's curse. I am not suggesting legislation of any kind, but it is interesting to see how a different system may have an internal brake.

The person who wins an auction may well be cursed because he paid more than everyone else was willing to pay.

MR. GRUNDFEST: There are substantial variations in patterns of bidder gains. It makes a big difference whether the bidders are specialists in the business, dabblers, or conglomerateurs; whether they are large or small; whether the deals are done for cash, as swaps, or as equity subscriptions. Even though the findings are preliminary, some trends are emerging. I suspect, for example, that the more subject the bidder is to market discipline, the greater are his gains. Cash deals are more subject to market discipline than swaps and thus may be correlated with superior performance.

Also stock prices often increase significantly when CEOs die. This "morbidity effect" occurs because problem CEOs are often perceived by the market as having hung around too long. When they die, stockholders often feel relieved. Two examples often cited in the popular press are Gulf and Western, and Resorts International, where the CEOs passed away unexpectedly and stock prices rose remarkably. This confirms Murray Weidenbaum's observation that boards do not always effectively discipline managers.

ROBERT H. MALOTT: I am the Chairman and CEO of the FMC Corporation. All of you have talked about the short-range value of takeovers to the seller, to the buyer, or to the shareholder, but I did not hear any of you address whether in the long run the takeover movement is positive or negative. Is the economy better off for having Phillips, Union Carbide, Borg-Warner, or other companies go through this process? Are those companies better off?

PROF. WEIDENBAUM: I have a few observations, but no definitive answers to your questions.

First, I would have to say that Phillips and Unocal—their shareholders and maybe the industry—would have been better off if they had sold out to Boone Pickens. I do not think you can blame Pickens for the heavy debt load those two companies have. In the case of Phillips, it was a decision to perpetuate the management and to protect the community.

Second, it is hard to translate takeover battles into reduced performance on the part of American industry. I know there are many examples of companies forced to think and act short-term, but look at the aggregate data on research and development. In the 1980s, just as the takeover trend has accelerated, the private sector has displaced the federal government as the primary source of funding for research and development. This is a very encouraging shift, and it shows the long-term orientation of American business as a whole.

PROF. ROMANO: I agree with Murray Weidenbaum on this issue. Studies by the Office of the Chief Economist of the SEC and by Bronwyn Hall of the University of California at Berkeley have found that acquisitions do not have a negative effect on research and development expenditures. The SEC study also found that the market placed a positive value on announcements of long-term investments such as research and development.

MR. GRUNDFEST: I think Mr. Malott's question deserves a direct answer.

The question is whether all of these takeovers and restructurings are really good for the economy. The answer is that I can imagine more civil and less costly ways of achieving these restructurings where the investment bankers' and lawyers' fees would be lower, and where there would be less grief. But, given the way we do it today, is restructuring beneficial? Absolutely. Some of your own examples illustrate why.

Take the oil industry. If ever you saw a situation of screaming disequilibrium, it was the oil industry in the early 1980s. You could buy oil for $6 or $7 a barrel on the New York Stock Exchange and, at the same time, companies were investing in drilling projects that made sense only if the price of oil were to rise to $35 or $40 a barrel. That is disequilibrium in anybody's book. The companies taken over usually had bloated exploration budgets and were not very effective in finding new oil. I do not want to say that hindsight is the right way to judge anything. But in this case the market's judgment was right.

PROF. COFFEE: There are multiple perspectives on the assertion that bust-up takeovers occur because the liquidation value of assets substantially exceeds the market value.

In the "go-go" market of the 1960s, two small companies could somehow be put together into a conglomerate to produce positive synergy. Oliver Williamson, the leading theorist in this area, explained why the conglomerate was an efficient response to market conditions then.

Today the market believes that the conglomerate is an inefficient dinosaur. Substantial market pressure forces companies to define more narrowly their products and services, and their area of special competence. Even companies not threatened by takeovers are selling off their peripheral activities in a belief that the stock market will value them more highly if they focus on their core business.

What is behind that? One possibility is negative synergy. Somehow the large conglomerate has gone beyond its most efficient or optimal span of control. Another possibility is the free cash flow theory, which maintains that managers of conglomerates cross-subsidize their losing division with profits from profitable divisions. Spinning off divisions disciplines managers.

I see no great social harm in reducing the span of activities of the large conglomerate. That is occurring, and would be occurring even without the takeover. Exxon, for example, is repurchasing shares even though it does not feel threatened by takeovers.

I think the takeover is the most powerful force toward this shrinkage. The downside is that takeovers disturb the nexus of contracts that used to exist in the firm, disrupting some of the implicit contracts that bound managers to firms and gave them reasonable expectations of lifetime employment. Managers are now in a much more unsettled world.

MR. DeMUTH: I would like to ask the panel whether there are any areas of potential abuse or other problems that warrant attention from legislators. Can you identify areas that require public policy intervention?

MR. GRUNDFEST: Our system today is far from perfect and much can be done to improve it. The most important improvements may involve a shift away from across-the-board rules that regulate all corporations identically, and toward a system of self-determination that allows each company's stockholders and management an opportunity to define the rules under or by which it will respond to takeover proposals.

We must have a flexible system that can reach judgments on a case-by-case basis. The government must look toward "private ordering," where the interests involved in the operation of the corporation can establish for themselves rules of governance and patterns of behavior that define how corporations will be taken over. I can see no reason for making the rules for takeovers the same for every corporation in the United States.

PROF. ROMANO: Let me reemphasize what Jack Coffee mentioned. We really do not have a good theory of acquisitions. With limited understanding, we should be very hesitant about enacting federal laws to affect acquisitions. There are at present several varieties of state takeover laws. If we knew what the ideal statute was, then there would be more uniformity as all of the states would have adopted it.

PROF. COFFEE: Is there a potential for abuse? We have focused on shareholders. I agree with the rest of the panel that shareholders are not being abused. In fact, they are making out like bandits. Takeovers increase shareholder wealth tremendously. Self-help or private-ordering remedies such as the fair price charter amendments, the poison pill—if approved by stockholders, and the super-majority provisions can promote stockholder interests. The increasingly competitive market for control under which a low bid simply triggers an auction also protects them: the greatest defense against exploitation through inadequate tender offers is that someone else will make a higher tender offer. We have seen a very competitive pro-auction policy in this area. The Williams Act, in effect, facilitates auctions by stretching out the time period.

From this standpoint, shareholders do not appear to be abused. That is the irony—every reform proposal that we see today, including the 15 state statutes that have been passed just since April, are premised on the myth that shareholders need protection. The problem is excessive defense, not inadequate tender offers.

WILLARD C. BUTCHER: I am the Chairman and CEO of Chase Manhattan Bank. In this discussion, we have spent a lot of time focusing on whether takeovers enhance shareholder value. I would just submit that the shareholder is not the owner, but a speculative renter.

When we think of owners, we might imagine a 19th-century mill owner in New England who had a long-term responsibility not only to the company but also to the community. Today we have institutional investors. If directors or managers consider only their own interests, they will sell out on every single takeover offer that enhances shareholder value.

It seems to me that shareholder value is not the issue. I represent a company that was incorporated before corporation law. I recently read the charter, and nowhere does it mention enhancing shareholder value. We have a broader societal issue here: what is really good for building economic capability in the country? That is why we have corporation laws in the first place. It is not just an issue of enhancing shareholders.

Are we better off because there is no St. Regis Paper or Continental Can Company? Is the economy basically better off?

I have not heard much about that. If it were merely a case of enhancing shareholder value, every CEO in this country nearing retirement would put his company into play. Their stock options would be worth a great deal more. And yet they do not do that. I do not want to attach either noble or stupid motives to CEOs. But there are broader issues.

PROF. COFFEE: I think there is something in what you are saying. Maybe you have stated it too broadly, though, by focusing on institutional investors.

You mentioned St. Regis disappearing. I think there is a danger of reifying companies and treating them as the real players. We have to decompose the corporation and look at its various constituents—creditors, employees, managers, and shareholders, only some of whom are institutional investors. Institutional investors are often pension plans such as the California State Teachers' Retirement Plan. People are ultimately the beneficiaries of these gains. These gains flow through institutions.

(Continued on page 47)

(Continued from page 29)

I admit that shareholder gains do not necessarily equal social gains. But to say takeovers are bad, we have to find a clear loser because we know someone is benefiting. The only possible losers are managers and employees. I have argued at great length elsewhere that the tin parachute is something the court should show great tolerance because with very generous programs of tin parachutes there need not be any clear losers.

PROF. ROMANO: Let me say two things in response. First, I do not think all firms can be profitably taken over, and not every CEO, when nearing retirement, can find someone who can profitably pay a lot more for the firm.

Second, we focus on enhancing shareholder value because when looking at a corporation, it is difficult to conceive of who else's interests would be appropriate for determining the efficient allocation of resources in the economy. For instance, the literature suggests that firms that are worker-owned rather than shareholder-owned, such as Yugoslavian firms, do not end up with the most efficient allocation of resources. Workers appear to have far shorter time horizons than investors. In fact, in the U.S. plywood industry, where we have workers' cooperatives, workers hire managers and these firms look a lot like corporations with outside non-management shareholders.

MR. GRUNDFEST: I agree with Mr. Butcher's observation that the modern role of the shareholder is very different from the 19th-century role of the owner in a closed corporation. Corporations raise capital from a variety of sources: by borrowing money, by selling preferred stock, or by selling common stock. These various sources of capital exercise different types of control over management.

Nobody says,"Here, have some money, have fun." Bond holders lend money and in return get covenants that protect them. Preferred shareholders have other protections. Common stockholders are most at the mercy of the decisions made by management. The board must vote to give them dividends. They are the ones with the residual claims that have value after everybody else has been paid off.

I think we are seeing a change in the technology of finance that has increased the power of the shareholder in corporate control. After many years of neglect, the shareholders are revolting against a system that has not rewarded their risk and investment as well as it could have.

Is the only role of the corporation to enhance shareholder value? Of course not. That would never work. To enhance shareholder value, you have to have satisfied workers and good products, and you have to make a profit. Nobody will invest in a corporation whose workers are on strike all the time or who do not produce quality products. I believe that in corporations in which management is doing a bad job, workers *and* stockholders are hurt.

Consider the automobile industry. Honda and other companies are building cars in the United States for export to Japan. The capital investment in those plants is a fraction of the investment that General Motors has made in many of its facilities over the last few years. Who has been hurt in General Motors? The workers and the stockholders. If you help the workers, you will help the stockholders. If you help the stockholders properly, you will definitely help the workers. It is a cooperative situation, not a competitive one.

I disagree with Jack Coffee about one thing: tin parachutes. Tin parachutes are hypocritical. A tin parachute says that if I, senior management, get fired or lose my job in a hostile takeover, you, middle management and lower level employees, will get tremendous severance benefits at the expense of the stockholders. However, if I keep my job but decide to restructure the corporation, you get nothing—and the stockholders lose nothing. It is a hostage strategy, pure and simple. I think those types of strategies will not, in the long run, serve management's interests. They will increase pressure at the federal level for job security legislation, for plant closing legislation, and for rules against laying people off under a wide variety of circumstances. The regulators' rationale will be that we are not doing anything that management was not willing to promise anyway.

PROF. COFFEE: In several airlines, the pilots' and machinists' unions are negotiating for a right of first refusal to take over the company. At United, the new collective bargaining agreement terminates in the event of a takeover. That is not purely a case of management putting in a poison pill. That is the union's own self-interested position. Faced with a new level of job insecurity, workers want the ability to renegotiate.

If we see a potential for opportunism, we should be sympathetic to new contracting arrangements which try to reduce the prospect for opportunism, such as by giving some kind of takeover-related severance benefits. I think we will see more of this. Without legislation, and I am certainly not urging any, we will see new contracts involving employee unions, particularly in industries like the airlines.

MR. GRUNDFEST: I understand how you could say that these new contracts just reaffirm the preexisting arrangements. However, in some industries, wages are way out of line with the wage costs encountered by new entrants. Someone can hire a group of pilots at far less than they are being paid at their current airline jobs, lease a fleet of planes, and be in the airline business, competing at lower costs. This reflects a fundamental disequilibrium in the industry. To the extent this type of renegotiation takes place, putting contingent claims on an existing firm, losses are shifted from workers to the stockholders and other people with capital claims on the corporation. This increases the cost of capital in these industries. In this process, losses are never eliminated—they are merely shifted.

PROF. COFFEE: Are you suggesting that if the union and the existing management reach such an agreement, you would invalidate it?

MR. GRUNDFEST: Absolutely not. The point I am making is that these contracts will be unstable unless the participants also address the underlying economic changes that induce the renegotiation.

PROF. COFFEE: We have not seen stability in the takeover field since the very first takeover.

PROF. ROMANO: It is important not to forget the context in which the controversy over takeovers and the demand for their regulation arises. In our federal system of government, corporate law is under the jurisdiction of the states. We have dual jurisdiction of takeovers, however, through the Williams Act, which is part of the federal securities laws. The modern debate over who should regulate corporations, and hence corporate takeovers, was launched by William Cary's 1974 article on federalism and corporate law in the *Yale Law Journal*. Cary called for federal regulation to end what he termed "the race for the bottom": the competition between the states to loosen corporate regulation and thus to attract more corporations. Delaware was—and is—winning this competition.

The classic statement in support of regulation by states, which permits competition among regulations, was Ralph K. Winter's response to Cary. This was expanded into a book, *Government and the Corporation*, published by the American Enterprise Institute in 1978. Winter identified a crucial flaw in Cary's analysis. He suggested that the race was to the top, not to the bottom. Cary had overlooked the fact that firms operate in many markets, including the capital, product, and corporate-control markets. Each of these constrains managers from operating under a suboptimal legal regime for, as Winter argued, firms in non-value maximizing legal regimes will be outperformed by those operating under value maximizing laws. They will have lower stock prices, subjecting their managers to the possibility of replacement by a successful bidder who can increase firm value by changing domicile.

Managers have an incentive—job protection or preservation—to opt for the legal regime that shareholders prefer, the one that maximizes the value of the firm. Accordingly, states have an incentive to offer value maximizing laws: doing so increases revenues by attracting corporations from other states.

Since Cary's and Winter's papers were written, we have accumulated much empirical evidence on the effects of state competition. If state competition truly harms shareholders, we should expect the stock prices of firms that change their state of incorporation to drop. Yet using conventional financial econometric techniques, several studies have found the opposite: such firms had either statistically significant increases or no significant change in their stock prices. No study has found a negative stock price effect—that is, any shareholder wealth loss—from reincorporating.

Do states compete for incorporation business? As innovations in corporation codes spread across the states, there is evidence of a positive correlation between a state's responsiveness and the percentage of its revenues received from franchise taxes. My own research has sought to explain Delaware's continued success in the corporate charter market. As a measure of its success, consider these figures. In a sample of about 700 firms that changed their state of incorporation between 1961 and 1983, 82 percent moved to Delaware. Slightly more than half of *Fortune's* top 200 manufacturing firms are in Delaware.

Firms, particularly those that go to Delaware, relocate when they anticipate engaging in certain types of transactions, such as public offerings, mergers and acquisitions, or defensive tactics against takeovers. These transactions increase the likelihood of shareholder litigation. The cost of such transactions can be reduced under a new legal regime.

After a firm incorporates in a particular jurisdiction, the state can change or fail to update its code when other states innovate; relocating would be costly for the firm. This leaves firms vulnerable to opportunistic behavior by states.

To be able to charge a premium for chartering in its jurisdiction, a state must guarantee that it will not be opportunistic, that it will continue to respond to the firm's demands. Delaware receives a large proportion of revenues from the franchise tax: from 1960 to 1980, franchise taxes averaged about 16 percent of state revenues.. This high percentage guarantees continued responsiveness because Delaware has no readily available alternative source of revenue. In addition, many of Delaware's citizens earn substantial income by servicing Delaware corporations. Other states, such as New York and California, collect more from the franchise tax in absolute dollar terms, but only about 1 percent or less of their budget.

Managers have an incentive—job protection or preservation—to opt for the legal regime that shareholders prefer, the one that maximizes the value of the firm.

Delaware also has invested in intangible assets that have no use outside the chartering business. These assets, loosely called "legal capital," are a stock of legal precedents and judicial and administrative expertise in corporate law. This legal capital commits Delaware to being responsive. Delaware also has a first-mover advantage, making it difficult for another state to compete successfully by, for instance, offering the same code as Delaware but at a lower tax rate.

Admittedly, state takeover laws are the laws that are most troubling to proponents, like myself, of a state system. The reason is that changes in control are often accompanied by changes in management personnel, resulting in a very strong potential for conflict of interest between managers and shareholders over the success of a bid. Even here, though, I think the cautiousness of Delaware's approach provides some encouraging support for state competition. The extensive deliberative process in Delaware produced a law that is less restrictive of bidders than the laws of other states.

The problem is highlighted by the legislative process of takeover laws, which leaves much to be desired. State takeover laws are typically promoted by the Chamber of Commerce at the behest of a major local corporation that is, or fears it will be, the target of a hostile bid. The urgency of the firm's situation leads to rapid, sometimes overnight, enactment of legislation with little or no public debate. In fact, this is one feature that differentiates Delaware from other states. Delaware has such a large and diverse corporate constituency, including bidders as well as targets, that no one firm's management has the clout to get a bill passed overnight.

I think a damning feature of the recent state legislation is that it codifies defensive strategies that firms could already have adopted voluntarily by charter amendment. The difference between "self-help" and the legislation is that self-help requires a shareholder vote of approval; the vast majority of state takeover laws, on the other hand, cover firms unless they opt out, allowing managers to avoid obtaining their shareholders' consent.

The way these laws are enacted leaves me with a nagging suspicion that the managers promoting them believe that their shareholders' approval would be harder to obtain than their legislators'. There may be good cause for such a concern. The available empirical evidence on the effects of state takeover laws does not promote confidence in their value maximizing qualities. Studies find that these laws have either a negative stock price effect or an insignificant effect on share prices of firms incorporated in those states. If state takeover laws really increase shareholder welfare, we would expect to see a positive return to the affected firms. As in the case of reincorporations, although the data are not conclusive, they are relatively one-sided.

If there is an area of state regulation to worry about, therefore, it is takeovers. This does not mean that preemption by federal regulation is the answer. Most of the bills introduced in Congress rival the proposals before state legislatures in attempting to restrict bids. There are some differences in the constituencies at the national level and those at the state level: the former include the SEC, the securities industry, and some organized groups of investors. But it does not strike me that laws emanating from the U.S. Congress would necessarily be much different, let alone better.

So while our positions on the efficacy of takeovers probably differ greatly, I agree with Murray Weidenbaum that the best way to deal with corporate activities is through the parties' private contractual arrangements. If shareholders of a firm want to restrict their firm's ability to receive a bid, that is fine. They should place those restrictions in their charters. I am leery of the economic consequences of increased intervention in corporate governance.

With federal regulation, we lose the edge of responsiveness to changing circumstances, the key element in an efficient system of state competition.

But if we have to have government regulation, state regulation is preferable to federal regulation. With federal regulation, we lose the edge of responsiveness to changing circumstances, the key element in an efficient system of state competition. Given the size of its budget, the federal government has no revenue incentive to meet firms' desires. And corporate law, which deals with the relationships between shareholders and managers, is hardly a salient election issue at the national level. It is hard to believe that an unresponsive member of Congress would suffer immediate adverse reelection consequences; a Delaware legislator who suddenly shifted his or her position on corporate law would.

Most members of the public, as consumers and workers, stand to gain from a strong takeover process and from the efficient allocation of resources that occurs when firms are being run in the shareholders' interests. Yet the sentiment expressed in public opinion polls is negative toward mergers and takeovers. Maybe the poll results are misleading. We all know the importance of framing survey questions for the responses that are elicited. But as long as this mistaken view prevails, federal legislators would be under strong pressure to support the demands of the intensely vocal managers, the beneficiaries of the regulation, over the interest of the diffuse population of shareholders. This serious problem of public misperception must be recognized and addressed before anyone can optimistically embrace federal preemption of state takeover laws.

MR. GRUNDFEST: The takeover battle has traditionally been fought in Washington, DC, before the House and Senate committees that have direct oversight over the securities laws, and before the SEC. Within the last month, this has changed dramatically. The battle is about to be fought in Wilmington, Delaware, not Washington, DC.

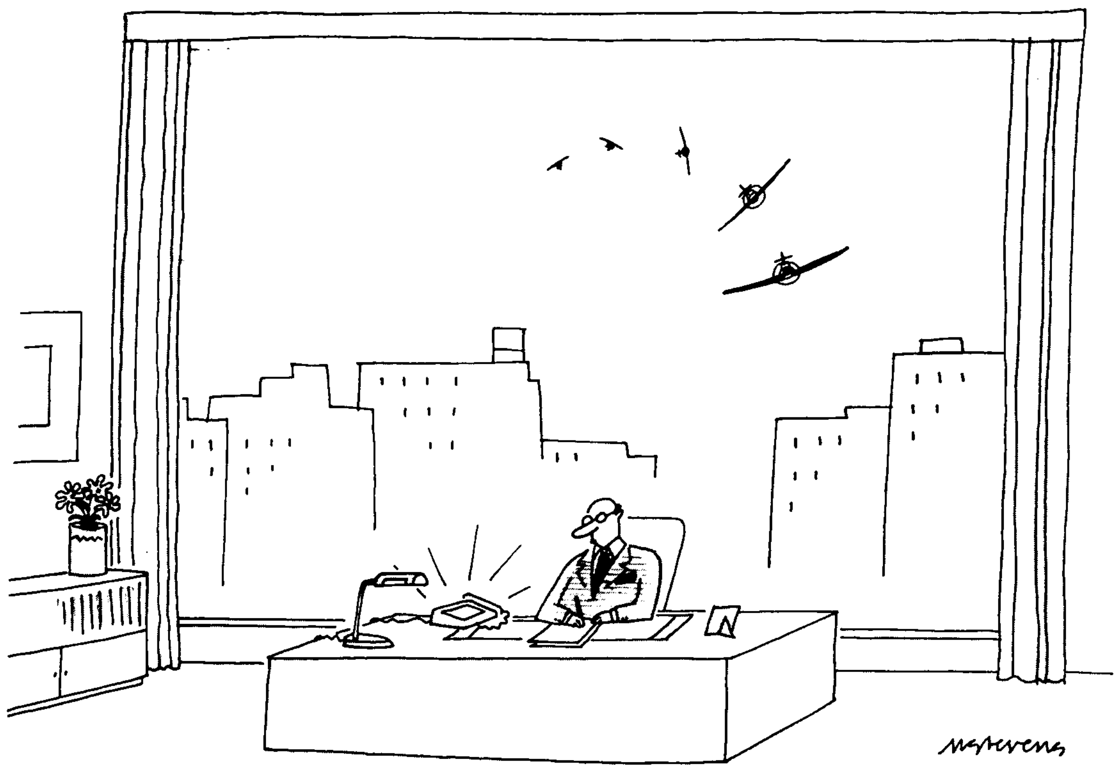
The move from Washington to Wilmington was precipitated by a decision of the United States Supreme Court in the CTS case, which, to the surprise of many observers, upheld an anti-takeover statute adopted by the State of Indiana (*CTS Corporation* v. *Dynamics Corporation of America*, 107 S.Ct. 1637, 1987). This statute required referendum approval from fellow stockholders before anyone who sought to acquire stock beyond certain thresholds could exercise the accompanying voting rights.

This decision breathed new life into the state anti-takeover movement. Since the CTS decision, approximately 15 states have adopted anti-takeover statutes of various forms. The latest, and by far the most significant, proposal is under consideration in Delaware. Under Delaware's proposed statute, if you are involved in a hostile takeover and do not acquire 90 percent of the target corporation's shares, then you cannot engage in certain self-dealing transactions for three years. Among other things, you cannot merge the acquired corporation into any other corporation in which you have a sufficiently large interest, and you cannot sell the assets to a corporation that is one of your affiliates.

A very significant debate is brewing as to whether this will really limit takeover activity, or whether the statute has so many loopholes that takeover lawyers and investment bankers would need only about a week to figure out a way around it. I do not know the answer.

MR. DeMUTH: How does the panel see the state takeover legislation playing out?

PROF. COFFEE: The Delaware statute will cause only a mild chill. Even before that law, the



"Bandits at two o'clock, Mr. Feldon!"

bidder typically wanted to acquire 80 percent of the target for tax reasons: at that level or above, intracorporate dividends are tax exempt. If the bidder acquires 85 percent, the new Delaware statute is inapplicable. Even when it applies, all the bidder is prohibited from doing is selling the assets to himself, merging with himself, or lending to himself. But he can sell the company in one piece to a third party or auction off a hundred pieces to a hundred different parties, and pay out the proceeds as dividends on a pro rata basis. And the bidder can keep on buying stock up to the 100 percent level. Once the buyer takes control and buys more stock, he will eventually cause a delisting of the company. Once the company is delisted and illiquid, the shareholders will sell to him because there is no other gain: he may even have suspended earlier dividends. There is a coercion potential there at least.

The Delaware law will also change the strategy for executing takeovers. We will see more 100 percent bids and fewer partial ones. We will see many bids conditioned on getting 85 percent control because then the statute does not apply.

So the short answer is that all that really counts for most of the New York Stock Exchange companies is Delaware, and I think Delaware has taken a deliberately cosmetic position. The statute does something, but not much.

MR. GRUNDFEST: I disagree with Jack Coffee about the likely consequences of the Delaware statute.

If raiders use those tactics, they will generally be perceived as squeeze-out tactics—very unfair and heavy-handed. The next generation of legislation could easily close those loopholes. To use the loopholes could be to doom them.

EDITORS' NOTE: *Delaware adopted its antitakeover statute in February 1988. In accord with certain suggestions made by Commissioner Grundfest, the statute was amended to provide for an exemption for any bidder who obtained 85 percent of a target's shares, excluding shares held by the target's management or controlled by certain pension plans that vote shares at management's direction.* □