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Public Policy Toward Corporate Takeovers

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by Murray L. Weidenbaum, Director
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Testimony to the Subcommittee on Monopolies and
Commercial Law of the House Committee on the Judiciary,
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Hostile takeovers hit the headlines. Boone Pickens, Carl Icahn and Ivan Boesky are far more colorful than the CEOs of General Electric, General Motors, General Foods, General Mills or the other generals. Beyond the headlines, there are genuine public policy issues that deserve attention. Let us examine the arguments put forth by the raiders and entrenched management.

The Case for Government Intervention

The key argument advanced by those who believe that corporate takeovers are harmful is that such hostile actions are socially and economically detrimental, and lead to forced liquidations or downsizing of viable companies -- and the "raiders" reap considerable profit in the process. In this view, takeover threats force managers to look to the short-term in order to keep their current stock price high.

The standard response of economists is that the stock market's valuation of takeover efforts is very positive. The stock of the target goes up quickly on the mere announcement of a tender offer. The rejoinder is that short-term increases in share prices are not the appropriate basis for evaluating the costs and benefits of takeovers.

Note: Murray L. Weidenbaum is Director of the Center for the Study of American Business at Washington University in St. Louis, and a director of several corporations. The views expressed are personal.

Opponents of takeovers argue that a gain in the share value of the target company does not reflect improved efficiency in the use of resources nor benefits to the economy, but rather tax advantages or short-term fluctuations in the stock market. There is little historical evidence that tenderers have achieved significant profitability improvements for the firms they have taken over.

What I find ironic about takeovers is that, while the shareholders of the target firm usually do benefit, those of the raiders rarely do -- often the price of their stock declines. Takeover efforts must therefore reflect a lack of concern by the raiders with the interests of their shareholders.

What then motivates them? One explanation is that there are significant, extraordinary gains available from control and management of large enterprises. In order to obtain such special gains, the raiders offer above-market prices for the shares of the target company. The academic supporters of takeovers look down at existing managements of target firms because of their supposed lack of concern for their shareholders. However, it is equally hard to deify the managements of the "sharks," who have little more regard for their own shareholders.

Alternate Approaches to Public Policy

Policy responses to hostile takeovers range from laissez faire to tough new legislation, depending on the evaluation of the effects of these changes in corporate control. I have identified five different approaches:

1. **No problem exists and, therefore, no "solution" is necessary.** The prevailing academic view is that the market for corporate control is functioning reasonably well. Hostile takeovers are helpful in keeping companies on their toes and in replacing inefficient, entrenched managements.

2. **There is a problem with regard to hostile takeovers, but it will cure itself.** The hostile takeover phenomenon will cool substantially when the next serious recession reduces the earnings of the highly-leveraged companies. These

negative experiences will dampen the ardor of other potential hostile suitors and reduce the funding available to them. Hence no change in public policy is warranted.

3. **There is a problem, but it can be handled with further changes in tax policy**. Because the tax deducibility of interest is key to hostile takeovers, changes need only be made in those tax provisions which continue to favor debt over equity.

4. **Additional regulatory devices are needed.** Several investment bankers and lawyers urge the SEC to investigate trading "abuses," such as manipulation of stock prices via false rumors and leaks.

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

As is true for most proposals to expand federal regulation, the benefits must be weighed against unexpected side effects -- the "government failure" that so frequently accompanies attempts to deal with "market failure."

Conclusions

Hostile takeovers represent only a small fraction of the changes in control of American corporations. Most takeovers continue to be friendly. Beyond that, it is hard to show that corporate takeovers promote economic efficiency. The great bulk of the academic literature states that the answer must be yes because why else would share prices rise on the mere announcement of a hostile takeover? The reality is that there is little organized data to affirm the efficiency hypothesis. Furthermore, it is difficult to reconcile that hypothesis with the large number of "post-merger divorces" -- up to 40 percent of the acquisitions of the 1970s.

Yet, there is no need to argue that all takeover attempts are benign or that every effort to repulse them is laudable. Reasonable amounts of self-interest should 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. Study after study shows that government often does more harm than good when it interferes in private business decisionmaking.

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.

But mine is not a do-nothing approach. If the raiders are opportunists, it is boards of directors and senior executives who have given them the opportunity -- by neglecting the interests of the shareholders. 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, the company's own board of directors.

Directors must really act as fiduciaries of the shareholders, as the law requires. But the rubber-stamp director has not 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. Too many CEOs still say that they "don't sweat the shareholders too much."

The most important, and rarely performed, duty of the board is to learn how to say no. The challenge to many boards is to pay out more cash for shareholders and to reduce outlays for low-yield projects. The 1986 tax reform bill underscores that point by eliminating the special tax treatment of capital gains. 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. It might be helpful if the person chairing board meetings were an independent outside director, as is cutomary with universities and other non-profit institutions. Corporate directors must stop singing that old song, "I'm just a gal that can't say no."