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# LESSONS OF AN OUTSIDE DIRECTOR

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Experience teaches us to be cautious in blithely accepting as fact things that everyone knows. In that spirit, this Article draws on my experience as a corporate director to challenge a few commonly held views.

The three sacred cows that will be engaged (let us not say slaughtered) are: (1) the widespread knowledge that leveraged buyouts (LBOs) only benefit a few insider wheeler-dealers (also rejected is the converse belief that all LBOs contribute to a healthier economy); (2) takeovers are uniformly good for shareholders; and (3) investment bankers are the appropriate folks to pass judgment on whether a board should approve a proposed acquisition, merger, or sale.

## LBOs

The public policy debate on LBOs is dominated by two polar alternatives. One says LBOs promote a more efficient and competitive economy. Therefore, they should be encouraged or at least not discouraged. The other position is that LBOs are an invention of shrewd lawyers and wheeler-dealers and should be prohibited, or at least made much more difficult.

But my own board experiences impel me to a third and less dramatic position. It takes into account the fact that there are two kinds of LBOs—arm's-length LBOs and management-initiated LBOs.

Most LBOs, especially the smaller ones, are of the arm's-length variety. They involve a corporation selling off a division or subsidiary to private investors. This was the case in more than seventy percent of the LBOs recorded between 1984 and 1987.[1]

Usually a competitive process is used. An intermediary is hired to solicit bids from potential buyers. The division's management may be one of the bidders. The fundamental differentiating characteristic of the

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1. Murray Weidenbaum, *Don't Stop All Leveraged Buyouts: Just Some*, CHRISTIAN SCI. MONITOR, May 1, 1989, at 9.

arm's-length LBO is the clear separation of those who bid for the unit and those who, representing the existing owners, choose the successful bidder.

There is considerable evidence—anecdotal and otherwise—attesting to improvements that frequently occur after the change in ownership. As a board member of Harbour Group, Ltd., for example, I have voted time and again to approve such LBOs. The acquisition is almost invariably followed by a predictable array of tough-minded decisions: stripping out layers of management and supporting staff; consolidating production units operating well below capacity; streamlining managerial controls; and, yes, investing in expansion. In the short term, employment is often reduced. The longer-run result, far more frequently, is an enhancement in output, market share, profitability, and jobs.

The new management reduces the high overhead and reporting requirements typically imposed on operating units of multidivisional enterprises. From the viewpoint of these large companies, such controls are necessary for effective supervision. But they come at a high cost.

Moreover, collapsing the many layers of management between an operating division with annual sales of twenty million dollars and the headquarters of a ten-billion-dollar-a-year corporation speeds up the decisionmaking process. That enables the newly independent enterprise to respond to opportunities foreclosed to the larger firm.

The prospective owners, though, may not have adequate financing to acquire the unit without substantial borrowing (i.e., leverage). Indeed, given the tax advantages of debt over equity, they have a powerful incentive to minimize the capital they bring to the new firm.

The second category of LBOs usually involves entire companies. Typically, the firm's management, together with outside investors, buys out the shareholders of a public company—and "goes private." Here, the conflict of interest is fundamental (as we will see a little later, fundamental conflicts of interest rarely arouse my legal friends). But think of it: in the management-initiated LBOs, the very same people who are paid to work for the shareholders wind up representing their own personal interest.

Recall the infamous statement by F. Ross Johnson, Chief Executive Officer of RJR Nabisco: "My job is to negotiate the best deal that I can for my people."[2] The "people" to whom Johnson was referring during the LBO negotiations were not the shareholders, but the senior management.

Inevitably, there are some counterarguments with which we should deal. Some contend that this second category of LBOs is necessary to provide greater incentive for management to make tough decisions and to provide greater leverage than is customary in publicly held firms. But if an executive earning two million dollars a year (plus all sorts of stock options and special fringe benefits) does not have adequate incentive to make the difficult choices required to enhance shareholder value, the answer is obvious: fire the lazy, greedy executive. As for the desire to free management of controls imposed by the externally elected board of directors, this board member can only respond that the typical corporate board operates with a very light touch.

By the way, it is not difficult to identify large, publicly held corporations that have made those tough decisions while maintaining their traditional status. In the early 1970s, when Boeing was faced with a major erosion of its markets, it laid off about one-half of its entire work force, including many senior, experienced professionals. In the 1980s, the FMC Corporation so leveraged itself that it attained negative net worth. Both of these publicly held corporations are now quite successful and, in the process, have avoided serious takeover battles.

To those uncomfortable with the continued, albeit dampened, trend of LBOs, the most desirable response is to focus on the aspect of public policy that gives rise to the phenomenon. I am referring to the double taxation of dividends, which provides a powerful incentive for debt over equity.

It is silly to berate business executives who respond to the status quo by adopting forms of organization that make the most of it. The sensible answer is to eliminate the preference for debt by doing away with the discriminatory tax treatment of dividends. But the large budget deficits make that most unlikely at this time.

## TAKEOVERS AND SHAREHOLDERS

The standard position of economists is that the stock market's valuation of takeover efforts is very positive. The evidence is that the stock of

2. Jerry Knight, *RJR Nabisco Chief Says He Bid Low for Firm*, WASH. POST, Nov. 29, 1988, at D1.

the target goes up quickly on the mere announcement of a tender offer. The great bulk of the academic literature states that corporate takeovers promote economic efficiency. After all, why else would share prices rise on the mere announcement of a takeover effort?

For those who need to be bolstered by data, the Securities and Exchange Commission (SEC) has estimated the dollar gains to shareholders that have resulted from corporate takeovers. The takeover premium was computed as the amount that the payment for the stock exceeded the market value of the stock five days before the initial public announcement. During the period 1981-1986, the aggregate premium or gain to target-firm shareholders was $123 billion.[3] That certainly should convince the skeptics.

But, not content to leave well enough alone, let us pursue the matter a little further. On reflection, would we have expected the results to be substantially different? Who would make a bid for a company below its current market value? Such a takeover attempt would be ridiculed in financial markets. Naturally, bidding for a company's stock raises its price. As we teach in Economics 101, an increase in demand for an item, without a commensurate increase in supply, will result in a higher price.

But the prevailing view in the economic literature goes beyond a restatement of the obvious to make a very important assumption: the rise in shareholder value of the target company reflects the likelihood that the new management team will prove more effective than its predecessor. After all, in an efficient market, why else would the share price rise? Why else would the raiders invest in the target company? That does sound quite logical.[4]

But the presumption of enhanced corporate productivity is difficult to support empirically. It is difficult to reconcile the synergy or efficiency hypothesis with the large number of post-merger "divorces," especially those involving the abandonment of the acquired firm or its sale at a loss.

An analysis of over ten thousand acquired companies during the early 1980s revealed that most of them did not perform as well in terms of sales growth as did comparable companies that remained independent.

3. JOSEPH A. GRUNDFEST & BERNARD S. BLACK, SECURITIES AND EXCHANGE COMMISSION STOCK MARKET PROFITS FROM TAKEOVER ACTIVITY BETWEEN 1981 AND 1986 (1987).

4. *See* Richard E. Cook, *What the Economics Literature Has to Say About Takeovers*, *in* PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 1-24 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988).

Moreover, they were more likely to be liquidated for poor performance.[5] A study at the Wharton School of fifty-six hostile tender offers initiated during the period 1975-1982 found that the targets, as a group, had outperformed their bidders over the preceding two years.[6] An analysis by the staff of the Federal Reserve Board reported that a large sample of banks acquired by holding companies during 1968-1978 did not perform any differently from other banks either before or after acquisition.[7]

In any event, it is premature to jump to the conclusion that stockholders generally benefit from takeovers. After much research, I came up with one of those earthshaking conclusions that seem to have escaped the specialists in corporate finance: for every seller, there is a buyer. What happens to the stock of the firm that does the taking over? The answer to this question is almost universally downplayed in the takeover literature. In that regard, Michael Jensen wrote in a 1988 article in the *Journal of Economic Perspectives*, "The gains to buying firm shareholders are harder to estimate, and no one to my knowledge has done so as yet. . . ."[8]

In this era of modern communication, apparently news still travels to Cambridge at a very leisurely pace. In a 1987 article in the *California Management Review*, Steve Vogt and I had examined the studies that Jensen and his colleagues cited on the benefits to target shareholders. Sure enough, the same studies show that the price of the stock of the acquiring firm usually declines in the period following the announcement of the merger. In those cases in which the price does not decline, the odds are that it remains flat.[9]

How about the broader SEC study cited earlier? That 1987 study found that the average above-market return to bidding firms during 1980-1985 was −0.04% for the period ten days before the takeover announcement to twenty days after.[10] Of course, that figure is not statisti-

5. David L. Birch, *Buyer Beware*, INC., June 1988, at 21-22.

6. Edward S. Hermann & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers: An Empirical Study* (Paper Presented to the Center for Law and Economics Studies, Columbia University, 1985) (copy on file with author).

7. STEPHEN A. RHOADES, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, THE OPERATING PERFORMANCE OF ACQUIRED FIRMS IN BANKING BEFORE AND AFTER ACQUISITION (1985).

8. Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988).

9. Murray Weidenbaum & Stephen Vogt, *Takeovers and Stockholders: Winners and Losers*, 29 CAL. MGMT. REV. 157-68 (1987).

10. GRUNDFEST & BLACK, *supra* note 3.

cally different from zero. Investments in Treasury Bills surely are more attractive and are a simple measure of the opportunity cost.

It is clear that most owners of the acquiring firm's stock do not evaluate the takeover announcement positively. The widely held belief that shareholders generally benefit from takeovers does not hold up. There are both winners and losers. But the distribution of investors within the two categories is counterintuitive: the owners of the "winning" firms lose; the owners of the "losing" firms win.

That leads to a related question: What motivates the managements of acquiring firms to launch risky, difficult, and expensive takeover battles if, on average, the expected return to their shareholders is zero?

This question must arouse our sense of cynicism, because one of the standard pleas of the "raiders" is that they are more interested in the shareholders than the so-called entrenched management. It strains credulity to believe that the managers of the acquiring companies are so idealistic that they are willing to risk the assets of their own shareholders to liberate the downtrodden shareholders of the target firms. Some other explanation must be sought.

My answer is that corporate managers are no different from other individuals. Self-interest dominates their decisionmaking. Studies by Charles A. Peck at the Conference Board show that increasing the size of a firm promotes management's own interests.[11] One-half of the variation in pay of corporate chief executives is explained by variations in company size, as measured by sales—that is far more than is explained by profits. Moreover, the larger the company, the greater the bonuses as a percentage of salary. Thus, on average, the bigger the company, the larger the financial rewards to top management.

Those who have examined the workings of board executive compensation committees are not surprised by these results. The firm's top management, in the supporting compensation surveys, is typically compared to peer firms, chosen primarily by size. The psychic rewards of sales growth are not trivial either. Being on the cover of *Fortune* or *Business Week*—or even *Women's Wear Daily*—is a heady experience for most corporate CEOs.

Nevertheless, none of this justifies the various proposals to increase regulation of takeovers. Typically, they would adversely, albeit inadver-

11. CHARLES A. PECK, TOP EXECUTIVE COMPENSATION 2-7 (1987).

tently, affect very desirable changes in corporate control. As is so often the case, government failure outweighs market failure.

## Investment Bankers

Having thus insulted corporate managements and economists, whom have I left out? Oh, yes, investment bankers. As a board member, I find it fascinating to listen in awe or at least with great deference as some distinguished, or at least highly paid, investment banker tell us whether we should go ahead and buy or sell a company or subdivision thereof.

The so-called fairness opinion has become virtually mandatory. That is especially so since the Trans Union case[12] hit so hard the members of a corporate board who had the temerity to rely on their own judgment and experience in agreeing to what was clearly a good deal for their shareholders. The most unforgivable omission on the part of that board was the failure to do what has become standard practice—to delay the decision while the corporate secretary, stopwatch in hand, times the boring reading of trivial detail by the investment banking representative who is an MBA two years out of graduate school.

I find the entire exercise so fascinating because of the basic conflict of interest that results. Should the board go ahead with the contemplated action, the same investment banking firm that renders the fairness opinion is likely to receive a large commission for the resulting transaction. Typically, that second fee is many times the modest charge for the original fairness opinion—which is only a couple of million or so.

The implications are fascinating. If, in a burst of candor, the investment advisor tells the board that the contemplated action would be a lousy move for the shareholders, it will only receive the fee for the "fairness" opinion. It would forego the possibility of earning the much more generous second fee.

Apparently, this situation does not disturb my friends who practice the law. My only conclusion is they should keep on practicing. Some day, they may get the hang of it.

12. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).