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Responding to Corporate Takeovers: Raiders, Management, and Boards of Directors

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Raiders, Management, and Boards of Directors

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As news about hostile takeovers hits the headlines and not just the business pages, names like Boone Pickens, Carl Icahn and Ivan Boesky have become far better known than the CEOs of General Electric, General Motors, General Foods, General Mills or any other general. Takeovers have also developed a colorful vocabulary of their own—"poison pills," "shark repellents," "junk bonds," "raiders," "white knights," "wolf packs," and "greenmail." Beyond the glamour there is a genuine public policy debate about takeovers that deserves examination and evaluation. This report looks at the arguments put forth by the "raiders" and "entrenched management" and then discusses the potential but vital role of a third force in corporate takeovers.

Introduction

Many members of Congress have become concerned over what is viewed as a rising trend of hostile mergers. "I think it is time for Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top managements for control of corporate assets." That stirring indictment of competition in the market for corporate control was stated by

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Representative Peter Rodino, chairman of the House Judiciary Committee.

In that spirit, in the last session of Congress, more than 50 bills were introduced to deal with mergers and acquisitions. Over twenty hearings on the subject were held by nine different committees. However, no single piece of legislation came close to passing.

If the raiders are opportunists, it is boards of directors and senior executives who have given them the opportunity.

Opinions vary sharply on many aspects of corporate takeovers, and especially those initiated by shareholders who oppose existing managements. Many economists and other scholars contend that this process keeps executives on their toes and thus enhances shareholder value. The executives of these same firms, in striking contrast, assert that hostile attempts to change corporate control reduce business productivity and performance. They argue that unfriendly tender offers divert management attention and corporate resources from the serious business of producing and distributing goods and services.

Yet, on reflection, if the raiders are opportunists, it is boards of directors and senior executives who have given them the opportunity. Too many CEOs and boards have focused on the ballet and the opera as the epitome of a corporation's responsibility to society. They seem to forget that a business is an economic institution, designed to provide goods and services for consumers in order to benefit the shareholders.

The irony is that some of the problems of the takeover "targets" have arisen from their desire to be more socially responsible. The modern business literature tells management to balance the desires of employees, customers, suppliers, public interest groups, and shareholders. For example, the Committee for Economic Development, in its influential report on the social responsibility of business, states that the professional manager regards himself as a "trustee" balancing the interests of many diverse participants and constituents in the enterprise. It is interesting to note that shareholders are only listed as one among those worthy groups—and they are listed last.

The Case for Government Intervention

Three key arguments are offered by those who believe that corporate takeovers are harmful and should be regulated more fully by the federal government:

#1. Hostile takeovers are socially and economically detrimental. Hostile takeovers are viewed as leading to forced liquidations or restructuring of viable companies by "raiders" who reap considerable profit. The process is supposed to leave the companies in weakened and highly leveraged positions. The groups initiating hostile takeovers are considered to be mere financiers and speculators who are not serious about the operations of the companies, and who are in it solely for quick profits.

In this view, takeover threats force managers to look to the short term in order to keep their current stock price high. This diverts attention from longer-term investment potential and growth. Alfred Chandler, Jr., the distinguished business historian of the Harvard Business School, worries about the rising trend of unfriendly takeovers: "How can anyone justify it? It provides no productivity, services, or function.... While our managers are fighting takeovers, the Japanese are finding it easier to take over their markets."

As investment banker Felix Rohatyn put it, "large corporations can be treated like artichokes and simply torn apart without any regard for employees, communities, or customers, solely in order to pay off speculative debt." Peter Drucker has echoed this theme:

> The new wave of hostile takeovers has already profoundly altered the contours and landmarks of the American economy. It has become a dominant force . . . in the behavior and actions of American managements and, almost certainly, a major factor in the erosion of American competitive and technological leadership.

The standard response of economists is that the stock market's valuation of takeover efforts is very positive. Numerous studies show that the stock of the target goes up quickly on the mere announcement of a tender offer, and that of the buyer usually moves little at all.

The common argument offered by economists who assume that markets are "efficient" is that mergers, even hostile ones, provide economic gains in the form of economies of scale, better management and more productive allocation of resources. The very threat of a takeover is supposed to discipline inefficient management. Redeploying assets in restructured companies may cause some unemployment and community dislocations, but the assets do not disappear from the economy. The new investors have a strong economic incentive to put them to productive use. Thus, hostile takeovers are seen as creating real value for both bidders' and target companies' shareholders.

Management's rejoinder to the economists is that short-term increases in share prices are not the appropriate basis for evaluating the costs and benefits of takeovers. Nor do all economic analyses of stock data support the standard view that stockholders of the target necessarily benefit from takeovers. A study at the University of Maryland of 78 mergers and takeovers in the period 1976–81 concluded that three years later the price of the acquirers' stock was much lower than if it had continued performing as it had before the acquisition.

Takeover opponents also argue that a gain in the share value of the merged company

does not necessarily prove that expected efficiency increases are responsible. The key factor may be a reduction in taxes, which reflects neither improved efficiency in the use of resources nor benefits to the economy.

It is intriguing to examine what actually happens to target firms subsequent to acquisition. In the case of the 25 major acquisitions of 1965, only 13 were still part of the acquirers or their successors by early 1986. Ten others were divested, one was dissolved, and still another is up for sale. To be sure, this is a small sample from which to draw conclusions, but there seems to be little historical evidence that tenderers have managed the businesses they acquired any more profitably than their industry peers. Nor does there appear to be much evidence that they have achieved significant profitability improvements for the firms taken over.

To sum up the controversy about takeovers, the shareholders of the target firm usually benefit but those of the raiders rarely do. The takeover effort must therefore reflect a lack of concern by the raiders with the interests of their shareholders.

What then motivates them? There must be large "rents" (extraordinary gains) available from control and management of large enterprises. In order to obtain such special gains, the raiders are willing to offer above-market prices for the shares of the target company.

The academic supporters of takeovers look down at existing management of target firms because of their supposed lack of concern for their shareholders. To be consistent, it is equally hard to deify the managements of the "sharks," who have little more regard for their own shareholders.

#2. <u>Credit markets are negatively affected by "non-productive" merger activity</u>. Speaking for the Federal Reserve System, Board Chairman Paul Volcker says, "I . . . have concerns about the potential risks associated with mergers and takeovers when these transactions involve unusual amounts of leveraging." After acknowledging that many mergers may have positive social effects, Volcker warns that "these potential benefits clearly are diminished if the mergers are accompanied by more fragile balance sheets or more precarious loan portfolios."

Other critics view takeovers as draining resources from longer-term investment and growth-enhancing activities. In the event of default on "junk" bonds, many financial institutions may be adversely affected. Takeover activity is also criticized because of large "transaction costs" benefiting lawyers, investment bankers, accountants, and printing and advertising firms.

The responses to these arguments take many forms. The concern over transaction costs is put into perspective; their large absolute size (in millions of dollars) is dwarfed by the billions of dollars involved in the financing process. To the critics of junk bonds, the rejoinder is that the risk-reward ratio of these securities is in line with the economics of the market and basic principles of financial analysis. One risks more in order to earn more. Moreover, the credit is not "used up" but recycled in the economy.

In any event, new bonds issued in exchange for stock in target companies came to less than 1 percent of new debt in non-financial corporations in 1980–83. Credit to finance the equity purchases in the largest takeovers in 1984 amounted to only 1 to 1.5 percent of domestic debt. Moreover, two-thirds of the bank loans extended to finance those mergers were repaid by April 1985, the bulk within six months.

#3. Abuses have crept into the takeover process. One prominent attorney describes the situation as follows: "We have entered the era of the two-tier, front-end-loaded, bootstrap, bust-up, junk-bond takeover." In this view, the free flow of information has been impeded and the relative economic power of bidders and management has been altered. The use of high-yield, low-rated "junk" bonds to finance acquisition is one such example.

Investment bankers note two current practices that may be considered to be "abuses." One is the ability to commence a takeover without having binding financial commitments in place. Such conditional bids have a headline-grabbing effect and stampede the shares of the company into the hands of arbitrageurs and speculators. The second abuse involves the tactic of putting a company into "play." Seemingly deliberate leaks drive the shares of the company into the hands of short-term speculators.

The proponents of takeover efforts note that many other abuses arise from the efforts of managements to repel unsolicited overtures. They contend that shareholder value is reduced when companies adopt "poison pills" and other "shark repellents."

Alternate Public Policy Approaches

Proposed responses to the problems generated by hostile takeovers range from laissez-faire to tough new legislation designed to "correct" the perceived market failures. Here are the five key alternative approaches:

1. No problem exists, therefore, no "solution" is necessary. The prevailing academic view is that the market for corporate control is functioning reasonably well. Given the passive roles of many boards of directors, hostile takeovers are helpful in keeping companies on their toes and in replacing inefficient, entrenched managements. If there is any role for public policy, it is to prevent management from thwarting the will of the shareholders.

2. There is a problem with regard to hostile takeovers, but it will cure itself. Those in this second category believe that the hostile takeover phenomenon will cool substantially when the next serious recession reduces the earnings of the highly leveraged companies. Many corporations being restructured to a riskier mode as a result of leveraged buyouts may go "belly up." These negative experiences will dampen the ardor of other potential hostile suitors and reduce the funding available to them.

In this second view, the takeover wave will subside as a result of natural causes and hence no change in public policy is warranted.

3. There is a continuing problem, but it can be handled with further changes in tax policy. Because the tax deductibility of interest is a key element of most hostile takeovers, this group contends that changes need only be made in tax provisions favoring debt over equity.

Interest charges are tax deductible while dividends are taxed twice, once at the corporate level and again at the level of the individual shareholder. Even though the current tax reform legislation will remove capital gains advantages for equity financing, the reduction in corporate and individual tax rates will reduce tax differentials for debt versus equity overall.

4. The federal government should resort to additional regulatory devices. One possibility is to tighten the criteria for allowable investments for life insurance companies and pension funds. Some favor the SEC investigating trading "abuses," such as manipulation of stock prices via false rumors, leaks, and other sharp arbitrageur practices.

5. The takeover problem is so serious that tough new legislation is required. The aim is to make it more difficult for shareholder groups to make tender offers that are not endorsed by the company's board of directors.

Most of the bills introduced in Congress to regulate corporate acquisitions are designed to protect target companies. For example, one bill would give outside directors of a target company the right to veto a tender offer or the acquisition of a controlling interest, subject to reversal by a vote of the shareholders. Another bill would prohibit open market

purchases by one corporation of more than 20 percent of another's stock. Yet another legislative proposal would deny successful acquirers a tax deduction for interest on debt incurred to finance their acquisition.

Moving across the spectrum of government intervention in corporate governance is no simple matter. Each of the more activist approaches is likely to generate serious and often unexpected side effects—the "government failure" that so frequently accompanies attempts to deal with "market failure."

Conclusions

Contests for control of some large companies have focused national attention on hostile takeovers. Yet these transactions represent only a small fraction of the changes in control of American corporations carried out each year. Most takeovers continue to be friendly and approved by the boards of both companies involved. In many cases, the board of the target firm may have required a bit of coaxing—such as the threat to "walk away" and see the price of the target company's stock drop sharply.

Considerable evidence shows that takeover contests are beneficial for stockholders of target companies. In this regard, it is intriguing to note the views of top executives of the most successful firms toward their stockholders. In one recent study, two faculty members of the Harvard Business School report that none of the top executives of the 12 successful American companies they studied was concerned about the current market value of the company's stock. One CEO stated this position very clearly:

> The highest priority with me is perpetuation of the enterprise. I'd like to leave this joint in better shape than when someone passed me the baton. I have to take care of the shareholders in this, but I don't sweat the shareholders too much. Most investors in our industry are passive.

The two researchers concluded that the successful managers were committed "first and foremost, to the enhancement of *corporate* wealth, which includes not only the firm's financial assets reflected on the balance sheet but also its important human assets and its competitive positions in the various markets in which it operates."

Do corporate takeovers promote economic efficiency? The great bulk of the academic literature states that the answer is yes. Why else, the reasoning goes, would share prices rise on the mere announcement of a hostile takeover effort?

The cold, hard reality is that there is little organized data to affirm or discredit the efficiency hypothesis. It is difficult, however, to reconcile that hypothesis with the large number of "post-merger divorces"—up to 40 percent of the acquisitions of the 1970s.

One comprehensive study shows that tenderers have not managed the businesses they acquired any more profitably than their industry peers. Nor have they achieved significant profitability improvements relative to the pre-takeover situation. In addition, the Congressional Tax Committee says a large portion of the stock price gain is due to capitalizing the tax benefits.

Yet there is no need—or justification—to argue that all takeover attempts are benign or that every effort to repulse them is laudable. Some businesses benefit from new management or even the threat of a change in management. Some "shark repellents" benefit small stockholders by providing barriers to two-tiered tender offers. Reasonable amounts of self-interest can be expected on the part of both those attempting corporate takeovers and those opposing them.

The most significant factor to take into account in evaluating proposals for government to "do something" about hostile takeovers is historical. The long and intricate experiences of government involvement in business decision-making are not impressive. Study after study shows that government

often does more harm than good when it interferes in private economic matters. The presence of some shortcoming in the private sector (often called "market failure") is not sufficient cause for government to intervene. Much government regulation fails to meet an elementary benefit-cost test.

The heart of a positive response to unsolicited takeovers rests with the company's own board of directors.

The balance between management's need to act expeditiously in the interest of the corporation and the shareholder's right to call that action into account should be resolved at the level closest to the problem and the relevant facts—by the corporation, its owners, and managers in the first instance; by state law, if necessary; and by federal law only as a last resort. This does not mean that inequities in the battle between management and tenderers created by tax biases or existing regulations should not be addressed. But the basic task of insuring that the market for corporate control serves investors, employees and other interested parties ultimately lies outside of government.

The heart of a positive response to unsolicited takeovers is not poison pills or shark repellents nor is it government restraints on raiders. There is a third and often neglected force designed to foster stockholder interests, the company's own board of directors.

Under law, all corporate power is exercised by or under the authority of the board. Directors must really act as fiduciaries of the shareholders. But the complacent or rubber-stamp director has not totally vanished from the boardroom. Responding more fully to the desires of the owners of the business is the key to repelling takeover threats. Corporate officials, both board members and officers, often forget until the company's stock is in play that shareholders continually vote with their dollars.

The most important, and rarely performed, duty of the board is to learn how to say no. It is up to the board to veto proposed capital investments whose yield is below the cost of capital—even if some key executive is going to get upset because it was his or her pet project.

The outside directors especially must learn to act on the knowledge that the inside directors who serve on the board with them are occasionally motivated by different concerns. Acquisitions may be good for executives whose compensation is related to the size of the company, but some can be poor investments for shareholders. A supergenerous corporate donation to the ballet may do wonders for the social life of the CEO, but it hardly benefits the shareholders.

The challenge to many boards is to pay out more cash for shareholders and to reduce outlays for low-yield projects. The record is clear: If the board will not make the difficult choices that enhance the value of the corporation, the takeover artists will. Takeover mania is not a cause but a symptom of the unmet challenge.

Outside directors are the heart of the critical third force in contests for corporate control. They need to bear in mind that the future of the corporation is in their hands—as long as they serve the desires of the shareholders.