Are Hostile Takeovers Different?

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In recent years some of the nation's largest corporations have been the object of fierce takeover battles. The effects of these battles for corporate control reach far beyond the board room. Many stand to gain or lose depending upon the outcome. Shareholders and employees, suppliers, creditors, competitors and state and local governments all have an interest in these struggles. In addition, the success of bidders in carrying out takeovers and of companies in resisting sends signals to management of other companies about their susceptibility to a takeover. It is not surprising, then, that both takeover attempts and the tactics used to thwart them have become subjects of intense controversy. A number of states have recently enacted regulations to delay and discourage takeovers, while federal legislators are considering limitations on both takeovers and takeover defenses. This paper examines the nature of the takeover controversy and some of the arguments in favor of restricting takeovers. In particular, it considers whether acquisition attempts distinguished by the opposition of target company management require more stringent regulation than acquisitions that have target management approval.

The conclusion of the paper is that legislation restricting hostile takeovers is not warranted. Shareholders of hostile takeover targets enjoy substantial increases in the prices of their shares as a result of takeover attempts. These increases are as large as, if not larger than, the increases resulting from acquisitions that have target management's approval. Those who would restrict hostile takeovers on the grounds of protecting target company shareholders have little empirical support.

On the other hand, the view that hostile takeovers are attempts to remove entrenched, incompetent management also receives little sup-

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port. Various accounting measures indicate that targets of hostile takeovers are unremarkable firms, or in consulting jargon neither "dogs" nor "stars." Since the nature of target management failure is not obvious, the argument that hostile takeovers exert a useful discipline on managers generally is not persuasive. At the same time, the unremarkable nature of hostile takeover targets provides no basis for protecting these firms and their managements from changes in control.

The first portion of this paper briefly reviews the relationship between takeovers and other forms of acquisition. The second section summarizes the arguments for and against takeovers. The paper then addresses two issues central to this debate: first, what do takeovers mean for shareholders of the target companies and second, are targets of takeovers performing up to their potential. The final section of the paper draws conclusions.

Mergers and Takeovers

In the past 100 years there have been four major merger "booms:" the consolidations of numerous firms in the same industry into industry giants in the 1890s and early 1900s; the large combinations of electric and gas utilities, as well as other types of mergers, in the 1920s; the conglomerate mergers of the 1960s; and the current merger boom, which began in the late 1970s.[1] In all three of the earlier booms, perceived abuses resulted in legislation regulating merger and acquisition activities. Regulations at the turn of the century focused on the anticompetitive effects of mergers, with fears of monopolization leading to the Sherman Antitrust Act (1890) and later to the Clayton and Federal Trade Commission Acts (1914). The regulatory response to the mergers of the 1920s was directed to ensuring that shareholders had sufficiently accurate information to make decisions about merger and acquisition proposals as well as other corporate matters; the Securities and Exchange Act of 1934 established disclosure requirements and otherwise regulated the issuance of securities and related promotional activities. In the 1960s, concern over hostile tender offers led to the passage of the Williams Act in 1968; this Act and accompanying regulations extended disclosure requirements to cash tender offers, which had not previously been covered, and established procedural rules for such transactions. Again the justification was enabling shareholders to make more informed decisions.

The current merger boom is also generating a regulatory response.

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[1] Scherer (1980) and The W.T. Grimm & Co., *Mergerstat Review* 1986, p. 3. Grimm also identifies a merger wave in the 1940s characterized by the acquisition of many smaller companies by larger buyers.

Many states have already passed antitakeover legislation.[2] Other states, as well as federal lawmakers, are considering legislation that would make hostile takeovers more difficult. The model for many of the most recent legislative proposals is the Control Share Acquisitions Chapter of the Indiana Business Corporation Law, the legality of which was upheld by the U.S. Supreme Court in April 1987. Under the Indiana Act, the acquisition of shares in Indiana corporations above certain thresholds does not automatically include the voting rights normally associated with these shares. The transfer of voting rights must be approved by a majority of shareholders, not including the bidder or inside directors and officers of the target company. By its requirement of a shareholders' meeting, the Indiana Act stretches out the time required to consummate a tender offer and makes the outcome of a hostile offer more uncertain. The requirement of shareholder approval of voting rights does not apply if the acquisition is part of a merger agreement, in other words, if it has the support of the target's management and board of directors.

What distinguishes the current regulatory thrust is the focus on hostile takeovers. As the Indiana Act illustrates, most of the antitakeover proposals would not affect mergers or other acquisitions supported by target management. They are directed at hostile takeovers, especially tender offers opposed by target management. While the Williams Act was also prompted by hostile tender offers, its effect was to ensure that the disclosure requirements governing such transactions were comparable to those for other forms of acquisitions. In contrast, current legislation seems designed to discourage hostile tender offers by making acquisitions that are opposed by target management more difficult than those that have its approval.

What Constitutes a Hostile Takeover

Firms can be acquired by merger, purchase of assets, proxy fight, or tender offer. The method chosen depends upon such factors as the attitude of the target company's management, taxes on shareholders of both companies, the time required to complete the acquisition, and costs of the acquisition. A merger occurs when the boards of directors of both companies agree to combine. A vote of the shareholders of the target company and, sometimes, of the acquiring company is required to consummate the merger. Since shareholders generally vote with management, the outcome of the vote is usually a foregone conclusion. A purchase of assets also requires the agreement of target management and, if a major portion of the firm's assets is to be purchased, the ap-

[2] An article by Robert Lenzner in the *Boston Globe*, July 9, 1987, counted over 20 states with antitakeover legislation.

proval of target shareholders.

Most bidders seeking to acquire a company would prefer the cooperation of the incumbent management. Friendly management is more likely to disclose "skeletons" that may not appear on financial statements and to help make the change in control go smoothly. Target management may also be an important asset—one of the reasons the bidder wanted the company in the first place.

Sometimes, however, a bidder faces opposition from target management and sometimes a bidder does not place great value on target management's support. Under these circumstances the bidder may bypass target management and go directly to the shareholders with a tender offer. In a tender offer, the bidder announces his willingness to purchase shares of the target company on the open market; to induce shareholders to sell, a premium over the current market price is usually offered. Engaging in a proxy fight is also an option for a bidder facing management opposition to an acquisition proposal. However, proxy fights, which are determined by shareholder vote, are difficult to win because so many shareholders routinely vote with management. They can also be very expensive. While proxy fights were used in the 1950s, the tender offer has been the preferred mechanism for making hostile takeovers for the past 25 years.

Although tender offers are used to accomplish hostile takeovers, by no means are all tender offers hostile. Since no shareholder meeting is required, tender offers can be completed quite rapidly. Thus, if time is an important consideration, a tender offer may be an advantageous means of effecting a combination even when target management has been involved in the negotiations and supports the transaction.

While not all tender offers are hostile, not all mergers are friendly—even though mergers require a shareholder vote and shareholders commonly vote with management. The fact that a bidder has the option of resorting to a tender offer if merger discussions break down can lead target management to acquiesce to mergers that it might otherwise oppose. The point is simply that what constitutes a hostile takeover attempt is not always clear-cut. Target management may know one when it sees one, but the researcher looking at merger and acquisition statistics may have difficulty. In the following discussion, contested tender offers are taken to represent hostile takeovers. Tender offers that were not contested by target management are not considered hostile, even though they may have been unwelcome.

Hostile Takeovers in the Current Merger Boom

Contested tender offers account for a very small fraction of mergers and acquisitions and a very small fraction of the recent increase in merg-

Table 1
Merger and Acquisition Announcements, 1976–86

Year	Net Announcements	Divestitures	Privately Owned Sellers	Foreign Sellers	Publicly Traded Sellers	Tender Offers[a] Total	Tender Offers[a] Contested
1976	2,276	1,204	856	53	163	70	18
1977	2,224	1,002	971	58	193	69	10
1978	2,106	820	969	57	260	90	27
1979	2,128	752	1,049	79	248	106	26
1980	1,889	666	988	62	173	53	12
1981	2,395	830	1,330	67	168	75	28
1982	2,346	875	1,222	69	180	68	29
1983	2,533	932	1,316	95	190	37	11
1984	2,543	900	1,351	81	211	79	18
1985	3,001	1,218	1,358	89	336	84	32
1986	3,336	1,259	1,598	93	386	150	40

[a]Included in publicly traded sellers.
Source: The W.T. Grimm & Co., *Mergerstat Review 1986.*

er and acquisition activity. Table 1 compares the pattern of merger and acquisition announcements by major category over the period from 1976 to 1986. As can be seen from the table, announcements of mergers and acquisitions rose sharply from 1980, with all categories contributing to the increase. Total tender offers and contested tender offers more than doubled between 1976 and 1986, with much of the increase coming in 1986. Even so, tender offers accounted for fewer than 5 percent of total acquisition announcements in 1986 and contested tender offers just over 1 percent. Why then all the fuss?

One answer is size. Almost half of all acquisitions involve the purchase of privately owned companies. These are generally quite small, although the size is increasing. According to *Mergerstat Review,* the average purchase price in 1986 for those private companies for which such information was available—presumably the largest—was $40 million. In contrast, the average purchase price for publicly traded companies, which include targets of tender offers, was $255 million. The average purchase price for divestitures, the second largest acquisition category, was also considerably smaller than the average for publicly traded companies. The larger the company the more people—managers, employees, investors, suppliers—who might be affected by a change in ownership and the greater the attention the acquisition will receive in the press.

Not only are publicly traded companies larger than other acquisitions, but also the targets of tender offers are larger than other publicly traded targets. Table 2 shows the average market value in 1983 and 1984

Table 2
Average Market Value in 1983 and 1984 of Companies Trading on the Major Exchanges That Were Targets of Takeover Attempts in 1985

Nature of Attempt	Number of Target Companies[a]	Average Market Value (Millions of Dollars) 1984	1983
All Attempts	133	692.4 (111)[b]	578.2 (129)[b]
Tender Offers	49	1532.2 (39)	1139.5 (48)
Uncontested	29	1072.4 (20)	834.0 (29)
Contested	20	2016.2 (19)	1605.9 (19)
Contested, excluding Refining Companies	17	485.8 (16)	460.9 (16)
Mergers and Other Offers, Excluding Tenders	84	237.4 (72)	245.5 (81)
Private by Management	23	162.5 (20)	164.4 (22)
Mergers	61	266.3 (52)	275.7 (59)

[a]Target companies consist of (1) companies that were removed from the CRSP files in 1985 because they were acquired in a transaction that appears in the Transactions Roster of either the 1984 or 1985 volumes of *Mergerstat Review* and (2) companies appearing in the CRSP files that were targets of unsuccessful acquisition attempts according to the 1985 volume of *Mergerstat Review*.

[b]Number of companies with data for that year.

Source: *CRSP Stock Files*, Center for Research in Security Prices, University of Chicago, 1987; *Mergerstat Review*, various issues.

of companies trading on the New York or American stock exchanges that (1) were acquired in 1985 in a transaction reported in *Mergerstat Review* in 1984 or 1985 or (2) were targets of an unsuccessful acquisition attempt reported in *Mergerstat Review 1985*.[3] (Limiting the sample to companies trading on the major exchanges increases the average size.) The companies are grouped according to whether they were targets of contested tender offers, uncontested tender offers, acquisitions in which the bidding entity was a private group including company management (private by management), and mergers and any other forms of acquisition (mergers). Companies that were targets of more than one acquisition attempt in this period are classified according to the initial announcement. Tender offers by company management are considered uncontested tender offers.

Targets of tender offers were larger than companies taken private by their management or acquired in mergers. The average market value of companies that were targets of tender offers was over a billion dollars;

[3] More specifically the companies shown in table 2 consist of (1) companies that were removed from the CRSP files in 1985 because they were acquired in a transaction that appears in the Transactions Roster of either the 1984 or 1985 volumes of *Mergerstat Review* and (2) companies appearing in the CRSP files that were targets of unsuccessful acquisition attempts according to the 1985 issue of *Mergerstat Review*. The CRSP Stock Files are produced by the Center for Research in Security Prices, University of Chicago.

the average market value of companies targeted in other acquisition attempts was less than one-quarter of a billion. The average size of targets of contested tender offers was roughly double that of companies receiving tender offers that were not contested. Among the contested group were three refining companies with very large market values; but even excluding these three, targets of contested tender offers were still larger than companies that were targets of merger proposals or that management attempted to take private.

The three refining companies that were targets of contested tender offers were the only firms in table 2 that were members of this industry. Since hostile takeovers were so few in number this concentration in a single industry is striking. However, an examination of acquisition patterns by industry over several years suggests that the usual pattern is not markedly different for hostile takeovers than for other types of acquisition. Table 3 shows the distribution of offers made from 1983 to 1985 for companies trading on the major exchanges, according to the industry of the target company. (Some companies were targets of several acquisition offers and consequently appear in the table more than once.) As can be seen, contested tender offers were more concentrated in oil and gas related activities—exploration and development, refining, utilities—than acquisitions generally. Contested tender offers were also more concentrated in manufacturing and they were relatively infrequent in the trade and the finance, insurance and real estate industries. However, the differences do not seem dramatic.

Michael Jensen and others have suggested that hostile takeovers occur in response to a need for restructuring in an industry, with the oil industry providing a particularly good example of a radical change in environment leading to an increase in takeover attempts. The figures in table 3 indicate that while such a view has some basis as regards oil and gas, hostile takeovers are not confined to a few industries in the throes of deregulation or otherwise undergoing major changes. Of course, it may simply be that many industries have encountered unusual competitive pressures in recent years. In any event, the distribution of hostile takeovers is fairly similar to that of other acquisitions. This similarity may itself explain why such a small number of transactions generates such widespread concern. If hostile takeovers were concentrated in just a few industries, only those involved with these industries need be concerned about the possibility of a takeover; everyone else could rest secure. If hostile takeovers are widely distributed, no one is safe.

Finally, it is important to recognize that the number of contested tender offers understates the number of unwelcome offers. Probably a substantial fraction of uncontested tender offers, and possibly of merger overtures as well, are not welcomed by target management. Some of these acquisition attempts might be contested were it not for the fact that

Table 3
Acquisition Attempts by Industry of Target, 1983–85

	Number of Attempts				Percent of Total			
		Not	Tenders			Not	Tenders	
	All Attempts	Tenders	Uncontested	Contested	All Attempts	Tenders	Uncontested	Contested
Agriculture	3	2	1	0	.7	.7	1.2	0
Mining	27	17	6	4	6.6	6.2	7.0	8.7
Oil & Gas	24	14	6	4	5.9	5.1	7.0	8.7
Construction	7	6	0	1	1.7	2.2	0	2.2
Manufacturing	225	151	46	28	55.3	54.9	53.5	60.9
Food	24	14	6	4	5.9	5.1	7.0	8.7
Textiles	10	8	2	0	2.5	2.9	2.3	0
Apparel	13	7	3	3	3.2	2.5	3.5	6.5
Paper	11	7	3	1	2.7	2.5	3.5	2.2
Printing	8	7	0	1	2.0	2.5	0	2.2
Chemicals	12	7	3	2	2.9	2.5	3.5	4.3
Refining	9	3	3	3	2.2	1.1	3.5	6.5
Rubber & Plastics	10	6	2	2	2.5	2.2	2.3	4.3
Stone, Clay, Glass	7	4	1	2	1.7	1.5	1.2	4.3
Primary Metals	13	12	1	0	3.2	4.4	1.2	0
Fabricated Metals	17	14	3	0	4.2	5.1	3.5	0
Nonelectrical Mach.	24	14	7	3	5.9	5.1	8.1	6.5
Electrical Equipment	26	20	3	3	6.4	7.3	3.5	6.5
Transportation Equip.	18	13	4	1	4.4	4.7	4.7	2.2
Instruments	10	5	3	2	2.5	1.8	3.5	4.3
Transportation	13	10	1	2	3.2	3.6	1.2	4.3
Air	6	5	0	1	1.5	1.8	0	2.2
Communications	6	4	1	1	1.5	1.5	1.2	2.2
Utilities	15	6	5	4	3.7	2.2	5.8	8.7
Gas Prod. & Distrib.	14	5	5	4	3.4	1.8	5.8	8.7
Trade	50	32	15	3	12.3	11.6	17.4	6.5
Finance, Insurance, & Real Estate	38	33	4	1	9.3	12.0	4.7	2.2
Services	23	14	7	2	5.7	5.1	8.1	4.3
Total	407	275	86	46	100.0	100.0	100.0	100.0

Note: Distribution of offers by industry of target company for companies that were targets of acquisition attempts 1983–85. Some companies were targets of more than one offer. The sample consists of companies trading on the major exchanges that ceased to trade because of an acquisition appearing in *Mergerstat Review* or that were targets of an unsuccessful acquisition attempt recorded in the *Mergerstat Reviews* for 1983 to 1985.

Source: *CRSP Stock Files*, Center for Research in Security Prices, University of Chicago, 1987; *Mergerstat Review*, various issues.

so many contests fail to preserve the target's independence. Between 1976 and 1986 only one-quarter of the companies that contested tender offers succeeded in remaining independent; if they were not taken over

by the initial bidder they were acquired by a third party.[4] Moreover, for a number of companies that did succeed in remaining independent, the price of independence was severe cost-cutting or the sale of major portions of their business.

Although the large size of the targets of hostile takeovers and the fact that no industry is immune mean that the economic significance of takeovers is greater than their numbers would suggest, this is not reason to treat them differently from other forms of acquisition. The following section summarizes the central issues in the dispute over whether takeovers should be restricted.

What Is Wrong/Right with Takeovers?

Discussions of whether or not takeovers should be restricted are often mixed up with discussions of the positive and negative consequences of mergers in general. Do mergers "work:" Is the resulting entity more competitive and more profitable? What is the source of any increased profitability? Is too much debt incurred in the acquisition process? What will be the impact on employees? However, while the debate often follows these lines, much of the opposition to hostile takeovers seems to derive less from the adverse consequences of corporate combinations than from the mechanism whereby combinations occur and from the relationship between acquirer and acquired. Among the most vociferous critics of hostile takeovers are some of the chief executives of large companies that have been active participants in the merger and acquisition process, although as bidders rather than targets. Clearly they are not opposed to acquisitions in general. Moreover, most antitakeover legislation does not address problems arising from acquisitions in general; it would not preclude friendly combinations. It is directed only at acquisition attempts opposed by management of the target company.

Why should the opposition of target management be the basis for imposing more stringent requirements on an acquisition attempt? Managers typically defend their opposition to takeover proposals on the grounds that the offers are inadequate. The true value of the company exceeds the value offered and in opposing the proposal, management is acting in the shareholders' interests. The protection of shareholders is also the ostensible purpose of recent antitakeover legislation. Proponents of the Indiana Act argue that it enables shareholders to decide collectively upon the desirability of a change in control; in particular, the Act is said to permit a more considered response to potentially coercive two-tier and partial tender offers. This view was apparently accepted by

[4] *Mergerstat Review 1986*, p. 79.

the Supreme Court: according to Justice Powell, in the majority opinion, "The primary purpose of the Act is to protect the shareholders of Indiana corporations."[5]

Since the Indiana Act and its offspring are not intended to apply to mergers, there is a presumption that the agreement of target management to an acquisition proposal is sufficient protection for shareholders. If this is the case and if such protection is necessary, then one would expect shareholders to fare better in acquisitions that had target management's support than in hostile takeovers. The next section of this paper will compare what happens to stock prices in a contested tender offer with the experience in other types of acquisitions.

Managers may be quite sincere in opposing what they consider to be inadequate tender offers. Although most offers are substantially above the market price, stock prices can be volatile and a manager might have reason to think that his company's stock will sell at a higher price in the future. In addition, opposition to a tender offer may induce the bidder to sweeten his offer or may create an opportunity for additional bidders to enter the competition and bid up the price. In a recent examination of the premiums on contested and uncontested tender offers announced in 1985, the authors found that the highest premiums were offered by successful "white knights" — bidders acquiring companies that were already targets of takeover attempts. More generally, premiums were higher in situations involving multiple bidders (Browne and Rosengren 1987). Even the prospect of competition among bidders may result in a higher bid than otherwise; the initial bidder may set his bid so as to preclude competing offers and if competition seems to be materializing may subsequently increase the bid.

However, while management opposition to a takeover proposal can benefit target company shareholders, a conflict between the interests of shareholders and the interests of management exists in the face of a takeover that is not present in other corporate decisionmaking. Frequently target management is displaced as a result of a takeover, either because there is no room for target management in the hierarchy of the combined structure or because the acquirer does not think target management is doing a good job.

The incentive for target management to oppose an acquisition attempt is greater, the greater the threat of displacement. This suggests that acquisitions of larger companies are more likely to be opposed than smaller companies, since it will be more difficult to absorb target management. The chief executive of a small company can become a group

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[5] Supreme Court of the United States, *CTS Corp. v. Dynamics Corporation of America et al.* Appeal from the United States Court of Appeals for the Seventh Circuit, No. 86–71. Argued March 2, 1987—Decided April 21, 1987, p. 20.

vice-president within a larger entity with no loss of prestige or salary; but how many companies—no matter how large—have room for two "captains of industry"? By this reasoning, one might also expect acquisitions of companies that are performing poorly, since target management could expect to be judged inadequate. Thus, opposition to a takeover could be an admission of poor management.

Whether or not target management considers itself to be inadequate, the fact that a bidder makes a tender offer without engaging in negotiations with management may foster opposition. Such a tender offer is a statement that at least one entity—the bidder—views the target company as not performing up to its potential and, further, that the support of target management is not necessary to achieve a better performance. Such a statement obviously will not sit well with target management. However, to the extent that it is an accurate assessment, shareholders will be better off if the company is taken over than if it remains independent. At least from a shareholder's perspective, one would not wish to make such takeovers more difficult or less certain in outcome.

Equally importantly, if targets of hostile takeovers are not maximizing shareholder returns, takeovers may benefit not only the shareholders of the targets but also those of other companies. Managers of other companies will see that poor performance increases their companies' vulnerability to takeover and will, therefore, have an added incentive to achieve good results for their shareholders. Those who oppose restrictions on takeovers typically hold this view, arguing that takeovers not only result in gains to shareholders of the target companies but also exert a useful discipline on managers to the benefit of the economy as a whole.

This position does assume, however, that good performance can be discerned fairly readily: targets of hostile takeovers must be recognized to be performing below their potential if takeovers are to have a salutory effect on firm management in general. Moreover, if targets of hostile takeovers are not underperforming—or are underperforming according to criteria apparent only to the bidder—hostile takeovers will appear to managers as random "bolts from the blue." In this case, takeovers will not provide positive incentives, as management will not see serving their shareholders' interests as protecting them from takeovers. Indeed, takeovers may have a negative effect, as managers may be led to protect themselves in other ways. At a minimum, defensive activities distract management's attention from running the company, and in some cases they may actually be harmful, as when management embarks on its own acquisition program simply to make the company too big to swallow.

A later section of this paper will compare the performance of companies that were targets of contested tender offers and companies in-

volved in other types of acquisition attempts. It will also discuss some of the ambiguities surrounding the concept of good performance.

The Effect of Takeovers on Shareholders

Central to any debate over antitakeover legislation is the anticipated effect of restrictions on shareholders. Unlike management and employees, shareholders know with certainty that their economic interests will be directly affected by a takeover. As a result, numerous laws protecting the interests of shareholders during takeovers have been adopted since the 1930s. Requirements that a bidder disclose financing sources and intentions, as well as restrictions on the tender process, provide investors an opportunity to evaluate a takeover proposal. In contrast, the focus of much of the current legislation is not on fuller disclosure; rather, it severely discourages offers actively opposed by management. Since stock prices are often very volatile, and the expected return of current projects may be difficult to assess, management may prevent bids that would be rejected if shareholders were better informed. However, if management is overly optimistic about its firm, or if management's interests diverge from those of the shareholders, management may reject offers that fully informed shareholders would accept.

Table 4 provides the average premium for merger and acquisition offers from 1983 to 1985. Each offer is classified as a merger, uncontested tender offer, or contested tender offer. Firms taken private by means other than tender offer are included in the mergers and other offers category. The premiums are calculated as the percentage increase from the closing price of the stock five days before the date of the announcement; for offers with a previous bidder, the premium for the new offer is calculated from five days before the announcement of the initial offer.

Acquisition attempts, regardless of their form, generally provide stockholders substantial gains. The lowest average premium for any category is 30 percent. Thus, legislation that prevented takeover targets from receiving any offers would clearly be detrimental to shareholders. Average premiums show remarkably small differences between contested offers, uncontested tenders, or mergers. In 1985 the average premium for hostile tender offers was 31.1 percent, within 2 percentage points of uncontested offers and mergers. In 1984 hostile tender offers had premiums equal to those of uncontested offers and 1 percentage point larger than mergers. While there is substantial variation in the size of premiums within each acquisition category, as shown by the large standard deviations, there is little evidence that premiums on hostile tender offers are significantly different from offers not opposed by management. Surprisingly, there is also little difference between the average

Table 4
Average Premium Offered in Merger and Acquisition Attempts

	All Offers			Successful Offers		
	Number/Number with data	Average Premium (Percent)	Standard Deviation	Number/Number with data	Average Premium (Percent)	Standard Deviation
1985[a]						
All	152	31.6	23.9	100	33.3	24.3
Tender Offers	57	30.8	21.0	43	32.2	20.3
Uncontested	35	30.6	22.0	34	31.1	22.2
Contested	22	31.1	19.2	9	36.4	9.5
Mergers and Other Offers, excluding Tenders	95	32.1	25.5	57	34.2	26.9
1984[a]						
All	162/156	38.0	29.1	106/102	38.3	30.7
Tender Offers	46/45	38.8	26.1	36/35	38.9	27.2
Uncontested	36/35	38.8	28.3	32/31	38.2	27.9
Contested	10	38.8	15.9	4	44.2	19.5
Mergers and Other Offers, excluding Tenders	116/111	37.7	30.3	70/67	37.9	32.4
1983[a]						
All	92/90	43.7	47.5	65/63	38.6	24.7
Tender Offers	28	39.1	22.1	21	39.2	25.0
Uncontested	14	32.4	24.9	13	31.7	25.7
Contested	14	45.9	16.4	8	51.5	18.3
Mergers and Other Offers, excluding Tenders	64/62	45.8	55.2	44/42	38.3	24.5

[a]*Attempts in a given year include acquisitions of companies removed from CRSP file in that year and also included in Mergerstat and unsuccessful attempts listed in Mergerstat for that year.*

Source: *CRSP Stock Files,* Center for Research in Security Prices, University of Chicago, 1987; *Mergerstat Review,* various issues.

premium on successful offers and that on all offers, indicating that even unsuccessful acquisition attempts generally offer substantial premiums to stockholders.

While table 4 suggests that there is little difference in premiums between offers opposed by management and those without active opposition, it fails to control for several variables that could substantially affect the size of the premium. Premiums applied to only a fraction of the target shares, particularly those that provide a controlling interest in the company, may be higher than bids for all outstanding shares. Movements in the general level of stock prices around the time of the offer may influence the bid. Since stocks tend to move in conjunction with the market portfolio, failing to control for the movement in the market index at the time of the announcement could bias the results. Finally, the riskiness of the target stock may affect the size of the premium. Since movements in the market portfolio cannot be diversified away, stocks that move together with the market, frequently referred to as high beta stocks, subject the investor to greater risk. Our event study, a technique widely used in the finance literature, controls for these factors.

Event studies are an application of the capital asset pricing model. Using a simple model of stock returns, a forecast of what the return would have been in the absence of an event is compared with the actual return. The difference between the forecasted return and the actual return is attributed to the event. Equation 1 summarizes the calculation of excess returns, the difference between the actual return and the forecasted return after controlling for movement in the market portfolio and the riskiness of the stock.

$$(1)\ ER_{it} = R_{it} - a_i - b_i R_{mt}$$

where R_{it} = return on stock i for day t
R_{mt} = return on the market portfolio for day t
a_i = constant, estimated from a period prior to the event
b_i = beta of stock i, measure of non-diversifiable risk, estimated from a period prior to the event

It is assumed that the forecast errors are not attributable to other events possibly occurring at the same time or to a badly specified forecasting model. The latter assumption is particularly important. While the "true" market portfolio is unobservable, this study, like most event studies, uses the value-weighted New York and American Stock Exchange index as a proxy for the market portfolio. Roll (1977) has shown that applying the Capital Asset Pricing Model with the wrong index can bias the results; however, it is assumed that using the value-weighted index as a proxy for the "true" market portfolio does not introduce significant biases into the study. It is also assumed that a_i and b_i are stable and are not sensitive to the arbitrary choice of estimation period. In this

study the estimation period is the 180 trading days from 240 days before the event to 61 days before the event.

To determine the impact of the merger on takeover targets, the excess returns are summed over an event window and averaged over firms to obtain the cumulative average residual (CAR).

$$(2)\ \text{CAR} = \frac{1}{n} \sum_{i=0}^{n} \sum_{t=p}^{q} \text{ER}_{it}$$

where n = number of firms
p = number of days before the event day (day 0)
q = number of days after the event day

If takeovers were always a complete surprise, the event window over which the excess return should be measured would be the announcement date. However, as the Boesky disclosures have made clear, information about takeovers is frequently available to some market participants prior to the public announcement. A choice of a larger window may capture information released prior to the announcement but risks including movements in stock price unrelated to the takeover. A choice of a small window risks missing some stock appreciation related to early release of takeover information and underestimating the cumulative average residual attributable to the takeover. This is a particular problem in this study, which compares cumulative average residuals by type of acquisition, since some acquisition methods may be more susceptible to prior release of information, either because of the number of people involved prior to the formal takeover announcement or for strategic reasons relating to the bidding process. Consequently, two windows were considered—a 41-day window spanning the 30 trading days before the announcement date to 10 days after the announcement, and an 11-day window, from five days before the announcement to five days after. While arbitrary, they illustrate how sensitive the results are to the choice of window.

To test the significance of the cumulative average residuals it was necessary to construct a test statistic. A procedure common in the event study literature was followed, based on the construction of standardized cumulative residuals that are assumed to be distributed standard normal. (See the appendix for details.) Two hypotheses were examined. The first was that the cumulative average residuals are insignificantly different from zero, since previous studies of acquisition attempts found substantial positive returns to the target firm. The second maintained hypothesis was that excess returns for uncontested tenders, mergers, and firms taken private equal the average excess returns for contested tenders having the same event window. If tender offers that were op-

Table 5
Cumulative Average Residuals by Type of Takeover Attempt, 1985

	41-Day Event Window	11-Day Event Window
Tender Offers		
Contested		
Cumulative Average Residuals	.23	.16
z-0	(8.58)*	(11.62)*
Uncontested		
Cumulative Average Residuals	.23	.22
z-0	(12.00)*	(21.03)*
z-contested	(.57)	(5.28)*
Mergers and Other Offers, excluding Tenders		
Private by Management		
Cumulative Average Residuals	.12	.15
z-0	(4.45)*	(10.46)*
z-contested	(−2.92)*	(.58)
Mergers		
Cumulative Average Residuals	.20	.13
z-0	(11.89)*	(17.39)*
z-contested	(−1.98)	(−1.35)

Note: z statistic is distributed standard normal.
* significant at the 5% confidence level for a two-tailed test.

posed by management were not in the interest of stockholders, the return from offers opposed by management should be lower than the return from offers unopposed by management.

Table 5 provides the cumulative average residual for each type of takeover. Multiple bidder contests are classified by the original bidder, so that unlike table 4, which calculates bidder premiums, there is only one bidding firm included for each acquired firm. Using the 41-day window, the cumulative average residuals are all significantly different from zero at the 5 percent confidence level and no category of takeover has larger excess returns than the contested tender offer. Thus, for a 41-day window, stockholders appear to fare quite well from offers that were opposed by management, with an average 23 percent return after controlling for the general movement in stock prices.

While contested tenders have the same cumulative average residual as uncontested, the residual for contested tenders is 11 percentage points greater than for firms taken private. One can reject the hypothesis that average excess returns for private acquisitions are equal to the average excess returns for contested firms at the 5 percent level. Therefore, stockholders appear to have higher returns on acquisitions opposed by management than on acquisitions where management or family owners directly acquire the company. This difference cannot be

explained by the probability that an initial offer is successful. Both contested tender offers and offers to go private have a 50 percent chance of success, and the returns over the 41-day window are very similar between successful and unsuccessful takeover attempts.

One possible reason for the higher premiums is that contested tender offers are more likely to become multiple-bidder contests. Roughly 40 percent of the contested tender offers attract additional bidders while approximately 30 percent of the private offers result in additional bidders. Therefore, part of the excess return experienced by hostile tenders may reflect investors' expectations of higher future bids. Contested tender offers that eventually became multiple-bidder contests had a cumulative average residual of 30 percent, while contested tenders that remained single-bidder contests had a cumulative average residual of only 19 percent.

Using the 11-day window, the cumulative average residual for contested tender offers is larger than for mergers or for firms being taken private. However, uncontested tender offers have the highest cumulative average residual and the excess returns are significantly larger than the average excess returns for contested tender offers. The higher cumulative average residual for uncontested tenders may partly be explained by differences in bidding strategies. In contested tender offers, early release of information about a tender offer may apply pressure on the top management of the target firm and help to place the firm "in play." In addition, given management's opposition, it may be more profitable to sell to a "white knight." Therefore, encouraging additional bidders may be more rewarding than successfully acquiring the firm. Firms without active opposition by management are much more likely to successfully acquire the firm and may prefer to maintain secrecy to prevent additional bidders from entering the auction and driving up the price. If so, the cumulative average residual would follow the pattern we observe in the table, with most of the increase in returns for uncontested offers occurring around the announcement, while relatively less of the total appreciation of the contested firm occurs around the announcement.

From a shareholder's perspective, restricting tender offers that are opposed by management would be undesirable. In cases where existing management is firmly entrenched, no offers may occur, thus depriving the shareholders of the appreciation in share prices that normally results from a takeover offer. Policies requiring management approval are also likely to discourage multiple-bidder contests, contests that frequently provide the highest returns for shareholders. Acquisitions requiring management approval, mergers and firms taken private by management, have lower average returns than tender offers that management actively opposes. Thus, legislation that discourages offers not supported by management are not likely to be in the best interests of shareholders.

Characteristics of Targets of Hostile Takeovers

As was discussed above, there is some basis for thinking that targets of hostile takeovers might be more poorly managed than companies involved in friendlier acquisition attempts. If takeover targets are, in fact, poorly managed, this poor performance is a powerful argument against restricting hostile takeovers. Shareholders of potential targets will suffer; current management will remain in place or, if a change in control does take place as a result of a merger, it will be on terms determined by a management that has not represented shareholders well in the past. Of perhaps even greater significance is the message that protection of poor performers from possible displacement sends to managers of other companies. Assessing what constitutes poor management is far from simple, however.

One view—commonly held by those opposed to restricting takeovers—is that stock prices are the best guides to performance. Stock prices embody all that is publicly known about both a firm's current circumstances and its future prospects. If one thinks of the stock price as the present value of the stream of earnings that an owner of a share of stock can expect to receive, then a firm that has a promising future with rising earnings will have a higher stock price than one with the same current earnings but a more negative outlook. In other words, the ratio of price to earnings will be higher for the first firm. It is management's responsibility to maximize share prices and thus, shareholder wealth. Poorly managed firms, according to this view, are firms with low stock prices and price-earnings ratios.

However, while the price-earnings ratio may provide some indication of how investors see a firm's future, the quality of management is not the only factor that affects that future. The world may change in ways that even the best management could not anticipate, brightening the future for some firms and darkening it for others. In addition, price-earnings ratios are only meaningful for firms with earnings in some normal range. A firm may suffer losses, but the value of its shares will still be positive, resulting in a negative price-earnings ratio; or a firm may experience very small positive earnings, causing its price-earnings ratio to be very large even though the firm's prospects are not very promising.

The book value of shareholders' equity provides another basis for evaluating share prices. Comparing the ratios of price to book value (per share) for different firms is equivalent to comparing the firms' share prices with what earnings would be if the firms all achieved the same return on equity. For example, if all firms earned a 12 percent return on equity, comparing the resulting price-earnings ratios would produce the same results as comparing ratios of price to book value. Thus, the ratio

of price to book value can be seen as a price-earnings ratio in which the denominator is not the firm's actual earnings but what earnings would be if the firm achieved some "normal" return on equity. A low price-to-book ratio could reflect either below-normal earnings today or normal current earnings but an unpromising future.

In addition, a price-to-book ratio that is below one means that a firm cannot issue new stock without diluting the value of the holdings of current shareholders. This can be a deterrent to expansion, or at least to the use of equity to expand. From the standpoint of those who see stock prices as providing accurate assessments of future prospects, a low price-to-book ratio indicates that a firm's investment plans will not yield satisfactory returns and should be curtailed.

A more fundamental question is whether share prices are reasonably valid representations of firms' prospects. Despite a substantial literature based on this view, many people believe that the stock market is subject to whims, fads and unfounded rumors and, consequently, that share prices are unreliable indicators of future earnings. To the extent that there is some truth to this view, share prices are not useful guides to whether management is doing a good job. A low share price may mean simply that the firm in question is not "in;" perhaps there have been no recent developments to bring the firm to the attention of market participants or perhaps the price has been discounted on the basis of rather superficial analysis.

However, even if stock prices are not good guides to management performance, they might still be good indicators of vulnerability to takeover. Share prices are, after all, prices; and the significance of a low price-earnings ratio or price-to-book ratio may not be so much that the firm's future looks bleak—at least under current management—as that the price of acquiring the firm's assets and the associated stream of earnings is low. In other words, the firm is cheap.

Various accounting ratios offer another approach to measuring the performance of takeover targets. The problem with these is that they show only what the firm is doing today—or over some specified time horizon—and performance at any one time may not be a good guide to the future. Thus, earnings may be high today as a result of wise decisions by past managers; but today's managers may have embarked on a different course. Conversely, the future may be bright even though earnings are low today. Indeed, many start-up companies encounter losses in their early years. Some companies have highly cyclical earnings. Stock prices can capture both the present and what is known about the future.

The return on equity is one of the more common measures of firm performance. It is also one that does not suffer from any ambiguity about what is desirable. Higher is better. This is not true of some of the other standard accounting ratios. In particular, measures showing the

use of financial resources may be subject to different interpretations. According to one view, companies with relatively large liquid assets and low use of debt are likely to be takeover targets. These firms do not use their financial resources as efficiently as they might; by relying more heavily on debt and reducing the proportion of their assets in low-yielding working capital they could achieve higher earnings. However, others might see these firms as prudently managed, particularly if the firms were already achieving high earnings. High liquidity and low leverage provide managers with flexibility in the event of a downturn and reduce the firm's vulnerability to bankruptcy. These ambiguities suggest that an assessment of how well a firm is managed may depend upon one's attitude towards risk.

One variant of the view that takeover targets are not managing financial resources efficiently is the free cash flow hypothesis developed by Jensen. "Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital" (Jensen 1986, p. 323). Companies that generate substantial cash flows and that use these funds internally in low-value uses rather than pay out the cash to shareholders will be targets of takeovers. The share price will reflect the fact that the cash flow is going to projects with lower returns than could be obtained elsewhere. A bidder acquiring control of these companies can increase the share price simply by ceasing these low-value activities and paying out more cash.

Table 6 presents averages of financial ratios, representing some of these elements of performance, for the acquisition targets of table 2. Ratios in both 1984 and 1983 are shown for the 1985 targets. The financial ratios vary greatly within acquisition categories and outlying observations frequently result in large distortions. Consequently, the averages in table 6 are based on the 50 percent of observations around the median observation in each acquisition category; in other words, they are averages of the "normal" values for each acquisition category. The averages for all observations, along with associated standard deviations and the number of observations in each category, appear in the appendix. (The number of observations is smaller than the number of target companies as some financial variables were not available for some firms.)[6]

To provide some indication of what these financial ratios might look like for firms that are not targets of acquisition attempts, the table also includes the relevant ratios for "all industrials" from the Compustat industry aggregates file. (To be included in this file, the firms must be

[6] Also, financial reports for 1984 were not available in some cases. The annual data provided by the source, Compustat, are based on companies' fiscal years. Data for companies with fiscal years ending in the first five months of the calendar year are treated as occurring in the previous calendar year. This is one reason why there are more observations for 1983.

Table 6
Financial Characteristics of 1985 Acquisition Targets
Average Values for Middle Two Quartiles of Observation

Target	Market Value ($ millions)		Inverse of Price-Earnings Ratio		Ratio of Cash Flow to Market Value		Ratio of Price to Book Value	
	1984	1983	1984	1983	1984	1983	1984	1983
Contested Tenders	425.8	429.5	.096	.086	.179	.170	1.11	1.15
Uncontested Tenders	719.5	496.9	.087	.084	.158	.138	1.36	1.45
Private by Management	101.0	102.3	.088	.066	.146	.155	1.37	1.43
Mergers	139.6	126.6	.093	.066	.164	.129	1.22	1.39
All excluding Contested	175.8	162.0	.090	.072	.158	.137	1.29	1.41
All Industrials	621.7	671.2	.093	.072	.180	.149	1.44	1.58

Target	Return on Equity		Payout Ratio		Inverse of Coverage Ratio		Leverage (Long-Term Debt/ Assets)	
	1984	1983	1984	1983	1984	1983	1984	1983
Contested Tenders	.118	.096	.347	.329	.231	.247	.185	.192
Uncontested Tenders	.138	.132	.315	.215	.197	.197	.159	.145
Private by Management	.129	.114	.120	.063	.172	.141	.213	.225
Mergers	.117	.096	.194	.171	.217	.265	.179	.176
All excluding Contested	.124	.110	.201	.156	.196	.219	.180	.171
All Industrials	.133	.113	.382	.438	.206	.215	.178	.169

Target	Liquidity		Capital Expenditures/ Depreciation		R&D Expenditures/Sales	
	1984	1983	1984	1983	1984	1983
Contested Tenders	1.94	1.94	1.64	1.31	.014	.013
Uncontested Tenders	1.84	2.18	1.81	1.62	.015	.016
Private by Management	2.02	2.08	1.31	1.49	.009	.011
Mergers	1.96	2.36	1.52	1.14	.022	.019
All excluding Contested	2.05	2.23	1.56	1.33	.015	.015
All Industrials	1.56	1.61	1.76	1.55	n.a.	n.a.

Source: Standard & Poor's Compustat Services Inc.

followed regularly by Compustat and must meet certain size and industry representation criteria.) It should be noted, however, that the industrials' ratios are ratios of aggregate industry variables, while the ratios for the various acquisition categories are averages of individual firms' ratios.

The variables appearing in the table are as follows:

(1) Total market value, calculated as the calendar year closing price (Compustat data item 24) multipled by the number of common shares

outstanding (item 25).

(2) Inverse of the price-earnings ratio, calculated by dividing income before extraordinary items adjusted for common stock equivalents (item 20) by the market value. The higher the price-earnings ratio, the lower will be the inverse.

(3) Cash flow, defined as income before extraordinary items (item 18) plus depreciation (item 14), relative to market value. This was included on the grounds that cash flow might be a more meaningful indicator than income of the stream of funds available to those controlling the corporation.

(4) Price relative to book value, calculated as the market value relative to common equity (item 60).

(5) Return on equity, or income before extraordinary items adjusted for common stock equivalents relative to common equity.

(6) Payout ratio, or the ratio of common dividends (item 21) to income before extraordinary items adjusted for common stock equivalents.

(7) Inverse of the coverage ratio, or interest (item 15) relative to the sum of interest and pre-tax income (item 70). The lower the interest relative to interest and pre-tax income, or conversely the higher the coverage ratio, the more debt the company can carry without experiencing difficulties. Bond indentures often specify minimum coverage ratios. Thus, a higher coverage ratio may make a firm an attractive takeover target, while a very low coverage ratio may be an indicator of a firm in financial difficulty.

(8) Long-term debt (item 9) relative to total assets (item 6), a measure of leverage. A low value would indicate that a firm could assume more debt.

(9) Current assets (item 4) relative to current liabilities (item 5), a measure of liquidity.

(10) Capital expenditures (item 30) relative to depreciation.

(11) Research and development expenditures (item 46) relative to sales (item 12).

The last two items are included because opponents of takeovers have claimed that fear of takeovers causes firms to focus on increasing earnings in the short run to the detriment of the long run. By implication, firms that are targets of hostile takeovers are firms that have failed to adopt a short-run mentality and have continued to pursue long-run profit goals. Capital spending and research and development expenditures are intended to capture an orientation to the long run.

An examination of these financial characteristics reveals that targets of contested tender offers were not statistically different from targets of other acquisition attempts in any respect except size. In other words, all one can say with confidence is that targets of contested tender offers had larger market values than other acquisition targets. This conclusion is

based on the averages and standard deviations appearing in the appendix. Despite this general finding, the ratios in table 6 warrant comment. For normal observations, there appear to be small differences.

Share prices for targets of contested tender offers were a little low. Income and cash flow were both slightly higher relative to market value for targets of contested tender offers than for targets of other acquisition attempts. The ratio of price to book value was lower. Thus, depending on one's perspective, either managers of hostile takeover targets were not quite as successful as other managers in maintaining share prices or targets of hostile takeovers were a little cheaper than other acquisitions. The various ratios involving share prices did not differ markedly between the acquisition targets and "all industrials," although the industrial price-to-book ratio was somewhat higher.

The return on equity is perhaps the most interesting ratio. The variation in the return on equity was considerably smaller for targets of contested tender offers than for other firms in the sample. In particular, only two of 20 firms facing hostile takeovers in 1985 experienced losses in 1983; none (out of 19 observations) had losses in 1984. In contrast, 18 percent of the firms that were targets of other acquisition attempts experienced losses in 1983, 14 percent in 1984. Most of the firms experiencing losses were targets of mergers or of attempts by management to go private. Losses among targets of uncontested tender offers were rare. It would appear that bidders do not make tender offers for companies that are in serious financial difficulty, but companies in serious financial difficulty may look to merger partners to help solve their problems.

Because there were so few negative returns among the targets of contested tender offers, the average rate of return for targets of contested tender offers (shown in the apppendix) was higher than that for other targets. For the middle range of observations, however, the average return on equity was lower for targets of contested tender offers than for the rest of the sample. While there were few "losers" among the contested targets, the norm was mediocre. Payout ratios were normally higher for targets of contested tender offers than for targets of other acquisition attempts. (Payout ratios were below the "all industrials" averages; but to the extent that some firms with losses pay dividends, an average based on industry aggregates might well be higher than one based on individual firm ratios.)

Neither the inverse of the coverage ratio nor the ratio of long-term debt to assets suggests that targets of contested tender offers have more capacity to take on debt than targets of other forms of acquisition. Similarly, targets of contested tender offers were not more liquid than other targets. (The liquidity ratios for all acquisition groups were higher than the average for all industrials, however.) Finally, targets of contested tender offers did not engage in more capital spending or research and

development activity than other targets. They were not victims of a commitment to the long run.

In summary, targets of hostile tender offers in 1985 were not very different from targets of friendlier acquisition attempts, except as regards size. Targets of contested tender offers were larger than targets of other acquisition proposals, although not larger than targets of uncontested tender offers. The stock prices for the targets of contested tender offers seem to have been a little lower than the prices for other targets, particularly when measured against book value, but these differences cannot withstand much scrutiny. Targets of acquisitions, both hostile and otherwise, were smaller than the average company in Compustat's industrial file; they also appear to have had higher liquidity ratios. Once again, however, differences were not striking except as regards size.

These results are generally consistent with those of other studies. John Pound, in a study for the Investor Responsibility Research Center Inc., examined the financial characteristics of friendly takeover targets, hostile takeover targets that were acquired, hostile targets that remained independent and a control group (Pound 1985). He found that the variation in characteristics was so great within groups that the groups could not be distinguished statistically. Pound also found that the variables changed considerably from year to year, so that one's perception of the relationships among acquisition categories could differ depending upon the year in question. This caution should be borne in mind when looking at the ratios in table 6.

A recent working paper published by the National Bureau of Economic Research looked at financial and other characteristics of Fortune 500 companies acquired in hostile and friendly transactions (Morck, Shleifer and Vishny 1987). Again, there was little difference among the companies for most financial variables. An exception was the ratio of market value to replacement value of tangible assets, which was lower for the hostile targets. This variable was not considered in the current study, but some of its influence may have been captured in the price-to-book-value ratio, which seems to have been lower for targets of contested tender offers. The NBER study also found that the companies taken over in hostile acquisitions had earlier incorporation dates and differed in some ownership characteristics from friendly acquisitions.

The picture of targets of hostile takeovers as rather ordinary firms, at worst mediocre firms, does not change if one looks at them within their own industries. Table 7 shows how many targets of contested tender offers had returns on equity and price-to-book-value ratios above and below the averages for their respective industries. As can be seen from the table, more takeover targets were below the industry averages than above but the split was fairly balanced. Managers of most takeover targets have legitimate reason to ask, "Why me?"

Table 7
Return on Equity and Price-to-Book Value Ratios for Targets of 1985 Contested Tender Offers

	Number of Observations			
	Return on Equity		Price to Book Value	
	1984	1983	1984	1983
Firm Ratio as a Multiple of the Industry Ratio				
More than 1.1	6	6	6	5
.9 to 1.1	5	4	3	6
Less than .9	7	9	8	7

Data are not available for all firms or corresponding industries for both years. The number of observations is smaller than the number (20) of targets of 1985 contested tender offers.
Source: Standard & Poor's Compustat Services, Inc.

Conclusions

Hostile takeovers have become a source of intense interest and bitter debate. Following the Supreme Court's upholding in April 1987 of Indiana's antitakeover act, a number of states have adopted or are in the process of adopting legislation making hostile takeovers more difficult and more uncertain. Although advocates of restricting takeovers may be motivated by other considerations, such restrictions are commonly justified on the grounds that they protect the shareholders of the takeover targets. Since the restrictions would generally not affect friendly acquisitions, the implication is that hostile takeovers are less favorable to shareholders than other types of acquisition.

Opponents of restricting takeovers counter that target company shareholders, far from benefiting from antitakeover legislation, will be hurt: acquisition attempts will be discouraged and shareholders will be denied the opportunity to sell their shares at an attractive premium. In addition, shareholders of other companies will be adversely affected, as takeovers perform an important disciplinary function in removing managers who are failing to maximize shareholder wealth.

This paper examines, first, whether the experience of target company shareholders is less favorable in a hostile takeover attempt than in other acquisition proposals and, second, whether targets of hostile takeovers differ in key financial characteristics from the targets of other acquisitions. It finds that shareholders fare as well in hostile takeovers as in friendly acquisitions. The premiums offered in hostile takeovers are comparable. More importantly perhaps, the stock market's response to the announcement of a hostile takeover is no different from its reaction to other acquisition proposals. Stock prices rise just as much in response to a tender offer that is contested as they do at the announcement that

management is trying to take a company private or that a company is the object of a merger proposal. If one looks at stock prices over a very short span around the announcement date, prices do not rise as much in response to a contested tender offer as an uncontested tender offer. However, for a somewhat longer event window there is no significant difference. It appears that shareholders do not require protection from hostile takeovers.

It also appears that companies that are targets of hostile takeovers are not very different from targets of friendlier acquisition proposals and probably not very different from companies generally. The share prices for takeover targets appear to be a little lower relative to book value than those of other acquisition targets, but the difference is not statistically significant. Rates of return are not impressive for takeover targets, but losses are rare. Targets of hostile takeovers are certainly not the worst-managed firms. This is not the same as saying they cannot be better managed—only that simple measures do not show obvious failings.

Given the small number of firms that are targets of contested tender offers, it is certainly possible that individual bidders could have sufficiently detailed understandings of these companies to conclude that current management is inadequate, even though standard financial ratios do not reveal problems. In other words, takeover targets may be performing below their potential, but the management failures and the indicators of management failure may be unique to each case. It is also possible, given the small number of hostile takeover targets, that the choice of target has less to do with the failings of target management than with the characteristics of the bidders. Some bidders are obviously more willing to engage in hostile takeovers than others; and their knowledge of particular industries and preferences for particular types of firms will have a strong influence on target choice.

In any event, the message that managers will find their firms vulnerable to takeover attempts if they fail in their responsibilities to shareholders is fuzzy. To the extent that there are differences between targets of hostile takeovers and targets of friendlier acquisition proposals, they are very small and they certainly do not provide management with a guide to what sort of performance will protect them from takeovers. Discipline is only effective if the nature of the failure is clear and this does not seem to be the case for hostile takeovers.

In conclusion, target company shareholders benefit from hostile takeovers. Stock prices increase as much, if not more, in response to a hostile tender offer as in response to a merger or management buyout. However, the unremarkable nature of hostile takeover targets and the absence of clear evidence of management failure casts doubt on the argument that hostile takeovers exert a useful discipline on managers generally.

Appendix

The event study procedure followed in this article is the same as that found in Dodd and Warner (1983), Linn and McConnell (1983), Malatesta (1983), and Patell (1976). Patell provides the most thorough description of the assumptions underlying the event test. The first step is to estimate what the expected return of the stock would be in the absence of the event. Equation 1 is estimated from 240 days before the first event to 61 days before the event.

$$(1) \quad R_{it} = a_i + b_i R_{mt} + e_{it} \qquad t = -240, -239. \ldots -61$$

where R_{it} = return on firm i on day t
R_{mt} = return on market portfolio on day t
e_{it} = disturbance term with $E(e_{it}) = 0$

An event window, the period during which the event is expected to influence the return series, is arbitrary. Ideally, the event window would be determined by the day of the event. However, early release of information may cause the return series to be influenced before the public announcement of a takeover. Two event windows are used in this study. The first extends from 40 days before the event to 10 days after the event, while the smaller window extends from 5 days before the event to 5 days after the event. Over each window, the excess return (ER_{it}) is calculated.

$$(2) \quad ER_{it} = R_{it} - \hat{a}_i - \hat{b}_i R_{mt}$$

To determine whether an excess return is significantly different from 0, a test statistic is created (Johnston 1972, pp. 154–55).

$$(3) \quad SER_{it} = ER_{it}/s_{it}$$

$$s_{it} = \left[s^2 \left(1 + \frac{1}{V} + \frac{(R'_{mt} - \bar{R}_m)^2}{\sum_{1}^{V} (R_{mt} - \bar{R}_m)^2} \right) \right]^{0.5}$$

where s^2 = residual variance from equation 1
$\bar{R}_m$ = average market return over the period estimated in equation 1
R_{mt} = return to the market on day t
R'_{mt} = return on the market on forecast day t
V = number of days in estimation period

The standardized errors are summed to get the standardized cumulative residual.

$$(4) \quad SCR_i = \sum_{t=1}^{t=y} SER_{it} \times Y^{-0.5} \qquad Y = \text{number of days in event window}$$

The test statistic is then calculated as

(5) $z = ASCR * N^{0.5}$ $\quad N$ = number of firms

$$ASCR = \frac{1}{N}\sum_{i=1}^{N} SCR_i$$

The z statistic is assumed to be distributed standard normal.

Table A1 (1 of 3)
Financial Characteristics of 1985 Acquisition Targets

	Market Value		Inverse of Price-Earnings Ratio		Ratio of Cash Flow to Market Value		Ratio of Price to Book Value	
Type of Acquisition	1984	1983	1984	1983	1984	1983	1984	1983
Contested Tender Offer								
Observations	19	19	19	19	19	19	19	19
Average	2016.2	1605.9	.094	.086	.198	.187	1.185	1.247
Standard Deviation	408.3	2985.1	.039	.039	.079	.068	.370	.355
Uncontested Tender								
Observations	20	29	20	29	20	29	20	29
Average	1072.4	834.0	.063	.077	.146	.141	1.537	1.760
Standard Deviation	1116.7	966.9	.116	.046	.102	.060	.776	1.213
Private by Management								
Observations	20	22	20	22	20	22	20	22
Average	162.5	164.4	.061	.040	.166	.140	1.765	3.241
Standard Deviation	174.7	17.2	.091	.094	.092	.091	1.465	7.657
Merger								
Observations	52	59	53	59	49	55	53	59
Average	266.3	275.7	−.122	.013	.236	.099	1.378	1.612
Standard Deviation	436.4	505.0	1.430	.285	.680	.288	.875	1.323
All excluding Contested								
Observations	92	110	93	110	89	106	93	110
Average	419.0	40.6	−.043	.035	.200	.119	1.496	1.977
Standard Deviation	711.1	676.8	1.098	.216	.510	.215	1.025	3.668
t-statistics for difference between means								
Contested − Uncontested	.97	1.27	1.07	.75	1.75	2.42	−1.74	−1.76
Contested − Private	1.98	2.20	1.41	1.97	1.15	1.79	−1.63	−1.11
Contested − Merger	3.00	3.24	.65	1.11	−.24	1.29	−.92	−1.17
Contested − All Other	3.47	3.69	.54	1.03	−.01	1.34	−1.29	−.86

Table A1 (2 of 3)
Financial Characteristics of 1985 Acquisition Targets

Acquisition	Return on Equity		Payout Ratio		Inverse of Coverage Ratio		Leverage	
	1984	1983	1984	1983	1984	1983	1984	1983
Contested Tender Offer								
Observations	19	20	19	20	17	19	18	20
Average	.110	.096	.341	.090	.244	.347	.199	.193
Standard Deviation	.045	.049	.261	1.135	.126	.380	.066	.085
Uncontested Tender								
Observations	20	29	20	29	20	27	20	29
Average	.107	.123	.632	.216	.162	1.524	.176	.156
Standard Deviation	.125	.083	.957	.667	.437	6.743	.099	.108
Private by Management								
Observations	21	23	21	23	21	23	21	23
Average	.100	−.275	.480	−.157	.189	.035	.217	.222
Standard Deviation	.124	1.852	1.480	.794	.384	.930	.119	.140
Merger								
Observations	53	60	53	60	52	59	53	60
Average	.108	.163	.210	.336	−.152	.383	.204	.213
Standard Deviation	.184	.563	.299	1.494	2.554	.581	.161	.176
All excluding Contested								
Observations	94	112	94	112	93	109	94	112
Average	.106	.063	.360	.203	−.008	.592	.201	.200
Standard Deviation	.161	.095	.875	1.215	1.936	3.454	.141	.156
t-statistics for difference between means								
Contested − Uncontested	.08	−1.29	−1.25	−.48	.73	−.74	.79	1.27
Contested − Private	.31	.87	−.39	.82	.55	1.34	−.56	−.79
Contested − Merger	.05	−.53	1.66	−.66	.63	−.24	−.15	−.47
Contested − All Other	.10	.15	−.10	−.38	.53	−.31	−.08	−.19

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Discussion

*John C. Coffee, Jr.**

Although the simple disciplinary model of the hostile takeover views it as an engine of efficiency that creates value for shareholders, largely by pruning corporate deadwood, the picture that emerges from the data gathered by Lynn Browne and Eric Rosengren provides only partial corroboration for this theory. Put simply, their findings support the first half of this story—that is, that shareholders gain—but tend to disconfirm the second half—namely, that takeover targets are inefficiently managed. Basically, they find that takeover targets are not statistically distinguishable from other firms—either other acquisition targets in "friendly" mergers or other firms within the same industry—at least in terms of their financial characteristics. This view of targets of hostile takeovers as rather ordinary firms, at worst mediocre firms, but rarely the laggards within their industry, has been corroborated by other recent research. John Pound's work for the Investor Responsibility Research Center, Inc. (1985), a recent paper by Morck, Shleifer and Vishny (1987) for the National Bureau of Economic Research, and earlier works by other scholars—for example, Langetieg (1978), and Harris, Stewart and Carleton (1982)—agree that the targets of takeovers do not appear statistically different in their financial characteristics from other acquisition targets or from other firms within their own industries. Still, the evidence that shareholders gain from takeovers is irrefutable; no one seriously challenges it, and the aggregate gains may be as high as $167 billion, according to Grundfest and Black (1987).

What explains wealth creation on this scale if there appear to be no villains that deserve the tender offer's guillotine? Several competing hypotheses can account for this pattern. At one polar position is Michael Jensen's "Free Cash Flow" theory, essentially a modified version of the

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disciplinary model, which argues that takeovers discipline a special kind of managerial opportunism, namely the tendency toward cash hoarding and empire-building. If most corporations engage in such behavior, then we should not be surprised that takeover targets do not stand apart from the herd in terms of their financial characteristics. At the other pole is a thesis that asserts that takeovers do not create wealth but only transfer it, largely as the result of disrupting (or breaching) "implicit contracts" that once bound together the modern corporation as an economic and social institution. This view has been most aggressively argued by Schleifer and Summers (1987), and earlier in a more qualified form by both Knoeber (1986) and Coffee (1986). Of course, these two rival hypotheses are not necessarily inconsistent; each could explain a part of the puzzle of the source of takeover gains.

By contrasting these two theories, I believe that we can better understand the forces that have produced the recent epidemic of state takeover legislation. Just since the April 21, 1987 decision of the U.S. Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 14 states have adopted or modified laws designed to restrict takeovers.[1] A majority of the states have now passed a "second generation" takeover statute, and with the recent passage by Delaware of its takeover statute, it has been estimated that 80 percent of business capital in the United States is now protected by such a statute.[2] Thus, there is a clear and present danger that over the next five-year period the rate of corporate takeovers and associated transactions (such as leveraged buyouts and defensive mergers) may sharply decline.

One can, of course, bemoan this trend or even suggest (as Securities and Exchange Commission Chairman Ruder has) that state takeover statutes should be preempted by new federal legislation, but the prospects for preemptive legislation are at best bleak, since none of the major bills pending before the Congress provides for it. Alternatively, we can inquire (as I will attempt at the end of this comment) whether state takeover regulation can be neutralized by a policy that seeks to secure management's acquiescence. My premise for this suggestion is that the takeover gains to target shareholders are large enough to permit them to compensate other constituencies who are adversely affected; thus, in true Coasean fashion, the winners can "bribe" the losers and reach an

[1] 107 S. Ct. 1637 (1987). The 14 states that have enacted antitakeover legislation since that case are: Arizona, Delaware, Florida, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, New Jersey, North Carolina, Oregon, Utah, Washington and Wisconsin. See Investor Responsibility Research Center (1987).

[2] See the article by Doug Bandow, "Curbing Raiders Is Bad for Business," *New York Times*, February 7, 1988 at F-2. For a recent list of states having antitakeover statutes, see Investor Responsibility Research Center (1987).

efficient equilibrium, despite the significant legal barriers now being erected in the path of takeovers at the state level.

The Alternative Hypotheses: Empire-Building versus Implicit Contracting

Even the strongest proponents of a market for corporate control have long conceded that the source of takeover gains remains a mystery (Jensen and Ruback 1983). Recently, the debate over the source of these gains has become more focused, as increasing evidence suggests that target firms sell in the market at significant discounts from their asset liquidation or break-up values. A National Bureau of Economic Research working paper finds the one financial characteristic that distinguishes hostile takeovers from friendly transactions (at least among Fortune 500 companies) to be the ratio of market value to replacement value of tangible assets. This ratio was lower for the hostile targets (Morck, Shleifer and Vishny 1987).

Elsewhere, I have argued that the characteristic pattern of takeovers began to shift in the early 1980s from "synergistic" acquisitions to "bust-up" takeovers (Coffee 1986). The former, which are aggregative and assume that the whole has greater value than the sum of the parts, had been the dominant pattern throughout the earlier history of the takeover (and indeed all earlier merger and acquisition peak periods). The bust-up takeover is disaggregative and essentially involves a bidder who is seeking to arbitrage the disparity between the stock value of the target and its higher asset liquidation value. Historically, it is easy to understand that the appearance of the junk bond market in the early 1980s made such arbitrage transactions possible, but the deeper question involves how to explain this "negative synergy" that makes many firms more valuable broken up than intact. A number of theories have been offered, including managerial risk aversion, imperfect information, the redundancy of diversified investors owning diversified conglomerates, and managerial compensation practices under which the firm promises an "ex post" settling-up, a promise that the bust-up takeover breaches. I believe further research will someday suggest that changes in the world economy have also made the diversified or "M-Form" conglomerate a comparatively less efficient vehicle for organizing economic activity than alternative contractual arrangements: to reverse Oliver Williamson's well-known thesis, markets may today be more efficient than hierarchies, at least over some range of corporations, which are therefore takeover targets.

Although a range of theories can be offered to explain the preva-

lence of the bust-up takeover, the best-known contemporary theory is probably Michael Jensen's "Free Cash Flow" hypothesis (Jensen 1986). Actually, this theory strikes me as largely a reinterpretation—with original elements, to be sure—of the long tradition of "managerialist" theories, which has featured notable efforts by such writers as Baumol (1959), Marris (1964), Williamson (1963), and more recently, Gordon Donaldson (1984). These writers agree that there is an inherent tendency for excessive growth, because managers' preferences deviate from those of the shareholders. If so, investors should logically discount the firm's stock value below its "break-up" asset value, because the market would anticipate that inefficient investment (that is, diversion of the free cash flow) would continue. In addition, managers may refuse to sell assets or divisions, even though another purchaser would pay more for the particular division; thus, assets do not flow to their highest and best use (or at least to the most optimistic purchaser) until the firm's bust-up permits this potential asset value to be realized. Obviously, the recent finding that target firms have a low ratio of market value to replacement cost seems to corroborate this theory.

An alternative theory has been offered by another group of writers, including this author, who view the modern corporation as a complex institutional mechanism designed at least in part to uphold (and thus permit reliance upon) "implicit contracts" reached between the shareholders and other "stakeholders" in the corporation—for example, managers, creditors, employees, and possibly certain suppliers (Coffee 1986; Knoeber 1986; Shleifer and Summers 1987). The nature of this implicit contract can be variously defined. Some emphasize risk aversion: that is, because shareholders own many stocks, while managers have but one job, they strike an arrangement under which shareholders keep the residual returns, while managers receive the assurance of continuing employment and stable income (Coffee 1986). In short, managers trade off higher returns for lower risk, but are as a result unwilling to commit the firm to risky financial or investment decisions that shareholders would favor. Alternatively, one can model the shareholder/manager "implicit contract" as an attempt to foster investment by managers in "firm-specific" human capital (Williamson 1984). To encourage such investment, managers must be promised a form of quasi-tenure, because such "firm-specific" capital will have limited value to the market. Finally, a third view begins with the recognition that it is difficult to evaluate the senior manager's value to the firm contemporaneously; thus, optimal compensation requires an ex post settling-up process (Knoeber 1986). That is, because one cannot know until years later whether a specific investment decision or marketing strategy will pay off, it is necessary to award deferred compensation on an ex post basis in order to reward managers on a basis commensurate with their contribu-

tion to the firm's earnings.

For present purposes, the differences among these theories are of secondary importance, because all recognize the possibility that shareholders could opportunistically breach the implicit contract. As a result of such conduct, shareholder wealth is increased, but not social wealth. At least in theory, it is possible that the losses to stakeholders could even exceed the gains to shareholders. On a more abstract level, the implicit contracting perspective produces an important paradigm shift, because it moves the focus of the debate from the law's usual concern with reducing "agency costs" to the protection of the interests of these "stakeholders" who are exposed to arguably opportunistic behavior by shareholders.

Implications of the Implicit Contracting Perspective

The assertion that social and shareholder wealth are not positively correlated is obviously subject to challenge. Because the opportunity cost to an employee from being terminated is seldom, if ever, the employee's full wage, it is difficult to believe that employee losses often exceed shareholder gains. Still, the real significance of the implicit contracting perspective is that it forces us to see the board of directors in a very different light. While the law has traditionally viewed the board of directors as the agent of the shareholders, this alternative perspective suggests that the board's role may be that of a mediator. Because long-term contracting between shareholders and the other constituencies is costly and numerous contingencies can arise that could not be foreseen in advance, the parties to the implicit contract need a body to serve in effect as an arbitration panel to preserve the fair expectations of each side. On an ex ante basis, the parties designate the board to perform this role through ex post adjustments (Coffee 1986). This view sounds heretical because, as we all know, only shareholders elect the board of directors, but in practice it is senior management who nominate candidates to fill vacancies on the board, with shareholders only ratifying their selection. Thus, while in theory directors are elected by shareholders, in reality the balance of power over their selection probably tilts in favor of management.

This view of the board as a mediating body brings us back to the distinctive character of the hostile takeover. Uniquely, it permits the bidder to outflank the board. In contrast, a merger or sale of assets generally requires board approval before it is submitted to shareholders. Preempting the board's role has special significance if we view this role as that of a mediator entrusted by the various stakeholders with the task of protecting the expectations of all the contracting parties and, argu-

ably, also with a responsibility for allocating "windfall" gains, such as takeover premiums. This view does not mean that defensive tactics are therefore justifiable, but it does suggest a role for the board beyond that of a bargaining agent for the shareholders; in particular, it invites criticism of those Delaware decisions, such as *Revlon*, that see the board's role (at least once a takeover is inevitable) as only that of a "fair auctioneer" (Coffee 1986, n. 225).

Predictably, some will respond that this view is overly idealized, because there is little evidence to believe that the board has behaved in the past as the wise, paternal, benign mediator that such a theory seems to contemplate. But it is a mistake to see this mediation model of the board's role as equivalent to benevolent paternalism. Lower-echelon employees contract through other means and institutions (for example, collective bargaining) and are not as exposed to opportunism because they do not invest in much "firm-specific" capital or expect an ex post "settling-up." The real contracting parties are chiefly managers and shareholders.

The next step in this analysis explains the appearance of state takeover statutes as the consequence of the preemption of the board's role. If the implicit contract has been breached, a contractual failure has arguably occurred, and legal regulation becomes justifiable. In this perspective, state takeover statutes have nothing to do with shareholder protection, but are instead aimed (albeit covertly) at managerial protection, because the old system of implicit contracting has failed.

To state these arguments is not necessarily to accept them. The first hypothesis—the Free Cash Flow theory—probably has greater explanatory power, because the scale of recent takeover gains (roughly $167 billion, according to Grundfest and Black 1987) cannot be explained simply on the basis of cost savings to shareholders from opportunistic breaches of implicit contracts. This becomes clearer if we consider an individual case. Today, the average takeover premium is around 40 percent. One cannot generally explain a rational bidder paying $1.4 billion for a target whose prior aggregate stock market value was $1 billion, simply in terms of the cost savings that managerial layoffs are likely to effect. Indeed, for such a takeover to be rational on this basis (given both the risks and the notoriously high transaction costs), the bidder would have to expect to realize cost savings considerably greater than this $400 million premium in order for it to earn a reasonable profit. There may have been some takeovers that fit such a pattern, but even in these cases the actual loss to the dismissed managers is their opportunity cost, which will generally be only a fraction of their former salary.

Let us assume then that the disparity between stock and asset values of the typical target firm is attributable more to inefficient empire-building and a bias for earnings retention than to shareholder

opportunism and the reneging on implicit contracts. Still, this view that Free Cash Flow theory explains more (or even most) of the discount does not refute the possibility that managers are exposed to significant losses as a result of takeovers. Rather, it leads us to the critical issue, from my perspective: If shareholders have more to gain from takeovers than managers have to lose, why haven't shareholders found ways to "bribe" managers into acquiescence? This is, of course, what Coase's theorem would predict. The most obvious means by which to align managerial incentives with those of the shareholders is through management compensation formulas. Why then has private ordering not devised new compensation formulas designed to secure managerial acquiescence in takeovers?

Takeover Resistance as a Problem in Management Compensation

Assume the Free Cash Flow formula is correct and managers are biased toward retaining earnings in investments that have negative present value once discounted at a rate equal to the corporation's cost of capital. Because such inefficient retention of earnings does not enrich management personally, it can have only a limited utility for them. Assume that for each dollar of "free cash flow" that is inefficiently invested, management receives a positive utility of 10 cents (because salaries are positively correlated with size, or because there is greater psychic income in managing a larger firm, or for some other reason). Seemingly, a compensation formula could be devised that effectively paid managers 20 cents for each dollar of free cash flow not so invested, but instead paid out. Why then hasn't internal contracting within the firm fashioned such a formula?

One answer may be that the failure to pay out free cash flow to shareholders may have more to do with implicit contracting within the firm than has hitherto been recognized. This answer may also explain why target firms do not have more distinctive financial characteristics (because the practice is widely prevalent). For example, risk-averse managers might prefer the lower, but less risky, positive utility associated with empire-building to the highly risky cash substitute that a compensation formula offers.

Another answer may be that there are legal barriers that preclude the adoption of more optimal management compensation formulas. This answer has been tentatively put forward by Jensen and Murphy in a recent, very interesting working paper, but it ultimately seems difficult to accept, at least in the form in which they articulate it. They begin with a striking fact: as they compute it, executive compensation is extremely

insensitive to the stock market performance of the firm employing the manager, changing "less than two cents for every $1,000 change in equity value" (Jensen and Murphy 1987). If this is the case, it is little wonder that managers have let stock market values sink below asset liquidation values. Managers are essentially in the position of fixed-interest creditors and, as such, should behave in a highly risk-averse fashion. This leads to the next question: Why are management compensation practices so indifferent to the firm's stock value? Here, Jensen and Murphy suggest that fears of legal liability may lead directors to undercompensate managers. This seems overstated, because cases imposing such liability are notoriously lacking, and only in the case of twelfth-hour "golden parachutes" or gratuitous pensions to the chairman's widow have courts intervened to enjoin the transaction.[3] In general, the business judgment rule reigns more supremely in this area than in most others.

The problem may instead lie with the difficulty inherent in designing the kind of management compensation formula that is needed (and also with its relative novelty, which might subject it to a greater likelihood that courts would enjoin it). Simply keying managers' salaries to the firm's stock price is too crude, because it does not distinguish the "firm-specific" component from the "systematic risk" component of the stock price. Possible formulas that could make such a distinction may be overly complicated and are not easily implemented, particularly if managers are poor risk bearers and need a stable income stream. Also, if some managers are risk-neutral, then stock-based compensation can give rise to a moral hazard problem, as these managers would have an incentive to accept highly risky investments and policies. The result would begin to resemble a world in which the managers were selected exclusively by the firm's warrant holders. To sum up, one needs to steer a fine line between Scylla and Charybdis: the former being the fact that managers make poor risk bearers and the latter the danger of creating a moral hazard problem.

More importantly, the higher we raise managers' salaries, the more we motivate them to resist a hostile takeover, by increasing their opportunity cost. Thus, while such a compensation formula might reduce the incentive to retain free cash flow within the firm, it would motivate the target's management to resist a "synergistic" bidder who saw unique gains from combining the bidder and target firms.

Still, other possible compensation formulas have not been adequately explored. Consider then a very different form of compensation formula, one patterned after the manner in which the law has historical-

[3] See, for example, *Adam v. Smith*, 153 So. 2d 221 (Ala. 1963). Of special importance is the fact that shareholder ratification shifts the burden to the plaintiff to prove waste. See *Saxe v. Brady*, 184 A.2d 602 (Del. Ch. 1962). For a review of the case law, see Vagts (1983).

ly rewarded the successful plaintiff's attorney in class or derivative actions: namely, a "percentage of the recovery" formula. This may sound like a strange precedent to consider, but uniquely it gives the firm's managers an incentive both to accept, and to maximize, the takeover gains. Hypothetically, such a formula could be implemented by a provision in the corporate charter authorizing the board to pay to the firm's senior managers a specific percentage (say, 20 percent) of the premium paid to shareholders in a merger, acquisition or tender offer; such payment would be made by the target corporation (not the bidder), and a bylaw could commit the board to make such a payment, subject perhaps to some limited circumstances where it could be voided in the judgment of two-thirds of the board or more. This compensation would be in addition to the salary and stock option compensation the managers were otherwise paid. (Admittedly, a tendency to reduce regular compensation in light of this contingent bonus might arise.)

What would be the incentive effects of such a system? In a more focused manner than stock options, such a form of compensation should encourage target managers not only to acquiesce in a takeover, but to seek out bidders and conduct legitimate value-maximizing auctions. To be sure, some managers might still resist, but particularly for the CEO nearing retirement age, the lure of such a bonus should be considerable. Nor is this compensation costly to shareholders of firms for which no offer is made (as stock options and bonuses are).

Would there be any perverse incentives? Here, any answer must be qualified. Because such a compensation system gives the manager an interest in maximizing the margin between the firm's stock value and its higher break-up value, there could conceivably be an incentive to mismanage the firm in order to maximize this spread. This possibility seems small. A decline in corporate earnings would likely affect the manager's ordinary compensation (by reducing bonus income or the value of stock options) and would expose the manager to the threat of ouster by the board. In addition, the truly inefficient, mismanaged firm seems to escape the hostile takeover (witness the success of International Harvester, Chrysler, Continental Illinois and others in this regard), possibly because the bidder fears that it will be acquiring a "turkey" with more intractable problems than it realizes from the outside. Corporate culture is another factor that makes deliberate mismanagement an unlikely scenario.

A more realistic possibility is that such a compensation formula would give management an incentive to withhold favorable information from the stock market in order to privately reveal it only to selected bidders. Again, this conduct would maximize the spread between the stock market and break-up values, but it would not lead to any penalty in terms of reduced current earnings (because salary tends to be based

on historical reported earnings, not future discounted cash flows). Of course, to the extent one believes in the efficiency of the stock market, the ability of management to conceal material information from the market (while revealing it selectively to potential bidders) seems limited. Bidders who learn such information will logically buy the stock in the open market, and insider trading and normal information leakage may also close the gap between the two values. Thus, although there is the possibility of allocative inefficiency caused by managerial concealment of material information, the magnitude of this problem seems small.

The real problems with this proposal are, first, that it is open-ended, and, second, that it does not benefit all those who, if we believe that implicit contracts have been breached, stand to lose unfairly. The concept of a percentage-of-the-recovery fee award, as used in class actions, was always subject to a judicial scrutiny for reasonableness, and fee awards over 40 percent of the recovery have been extremely rare. Thus, although it may be in the shareholders' interest to allocate on an ex ante basis 10 or even 20 percent of the takeover premium to managers who are otherwise in a position to block it, a 50 percent allocation seems unreasonable. How likely is such a result? Much depends on how much confidence we place in the charter amendment process, where collective action problems and high information costs may make shareholders rationally apathetic. The more we doubt this process, the more we may be legitimizing extortion by managers of the takeover premium. Yet, corporate control transactions may be the unique context where investors do pay close attention to proposed charter amendments, because the expected gains are large enough to overcome their rational apathy.

Second, if we believe that takeovers invite shareholder opportunism and reneging on implicit contracts, this proposal represents only a partial answer, because it does not necessarily benefit middle management or others. The tension here is obvious: the more senior management shares that portion of the premium allocated to management with middle levels, the less will be senior management's expected return and the more it is still likely to oppose a takeover. The difficulty of this trade-off and the arguable need for a ceiling on the maximum amount so allocable suggests the need for legislative limits, possibly including nondiscrimination rules paralleling the statutory provisions regulating pension plans.

Regardless of these specific and subsidiary questions, the sharing of takeover gains that I am here suggesting goes well beyond any use that has yet been made of golden parachutes. Even in the more "liberal" cases upholding such compensation, courts have looked to the predictable loss in compensation over, typically, a three-year period and have adopted a "reasonableness" test.[4] Under such a test, a decision by the board alone to allocate 20 percent of the takeover gains to management seems

unlikely to pass such a test, absent special factors.

However, if such a provision were inserted in the corporate charter by a shareholder vote well in advance of any takeover, its prospect for judicial approval seems materially enhanced (although still not certain). The case for it now is not that it is "reasonable" in judicial eyes but that it was approved by a disinterested majority of shareholders (and possibly ratified within some reasonable "sunset" period). Only if the plaintiffs could demonstrate "waste" (a legally vague term approaching sheer irrationality) would such a provision be invalid under the Delaware case law.

To implement such a provision, changes in the federal tax laws will probably also be necessary, because "change of control" executive compensation is today subject to special and punitive taxation. Hence, federal tax reform is a precondition to any policy of securing managerial acquiescence.

Conclusion

Because of the *CTS* decision and the adoption of antitakeover statutes by a majority of the states, takeovers may yet be sharply curtailed. This prediction has proven false before, but rarely has the coalition of forces opposed to takeovers seemed so organized as today, when they have succeeded in a majority of the states in enacting legislation. The political economy of these statutes is particularly interesting. Despite their overt purpose, it takes little analysis to conclude that state takeover statutes do not benefit target shareholders. Target corporations could adopt—and to a considerable extent have adopted—charter provisions protecting their shareholders against the coercive features of partial bids and two-tier tender offers. Even in the absence of shareholder approval, boards of directors can adopt "poison pill" plans that can have a similar effect. There is thus little need for legislative efforts to protect the target shareholder, who may already be overprotected in most instances, even without governmental regulation.

But the fact that such legislation does not really help its nominal beneficiaries does not mean that there are not covert beneficiaries. Target managements, local communities, suppliers, existing creditors—all fall into this latter category. Takeover legislation, particularly at the state level, has usually amounted to a form of rent-seeking by such groups, and they have been highly effective because they are a politically cohesive and visible local force, while shareholders are dispersed nationally;

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[4] See *Koenings v. Joseph Schlitz Brewing Co.*, 377 N.W.2d 593 (Wisc. 1985); (issue is the reasonableness of the stipulated damages clause).

bidders and their allies can also be pejoratively dismissed as "arbitragers and speculators."

Against this backdrop of contending forces engaged in a rent-seeking competition—investment bankers on one side and the corporate business community largely on the other—only an incurable optimist would predict a satisfactory legislative solution. Stalemate and piecemeal compromise seem more likely. From an economic perspective, however, we can witness a familiar story in a new context: instead of railroads and cornfields, we here see shareholders and managers locked in the familiar Coasean attempt to negotiate an efficient outcome. The gains to the shareholders seem to outweigh the losses to the managers, and thus the possibility of an efficient outcome is discernible if legal barriers can be relaxed that might prevent a mutually beneficially transaction. If not, I expect that the takeover boom of recent years will gradually turn into a leveraged buyout boom, as target managements find this option to be their exclusive means of protecting their economic position. Most likely, the alternatives for the future are either new systems of managerial compensation that give managers greater incentive to accept risk or a higher rate of management buyouts, as managers acquire a controlling position in order to assure their tenure in office.

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