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# CORPORATE TAKEOVERS: WHAT IS THE FEDERAL ROLE?

## INTRODUCTION

The debate over corporate takeovers is dominated by exaggeration and myth. It is claimed, for instance, that "We are selling off the furniture that saw us through the modern age," and that takeovers are "simply a tricky financial arrangement to get a lot of other people's money, target a company, buy it, sell it off and sock huge profits away."[1]

Spurred by the hype and hysteria regarding corporate takeovers, Congress is planning to leap into the fray. This is one time when it will serve the public interest if Congress looks carefully before it leaps. Before enacting legislation designed to thwart takeovers, Congress needs to look beyond the myth and to the reality behind corporate takeovers. Policymakers must examine the crucial policy questions regarding this issue:

◆◆ Do mergers and acquisitions improve corporate efficiency? Are shareholders benefited by hostile takeovers?

◆◆ Does the economy as a whole benefit?[2]

The answer to these questions is clear: an active market for corporate control can improve corporate efficiency to the benefit of shareholders and the economy at large.

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1. Russell Baker and A. M. Rosenthal, respectively, quoted in Dan Rottenberg, "Missing the Message On Mergers," *Washington Journalism Review*, June 1987, p. 18.

2. Council of Economic Advisors, *Economic Report of the President*, February 1985, p. 191.

Free competition for corporate control provides a powerful tool in enhancing the competitiveness of American business. Contrary to the hype over "merger mania," takeovers are: breaking up inefficient conglomerates; increasing employment opportunities; prodding managers to invest in long-range projects that make economic sense; and utilizing the advantages of low-cost debt capital. As in most transactions, takeovers have resulted in isolated instances of abuse. Corporate "raiders" as well as target managements have been guilty. Forms of redress, such as stockholders amending the corporate charter and court remedies, already exist to deal with actions perceived to be detrimental to the company or the shareholder.

Stocks are not just for the rich. One out of every five Americans owns shares of stock. Of these 47 million shareholders, two-thirds earn between $15,000 and $50,000 annually.[3] In 1984 and 1985 alone, stockholders earned nearly $75 billion in premiums as a result of takeovers.[4] Many of the measures now before Congress would effectively curb takeovers, thus depriving shareholders and the country of the benefits that accrue as a result of the process for corporate control.

## FINANCIAL AND LEGAL BACKGROUND OF TAKEOVERS

A corporate "takeover" occurs whenever one group or individual acquires enough stock in a corporation to assume control of that firm's management. In most situations, the acquiring group deciding to buy another firm negotiates with the existing management over a price. Upon reaching agreement, the existing management group will recommend that stockholders approve the merger with the acquiring group's firm. Such a transaction is referred to as a "friendly" takeover.[5] However, should the target company's management oppose a takeover, the acquiring firm must make a direct appeal to the target company's shareholders through a "tender offer" to purchase their shares at a specified price. This constitutes a "hostile" takeover. It is hostile only to the entrenched management, not necessarily (in fact rarely) to the shareholders.

Corporate takeovers occur when investors judge the price of a company's stock, relative to the company's potential worth, to be undervalued. The lower the stock price, the more attractive the acquisition becomes to those who believe that they can run the company more efficiently and profitably than its current management. The potential returns from the successful takeover can be enormous, including revitalization of poorly run companies, economies in production and distribution, reallocation of assets to more productive uses, and generally improved management.

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3. David L. Prychitko, "Corporate Takeovers and Shareholder Interests," Citizens for a Sound Economy *Issue Alert* No. 13, April 16, 1987.

4. John D. Paulus, "Corporate Restructuring, 'Junk,' and Leverage: Too Much or Too Little?" Morgan Stanley *Economic Perspectives*, March 12, 1986, p. 10.

5. Eugene F. Brigham, "Mergers, Divestitures, and Holding Companies," *Financial Management, Theory and Practice* (New York: The Dryden Press, 1986), pp. 963-964.

Corporate acquisitions already are governed by a variety of securities and antitrust laws, including:

**The Williams Act of 1968.** This is the principal securities statute regulating tender offer activities. Under Williams, those who acquire 5 percent or more of a company must, within 10 days, file disclosure form 13(D) with the Securities and Exchange Commission (SEC). The disclosure must describe the history of the stock purchases, the method of financing, and the acquirer's intentions--whether the acquirer wants to take over the company or is simply making an investment.

Should the acquirer desire to gain control of the company, he must file form 14(D), in which the bidder offers to buy stock from existing stockholders, usually at a premium over the prevailing market price. The Williams Act is designed to provide shareholders an opportunity to examine and to assess the merits of takeover offers and to make informed and unpressured investment decisions.

**The Clayton and Federal Trade Commission (FTC) Acts of 1914** and the **Hart-Scott-Rodino Antitrust Improvements Act of 1976** are the primary antitrust statutes applicable to corporate acquisitions and takeovers. The Clayton Act bars acquisitions that may lessen competition substantially or tend to create a monopoly in any market. The FTC Act bars "unfair methods of competition."

Courts determine whether an acquisition violates these acts by examining the facts of each particular case. The Hart-Scott-Rodino Act allows federal regulators to review proposed mergers and acquisitions for possible antitrust problems. It requires individuals, corporations, and many partnerships with takeover plans to report stock acquisitions of $15 million or more to the government and wait 30 days before buying more shares. Buyers seeking to acquire more than 10 percent of a company for "investment" purposes also must undergo antitrust review.

## CURRENT PROPOSALS

Several proposals to reform corporate takeovers are currently before the Senate and the House of Representatives. Virtually all of these would lower the dollar amount threshold for required disclosures, lengthen the time period for responding to tender offers, shorten deadlines for filing with the Securities and Exchange Commission, and curtail certain defensive practices judged to be abusive such as "golden parachutes," "greenmail," and "poison pills."[6]

There also are calls for: "economic impact statements," which would outline plans for plant closings, how assets will be pledged to support financing, and other factors; restrictions on debt-financed tender offers; requirements that bidders

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6. "Golden parachutes" are employment contract provisions that guarantee very substantial severance payments to top management if they should lose their jobs as a result of a takeover. "Greenmail" occurs when a company buys back its stock from a large shareholder, who is threatening a hostile takeover, at a price greater than that at which the stock trades on the market. A "poison pill" refers to an issue of stock designed to discourage hostile takeovers. Upon completion of a hostile takeover, the typical poison pill stock becomes convertible into cash or into common stock of the acquiring company, thus considerably raising the cost of the acquisition.

purchasing 20 percent of company's shares make tender offers for the remaining shares; requirements that disclosure include the identity of people with whom an acquisition was discussed within the last 90 days, the terms and sources of financing, and fees paid. The two major bills in this are Wisconsin Democrat Senator William Proxmire's "Tender Offer Disclosure and Fairness Act of 1987" (S.1323) and Michigan Democrat Representative John Dingell's "Tender Offer Reform Act of 1987" (H.R. 2172).

## RHETORIC AND REALITY

There is considerable misleading rhetoric surrounding the issue. Congress should ignore it and focus on the realities. Examples:

### Takeovers and Monopolies

**Rhetoric:** Takeovers are leading to a dangerous increase in concentration in U.S. industry.

**Reality:** Takeovers are doing precisely the opposite, decentralizing industry by breaking up inefficient conglomerates. The dominant corporate strategy of the 1960s and early 1970s was conglomerization, in which a company diversified its risks by acquiring as many other companies as possible. The prevailing wisdom was that the whole would be greater than the sum of its parts.

At the time, many urged government to use the antitrust laws to stop this trend. Yet it was the marketplace that stopped conglomerization. As the conglomerate structure spawned financial and competitive problems, the conglomerates became inefficient. Bigness can breed bureaucracy, and bureaucracy breeds stagnation. The ability of subsidiaries of American conglomerates to react to changes in the global marketplace was severely impaired. This has been a key factor in damaging America's ability to compete with Japan and other nations in the world markets.

The market for corporate control provides an effective method of slimming companies to their most efficient size. Much of this decade's takeover activity reflects the divestment and reallocation of subsidiaries to more efficient users, as corporations pare down and concentrate on the businesses they know best.

### Takeovers and Employment

**Rhetoric:** Corporate takeovers, because they "bust up" companies, lead to plant closings and increased unemployment.

**Reality:** An active market for corporate control increases, rather than decreases, employment by encouraging necessary restructuring. A study by Professor Glenn Yago, director of the Economic Research Bureau at State University of New York-Stonybrook, finds that less than 2 percent of the jobs lost through plant closings in New York and New Jersey were associated with corporate takeovers. A General Accounting Office study attributed job loss to changes in supply and distribution, import penetration, and appreciation of the dollar.[7] Yago concludes that mergers and acquisitions should be considered an alternative to plant closings.[8] It appears that plant closings often occur when attempts at selling the company or division fail and the benefits of restructuring are not realized.

Companies spun off after a takeover, of course, do not just disintegrate and disappear. They are either moved into the hands of other companies better equipped to handle them or made independent--sometimes even under the ownership of their own managers. Example: following Sir James Goldsmith's takeover of Diamond International, he began to spin off subsidiaries that were a drain on Diamond's profitability. In most instances, the divested companies were taken over by their managers through leveraged buyouts.[9] The faltering divisions soon found themselves back in the black. Remarked one new owner: "The prospect of personal enrichment makes Johnny run harder."[10] Restructuring is a powerful force in enhancing America's competitive position abroad and in spurring creation of more jobs at home.

**Takeovers and Long-Term Investment**

**Rhetoric:** The threat of a takeover encourages managers to concentrate on short-term earnings at the expense of long-term investment.

**Reality:** Investors are not short-sighted. They can and do recognize the value of long-term investment.

Critics of "hostile" takeovers argue that, to ward off potential raiders, managers will sacrifice research and development and other long-term projects to prop up stock prices with short-term earnings. This argument assumes that the capital markets systematically undervalue expected earnings and that investors cannot see the long-term consequences of corporate policies.

This is nonsense and ignores the facts. A recent Securities and Exchange Commission study found that: 1) institutional investors do not spurn companies spending above the average for research and development and in fact appear to prefer such companies; 2) most takeover targets invested substantially less than the

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7. General Accounting Office, *Preliminary Analysis of U.S. Business Closures and Permanent Layoffs During 1983-1984*, April 30, 1986.

8. Glenn Yago, "Mergers and Jobs," paper presented at the Annual High-Yield Bond Investors Conference, Los Angeles, California, April 3, 1987.

9. In a leveraged buyout (LBO), the buyer borrows a large amount of the purchase price, using the purchased assets as collateral for the loan. The buyers are usually the managers of the division being sold.

10. Myron Magnet, "Restructuring Really Works," *Fortune*, March 2, 1987, pp. 42.

industry average in research and development; and 3) the stock market reacts very favorably to announcements of new research and development projects.[11]

Investors have powerful incentives to examine long-term consequences. Even if they intend to sell their stock before long-term investments pay off, the anticipation of that payoff will let them sell for a higher price. Thus, by following a policy of concentrating on short-term earnings and eschewing long-term investments, the value of a company's stock will drop. The company will be more, not less, likely to find itself the target of a takeover.

**Takeovers and "Junk Bonds"**

**Rhetoric:** The extensive use of junk bonds has resulted in an "over-leveraging" of corporate America.

**Reality:** Junk bonds are commonly defined as all bond issues judged to be below "investment grade" by such credit-rating agencies as Standard and Poor's or Dun and Bradstreet, which make their assessment based on the company's past earnings, asset size, and industry position. The valuation does not necessarily take into account a company's strong growth potential or its managerial capability--characteristics often associated with smaller, entrepreneurial firms.

Most noninvestment grade companies get low ratings because of their relatively small size or lack of sufficient credit history. These are not necessarily valid indicators of the firm's earnings potential. In fact, according to a study based on data from the various rating agencies, 95 percent of the nearly 23,000 companies with annual sales exceeding $25 million do not qualify for an investment grade rating.[12] These companies employed over 16 million Americans in 1986.

Prior to the emergence of the junk bond market, noninvestment grade companies had to rely on short-term, adjustable rate bank financing and private placements, thus incurring a higher cost of funds. Junk bonds provide longer-term, fixed rates financing (hence a lower cost of funds) for those small and midsize emerging growth companies that have created a majority of new jobs in the U.S. in recent years.

**Four Basic Facts.** Critics, warning of the "leveraging of America," argue that corporations issue too much risky debt and investors buy too much of it.[13] These critics fear that an economic downturn will turn into a major tailspin for the economy when companies find it more difficult to meet their interest obligations on the bonds. This, however, ignores basic facts about junk bonds.

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11. Office of the Chief Economist, "Institutional Ownership, Tender Offers, and Long-Term Investments," Securities and Exchange Commission, April 19, 1985.

12. Drexel Burnham Lambert, "A Comparison of Investment and Non-Investment Grade Companies in United States" (no date).

13. William J. Carney, "Examine the Motives of Junk Bond Critics," *Business Week*, March 30, 1987, p. 17.

1) **As a percentage of total outstanding debt**, junk bonds represent only approximately $50 billion of the $8 trillion total U.S. debt or just a bit more than one and one-half percent of total debt outstanding. And only about $30 billion in junk bonds has been used to finance takeovers. This is too small an amount to threaten to destabilize the huge American debt system.[14]

To be sure, the value of debt used by U.S. corporations has increased significantly over the last two decades, growing over 200 percent from 1970 to 1984 in nominal terms.[15] Nevertheless, debt-to-book equity ratios[16] have changed little over the same period. They have inched up only from 44 percent in 1970 to 47 percent in 1984. In fact, debt-to-market equity ratios have actually been falling in recent years.[17]

2) **Junk bonds cannot make an otherwise uneconomic takeover profitable.** Corporate managers are often heard to decry the use of junk bond financing in hostile takeovers. They allege that leveraged takeovers "merely rearrange ownership interests by substituting lenders for shareholders." This fails to recognize that no matter how a bidding firm finances a takeover, it must increase the discounted cash flow to receive a positive return on its acquisition.[18] To increase the cash flow, the acquiring firm must restructure the acquisition so that it operates in an more cost-efficient manner. An acquisition, even when financed with junk bonds, will not be profitable unless the new owners can manage the firm better than did the ousted management.

3) **Most takeovers do not rely on junk bonds.** In 1985, junk bonds financed only 38 percent of American takeovers, and in 1986, 41 percent.[19]

4) **The premiums earned by investors in junk bonds** adequately compensate for risk of default. These bonds generally earn approximately 4 to 6 percentage points more than risk-free U.S. Treasury securities. Junk bonds have an average

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14. According to remarks of John Paulus, Managing Director and Chief Economist of Morgan Stanley, Inc., at a conference sponsored by Citizens for a Sound Economy, entitled "Financing Economic Growth," held November 19, 1986.

15. U.S. Department of Commerce, Table No. 913, "Manufacturing Corporations - Sales, Profits, Stockholders' Equity, and Debt," *Statistical Abstract of the United States, 1986*, p. 535.

16. The debt-to-equity ratio measures the amount of a firm's debt financing to the amount of owner financing. The book value of an asset represents the accounting value or the historical acquisition cost minus any accumulated depreciation or write-offs.

17. Paulus remarks, *op. cit.*

18. Kenneth Lehn, David Blackwell, and Wayne Marr, "The Economics Of Leveraged Takeovers, Including An Analysis Of The Mesa-Unocal Case," Center for the Study of American Business, June 1987.

19. Fritz Wahl and Martin S. Fridson, "More Plain Talk About Takeovers," Morgan Stanley *High Performance*, February 1987, p. 7.

default rate of 1.6 percent.[20] After default, moreover, junk bonds trade at about 40 percent of their nominal value. Thus, if the default rate even were to reach 6 percent, four times the historical rate, investors would experience only a 3.6 percent loss--an amount close to the risk premium of the bonds.

**Takeovers and Shareholder Interests**

**Rhetoric:** Hostile takeovers hurt shareholder interests in target companies.

**Reality:** One of the most reliable indicators of the value of merger or acquisition is the judgment of the stock market. If the acquirer's and target company's stock prices increase following a takeover, then the transaction has created wealth and is beneficial. A decrease in share prices reflects a reduction in wealth and is indicative of wasteful investment.[21] The evidence from numerous studies leaves little doubt that takeovers are likely to increase the value of both companies and thus benefit the shareholders.

Studies reveal that the shareholders of target companies typically realize stock price gains of between 16 to 34 percent. Shareholders of bidding firms earn only about 4 percent. Notes Professor Michael Jensen of the University of Rochester: "If the much feared raiding has taken place, it seems to be of a peculiar Robin Hood variety."[22]

**Takeovers and Insider Trading**

**Rhetoric:** Takeovers encourage insider trading.

**Reality:** Insider trading and takeovers are two separate issues. "Inside information" is undisclosed information on how some development will positively or negatively affect a particular company or industry. Obviously, the possessor of such knowledge is in a position to profit by buying or selling the companies' stock prior to public disclosure. No doubt, one can benefit rather handsomely from prior knowledge of a merger or acquisition. Recent revelations on Wall Street make this obvious. Yet there already are laws dealing with insider trading, as the perpetrators have learned first-hand.

Tender offers are not the only form of insider information. Any undisclosed information that may indicate the potential for significant profits or losses for a company is considered to be inside information. For instance, the discovery of a major new oil field, creation of a vaccine, or a breakthrough in superconductivity research would all be inside information. To restrict takeovers in order to curtail insider trading would be similar to restricting pharmaceutical research to ward off insider trading prior to the announcement of a new vaccine.

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20. Carney, *op. cit.*

21. Council of Economic Advisors, *op. cit.*, pp. 196-197.

22. Michael C. Jensen, "Takeovers: Folklore and Science," *Harvard Business Review*, November-December, 1984, p. 112.

**REMEDIES**

In today's takeover market, serious abusive practices exist. There are ways to protect stockholders from such practices without new legislation, which would hamstring the entire takeover process. Among the forms of protection available to stockholders and management are corporate charters and the civil liability system.

The corporate charter is essentially a private contractual relationship between a corporation's shareholders (the owners) and its management. If stockholders desire to make it difficult for their corporation to become a takeover candidate, they may vote to adopt poison-pill provisions or some other defensive measures in their charter.

**Shareholder Self-Help.** If, on the other hand, they would like to become more open to possible acquisition, they may amend the charter by adopting "one share, one vote" rules--if they have not already. If minority shareholders are unhappy with how the majority votes, they can always "vote with their feet" by selling their shares. Either way, the stock market can be relied upon to value the company appropriately. This kind of shareholder self-help on the matter of takeovers is much preferable to legislative attempts to regulate takeovers. Self-help affords the company and its shareholders the opportunity to enact the strategies they deem most suitable for their individual company.

A company's board of directors and its management must act as fiduciaries of the stockholders. If stockholders believe that management has abused its delegated powers, they may seek redress through the courts. Because the methods employed in individual mergers and acquisitions are often unique, a case-by-case basis evaluation in court is generally preferable to broad prohibitions etched into statutes and regulations.[23]

**Management Accountable.** Under the "business judgment rule," a common law precept, management is protected from liability for corporate transactions where it, in good faith, exercised its business judgment in the best interests of the stockholders. Courts, however, have begun to tighten their interpretation of the rule in matters of corporate takeovers. In *Norlin Corporation v. Rooney Pace Inc.*, the Second Circuit Court of Appeals, interpreting New York State law, recognized that defensive measures adopted in the course of a takeover battle can involve a measure of management self-interest. Thus, under certain circumstances, defensive tactics should be evaluated under a stricter fairness standard.[24] This is a welcome development, and will help make management accountable to stockholders for defensive tactics that help preserve the managers' jobs at the expense of stockholders.

23. Council of Economic Advisors, *op. cit.*, p. 212.

24. *Norlin Corporation v. Rooney Pace Inc.*, 744 F.2d 255 (2d Cir. 1984).

## STATE vs. FEDERAL ACTION

While Congress is deliberating on this issue, an increasing number of states are enacting their own anti-takeover laws. Indiana recently passed a law that, among other things, removes the voting rights of any investor who acquires 20 percent of a company, unless the shareholders vote to reinstate them. This April, the U.S. Supreme Court found this statute constitutional.[25]

These state laws are usually hastily enacted at the behest of a local firm in the name of protecting employees' jobs. In reality, they mainly protect management. Explains Professor Roberta Romano of Yale Law School, "[t]he statutes...could be a lever for preserving management's jobs while reducing shareholder wealth."[26]

**Interstate Problems.** The Constitution gives states the right to enact such laws, even if these laws are unwise. Supreme Court Justice Antonin Scalia notes that such laws may be constitutional even if "economic folly."[27] Nevertheless, state laws that interfere excessively with the takeover process may create interstate problems by creating a hodgepodge of inconsistent regulation and depressing U.S. securities markets. Separate studies conducted by the Federal Trade Commission and the Securities and Exchange Commission on the effects of state anti-takeover statues on shareholder interests indicate that such laws have generally harmed holders of a state-protected firm's stock.[28] Policymakers should examine such laws closely for negative effects on interstate commerce. If such effects are found, federal action may be needed.

In any case, states should hesitate before enacting such laws. They would do well to follow the lead of Delaware, the leading state in corporation law, which so far has rejected anti-takeover legislation.[29]

## CONCLUSION

The U.S. financial system traditionally has relied upon the owners of corporations, the shareholders, to decide whether a proposed merger is in the best interest of the company. Such a decision has not been the prerogative of the

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25. *CTS Corp. v. Dynamics Corporation of America*, 55 LW 4478 (April 21, 1987).

26. Roberta Romano, "State Takeover Laws: Constitutional But Dumb," *The Wall Street Journal*, May 14, 1987 p. 28.

27. 55 LW 4485.

28. See Laurence Schumann, "State Regulation of Takeovers and Shareholders' Wealth: The Effects of New York's 1985 Takeover Statutes," Federal Trade Commission, March 1987 and Office of the Chief Economist, "Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers," Securities and Exchange Commission, May 18, 1987.

29. See Lewis S. Black, "Why Delaware is Wary of Anti-Takeover Law," *The Wall Street Journal*, July 10, 1987, p. 18.

government decision makers.[30] The market for corporate control is a dynamic process that has led to leaner more efficient firms. Mergers and acquisitions can result in operating economies, financial economies, transfers of technology, the revitalization of faltering companies, and the reallocation of assets to more productive uses. These benefits deliver products and services to the consumer at a lower cost. This benefits the economy in general.

**Market Accurate Judge.** Of course not all mergers turn out to be beneficial. Witness the conglomerizations of the 1960s and early 1970s, which are being reversed by the current takeovers. Those who want the government to regulate mergers and acquisitions must have considerably more faith in the government's ability to foresee whether the merger will prove to be profitable and beneficial than in the ability of those who have their own money at stake. The market has proved itself a more accurate judge, as indicated by the stock price, of whether a takeover is in the best interest of the owners.

In the spirit of "competitiveness," critics charge that "merger mania" and corporate "raiders" are weakening America's ability to compete internationally. It is just the opposite. Takeovers are a symptom and an antidote for corporate inefficiency. Poorly operated American companies will fall behind overseas competitors. It is the corporate raider, with his money and reputation at risk, who trims the fat, makes the firm leaner and thus more competitive.

To enhance America's competitiveness, corporate America needs less regulation, not more.

John E. Buttarazzi
Research Associate

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30. Douglas H. Ginsburg and John F. Robinson, "The Case Against Federal Intervention in the Market for Corporate Control," *The Brookings Review*, Winter/Spring 1986, pp. 9-10.