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THE MARKET FOR CORPORATE CONTROL (INCLUDING TAKEOVERS)

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Abstract

Mergers, acquisitions and takeovers often imply dramatic changes for employees, competitors, customers and suppliers. Not surprisingly, the market for corporate control has generated controversy and is frequently regulated by law or business custom. Though transfers of control take place in many countries, explicit and public struggles for control occur most frequently in the US and UK. During most of the twentieth century, critics of mergers and acquisitions in the US pointed to the danger of monopoly and increased concentration. Partly in response to the emergence of new control transactions such as the hostile takeover and leveraged buyout, more recent criticism has focused on the consequences for corporate productivity, profitability and employee welfare. Subject to qualifications, the market for corporate control reallocates productive assets - in the form of going concerns - to the highest bidder. In cases where the bidder uses his own money or acts on behalf of the bidding firm's shareholders, the asset goes to the highest value use. In cases where managers of the bidding firm are able to serve their own interests rather than the interests of shareholders, the market for corporate control plays a paradoxical role. It simultaneously provides (1) a means by which managers may acquire companies using other people's money and (2) a means by which they may themselves be disciplined or displaced.
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1. Introduction

The shareholders of the modern, publicly held corporation buy and sell their shares freely, though ordinarily in small quantities and without major consequence for the corporation itself. Occasionally, a new owner - typically

another firm - will acquire a large fraction of a corporation's shares, elect a new board of directors, replace or absorb its top management, and alter its methods of doing business. Consequently, when a substantial fraction of shares does change hands - through a negotiated acquisition, market purchase or tender offer - the new owner often expects to gain.

What the acquirer expects to gain and what the acquirer actually receives have been the subject of a long-standing, lively and often acrimonious debate. During most of the twentieth century, merger, acquisition and the control of corporations in the United States were intimately related with the twin problems of monopoly and the concentration of economic power. The acquisition of a substantial stake in a corporation by another entity - whether another corporation, a bank or other financial intermediary - appeared to pose a threat to some part of the non-corporate sector, typically small business, labor or consumers.

By mid-century, corporate control and the transfer of that control began to raise other policy issues besides the threat of corporate power. Academic attention, for example, turned to possible strategic or financial objectives in mergers and acquisitions, or to managers' hunger for more turf. This shift came about partly because stricter antitrust laws had ruled out traditional monopoly explanations. In addition, the merger waves of the 1960s and the 1980s witnessed the emergence of hostile tender offers, new and controversial forms of debt financing, and new control transactions such as the leveraged buyout. Frequently, the acquisitions wrought dramatic and far-reaching changes in the marketplace and in the lives of employees. Acquired firms, even in cases involving hostile takeovers, came increasingly from the ranks of America's largest corporations.

Scholarly discussion and public debate covered a wide territory, but focused in large part on mergers and takeovers as a solution to mismanagement. In fact, the widespread restructuring that followed many acquisitions, leveraged buyouts and other transactions helped in large measure to rekindle interest in the problems raised by the 'separation of ownership and control'. Subsidiary questions concerned the effects of changes in state and federal takeover policy; the degree to which stock prices represented the underlying asset value of takeover targets; and the effects of takeovers and mergers on wages, investment, and research and development.

The transfer of corporate control in other developed countries, in particular Western Europe and the Far East, has been less dramatic and less controversial than in the United States. One might argue that these other countries do not need an active market for corporate control. Large financial intermediaries, in particular banks, monitor corporate performance more closely and exert a greater influence than they do in the US, in particular when a corporation gets into trouble. Major financial institutions may also see their own interests better

served by continuity. The impact of the state on mergers, though still powerful, has been more subtle than in the US, perhaps reflecting a lower level of concern with monopoly and the concentration of business. Finally, business in other developed countries makes less intensive use of the stock market as a source of finance than do American corporations, further limiting the scope for a market for corporate control. So, while the control of corporations and the transfer of control is a worldwide phenomenon, the use of explicit, market-based mechanisms is most advanced and most conspicuous in the United States.

2. Types of Control Transactions

An acquirer can gain of control of a large fraction of a corporation's shares using the following methods, either singly or in combination.

Open Market Purchase. This involves purchase of shares on an exchange. In the absence of any regulation, an acquirer will take pains to conceal his intentions and purchase as many shares as possible before the news leaks out. Since 1934, American law has required the disclosure of 10 percent ownership, and with the passage of the 1970 Amendment to the Williams Act, 5 percent ownership. This regulation effectively forces an acquirer to show his hand. Even without regulation, the attempt to gain control of a corporation without arousing suspicion and without increasing the stock price of the target firm is likely to prove difficult.

Block Purchase. A shareholder may purchase a large block of shares in a negotiated acquisition. Large blocks, especially those that confer the right to elect the board, typically trade at a premium to small blocks sold on an exchange, presumably because of the value of control.

Tender Offer. A potential acquirer may issue a tender offer - promising to pay a fixed amount per share for shares submitted by stockholders, subject to specified conditions. This price is typically greater than the market price. A tender offer may be made for only some fraction of the shares outstanding, it is likely to expire at some point, and the actual transaction may be made contingent on a minimum number of shares being tendered. The terms may be for cash or securities, and the offer may be made with or without the consent of the target management and board. If management is opposed, and especially if it offers active resistance, the offer is viewed as 'hostile'. An acquirer will often first buy a relatively cheap 'toe-hold' on the open market and then follow up with a tender offer. In the US, tender offers are subject to federal securities laws.

Negotiated Purchase. Often, the acquirer deals directly with the management and board of the target firm and negotiates the terms of an acquisition. This method usually involves the transfer of all outstanding shares of the target, for

either cash or securities. It may also involve other terms, such as employment contracts for the management of the acquired firm, provision for a 'break-up fee' if the company to be acquired backs out, or so-called lock-up agreements conferring on the acquirer the right to purchase shares. The transfer of control over shares is typically but one step in a longer negotiated transaction that includes the ultimate formal absorption of the acquired firm through merger. *Proxy Contest*. Typically, shareholders of a publicly held corporation may delegate their vote. Small shareholders and institutions who do not wish to take an active role typically delegate their vote to management. (In some countries the proxies of small shareholders may be held by a large bank, with the bank itself being a substantial shareholder.) A group of dissident shareholders may stage a proxy contest, by which the group solicits proxies from other shareholders. With sufficient votes, such a group is able to change the composition of the board and ultimately effectuate changes in the management of the corporation. A group of insurgent shareholders will typically hold a fraction of outstanding shares in order to certify their seriousness and to capitalize on any gain in share value from a successful effort.

In American practice, the acquirer is usually another publicly-held firm, and the transaction results in the merger of two publicly-held firms. Increasingly, however, acquirers take minority positions for longer periods of time. Partial acquisitions without any immediate plans for merger have had a longer tradition in Europe. Recent American practice has also seen the rise of leveraged buyouts (LBOs) and management buyouts (MBOs). In a leveraged buyout, a private firm uses borrowed funds to make a tender offer that - if successful - would give the acquirer sufficient votes to 'take the firm private'. The acquirer is then free to effectuate changes in the board and management, or require that top managers increase their equity stake. A management buyout typically involves the same substitution of debt for widely held public equity as an LBO, but the transaction takes place at the initiative of management, and management takes on a large stake in the remaining equity of the private firm. Finally, corporations often repurchase their own shares on the open market or by means of a tender offer or block purchase, with the intention of influencing the balance of control (Gilson, 1986, Part III; Brudney and Chirelstein, 1987, Part IV; Weston, Kwang and Hoag, 1990, chs. 18-19).

3. Explanations for Mergers and Acquisitions

The transfer of control through merger and acquisition emerged at the end of the nineteenth century and is linked, at least in time and quite likely in substance, with the development of the modern corporation. Early American

economists regarded the growth of firms such as Standard Oil, US Steel and DuPont through merger as largely natural and efficiency-enhancing. The emergence through merger of large industrial firms in the UK and continental Europe generated largely similar reactions. Subsequent generations of economists, in particular in the US, came to view merger largely in terms of monopoly, perhaps because the development of economic theory seemed to leave little choice.

For a good deal of the twentieth century, economic explanations for merger focused on the interaction of monopoly and scale economies, with scale economies playing a paradoxical role. If scale economies did not exist, that is, if a single large firm could not produce more cheaply than two or more smaller ones, then the motive for a merger of two firms in the same or related line of business could only be monopoly. If scale economies did exist and a larger firm was more efficient, then the large firm would take over the whole business and set its price above marginal cost but below the level that would lead to significant entry. Either way, the acquisition of one firm by another was linked with monopoly. Stigler's (1950) influential analysis of 'Oligopoly and Monopoly by Merger' appealed to the 'survivor principle' to argue that economies of scale were unimportant. He explained the emergence of large firms at the turn of the century and again in the 1920s as grabs for monopoly power facilitated by the growth of the stock market, which allowed firms to capitalize monopoly rents.

It is worth noting that the textbook models of competition and monopoly both assume a unitary, profit-maximizing firm. Those models have little to say about the mechanisms by which a group of individuals control a corporation, how the effectiveness of that control varies according to the concentration of stockholdings and the identity of stockholders, or how optimal control mechanisms might vary by type of business or over the life-cycle of the business. Regardless of the intellectual origins, the concern with possible monopoly motives and monopoly effects of mergers and acquisitions ultimately moved beyond horizontal mergers (involving firms making identical products or very close substitutes) to vertical mergers (involving merger of successive levels of production, such as cement and concrete) and even to conglomerate mergers (involving mergers of firms in unrelated businesses). However, the arguments and evidence supporting a monopoly explanation were particularly weak in the last case.

Beginning in the 1960s, the economic literature turned to a number of other, non-monopoly explanations. These new explanations struck one of several broad themes. Acquisitions may allow the implementation of managerial knowledge across businesses; they may allow firms to implement strategic goals; they may promote financial synergies such as diversification or the use of increased leverage; they may allow managers to indulge their appetites for more control using other people's money; and, paradoxically, they may be the mechanism by which new owners can impose much-needed

discipline on managers. The last explanation gained more and more adherents during the 1980s, when an increasing number of mergers were financed by debt and resulted in a leveraging up of the corporate sector. According to Jensen's (1986) 'free cash-flow' theory, companies with excess cash are likely to undertake negative net present value projects. For example, oil companies flush with cash from high oil prices may drill negative net present value oil wells and engage in dubious diversification efforts instead of returning cash to shareholders. An acquisition financed with debt forces the new management to generate cash and reject dubious projects. According to oral tradition, the 'free cash-flow' explanation originated with the colorful 1980s takeover king, T. Boone Pickens. Gilson (1986, Part II), Scherer and Ross (1990, pp. 159-167), Weston, Kwang and Hoag (1990, ch. 10), and Carlton and Perloff (1994, pp. 36-40) offer surveys of possible explanations for mergers and acquisitions.

4. Manne and Corporate Control

Though control transactions have a long history in fact and in law, the academic literature on the 'market for corporate control' and indeed the term itself begin with Henry Manne (1965). His analysis focused on control transactions that would address the problem of poor management, and he introduced a number of enduring themes. He viewed the competition for corporate control as encompassing (1) proxy fights, (2) direct purchase of shares and (3) merger. Manne also argued that control of the corporation was a valuable asset, he suggested that many mergers took place because the bidder valued that asset, and he advanced the idea of a 'positive correlation between corporate managerial efficiency and the market price of shares' (Manne, 1965, p. 112). He also viewed proxy fights as needlessly cumbersome and expensive, a conclusion shared by much subsequent commentary. Direct purchase of shares (open market purchases, block purchases, and tender offers) and merger differ in one important respect. Direct purchase does not require approval of the target management. In a merger that requires board approval, management would typically demand some compensation for its consent to be displaced. 'When we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring' (Manne, 1965, p. 118). He also observed that firms in the same industry are likely to be well situated to discover mismanagement and act on that knowledge by proposing merger, thus weakening the case for the stringent horizontal merger policy practiced in the 1960s.

Consistent with Manne's original approach, the subsequent literature has included negotiated merger among the panoply of control transactions that includes open market purchases, tender offers and control block purchases.

Doing so recognizes that many mergers take place under the threat of takeover or because the merger itself amounts to a takeover with side payments to secure the cooperation of target management.

Though control of managers has become an important theme in discussions of the market for corporate control, it bears emphasis that other mechanisms exist that also promote efficient operation of a corporation. Jensen and Meckling (1976) argue that managers act as agents of shareholders and that shareholders have an incentive to use resources efficiently to monitor managers. In common with the textbook model of the profit-maximizing firm, their model views shareholders as unitary agents and neglects the issue of incentives in the case of widely held corporations. As Manne himself observed, 'the separation of ownership and control' deals with the problem faced by diffuse ownership. 'So long as we are unable to discern any control relationship between small shareholders and corporate management, the thrust of Berle and Means's famous phrase remains strong' (Manne, 1965, p. 112).

Even in the case of the diffusely held corporation, however, various influences tend to promote efficient management. Competition in product markets imposes discipline on management because inefficiency may lead to the ultimate demise of a firm. State law allows shareholders to vote for directors, and these in turn are responsible for the appointment and dismissal of top management. States with corporate laws that encourage or allow inefficient management will not get their share of new incorporations. The job market for managers will penalize those who do not perform well. Finally, managers may own a large fraction of outstanding shares, which will tend to align their interests with those of shareholders.

Clearly, none of these and other possible forces is perfect. The workings of competition in the product market may be slow; shareholders may not have the incentives or abilities to assess corporate performance and the need for a new board of directors; states will still be able to retain and compete for established corporations that management controls by means of relatively small ownership stakes; entrenched top management may not care about moving to another job; and large shareholdings are the exception rather than the rule. Even jointly, then, these other disciplinary mechanisms may fail to protect shareholders.

5. Overview of Regulation

A variety of laws affect mergers and the market for corporate control. These include the law of corporations, antitrust policy and securities regulation. In the United States, corporate law is largely a creature of the individual states. About half of all large, publicly-held corporations choose Delaware, a small, east-coast state, and the remainder tend to gravitate toward large states such as New York,

California, Illinois and Pennsylvania. The states compete to grant corporate charters and to attract the fees and legal business that comes with them. Indeed, critics charge that this competition is a 'race to the bottom', with the states offering insufficient protection to shareholders and overly generous protection to managers. The influence of state corporate law on corporate control runs deep. State law affects the voting rights of shareholders, the duties of corporate directors, and the defensive tactics available to target management, for example. This influence over the mechanics of control ultimately affects the value of control.

In contrast to state law, the influence of American federal law is less direct, though perhaps no less important. Early federal law focused on antitrust, which limited mergers, acquisitions, cross-holdings of stock and interlocking directorates. The federal role increased dramatically with the 1934 Securities Exchange Act, and with subsequent legislation, notably the 1968 Williams Act, which imposed disclosure requirements on acquisitions above threshold levels and restricted the terms of a tender offer. Federal securities law also governs proxy fights and communication among shareholders. Finally, Federal law restricts the stock holdings of banks, mutual funds and other financial intermediaries, with subtle but arguably powerful consequences for corporate control.

In the late 1980s, the regulatory initiative passed back to the individual states, which passed antitakeover legislation when the federal government did little to restrict a wave of takeovers. In contrast to early state initiatives to control the takeover process, the courts gave their approval. Indeed, this last development illustrates one of the recurrent themes in the American approach to corporate control, namely regulatory competition between the federal government, the judiciary and the states (particularly Delaware). The other constant theme in America is the hostility toward concentrated power (Roe, 1994; Romano, 1987; Pound, 1992b, 1993).

6. Early Corporation Policies and Their Effects

The federal government may interfere with the transfer of control on various grounds. Chief among these is alleged monopoly, which has played an important role since 1890, when the modern corporation was in its infancy. The original trusts enabled a trustee to hold and control shares of several corporations, thus facilitating coordinated operation of several nominally independent enterprises. The device was pioneered by Standard Oil in 1882 but other groups of firms soon adopted the form. More broadly, a variety of related cooperative forms, also called 'trusts', emerged over the following two decades.

These included cartels, pools, holding companies, 'communities of interest' (later termed 'interlocking directorates') and merged firms.

The chief chartering states (notably New Jersey and Delaware) shaped and accelerated this development by allowing corporations to buy each other's stock and by permitting merger. Both measures facilitated the conversion of possibly illegal 'trusts' into statutorily sanctioned forms. In contrast, populist states and the federal government responded to the widespread cartelization with 'anti-trust' statutes, in particular the 1890 Sherman Antitrust Act. It bears emphasis that most commentary at the time regarded the various trust forms as different manifestations of the same underlying phenomenon - a single 'trust and corporation problem'.

According to early Supreme Court interpretation, notably *E.C. Knight* (1895), the new antitrust law applied only to cartels. Cartels implied an agreement to restrain interstate trade. Acquisition and merger, in contrast, involved the purchase and sale of corporate shares created under state law and no agreement to restrain trade. This odd legal situation - cartels always illegal, merger always OK - laid the basis for the Great Merger Wave of 1898-1902, including the formation or growth through merger of firms such as US Steel, DuPont and American Tobacco, as well as the conversion of the Standard Oil Trust into a holding company. Some very dramatic takeover struggles took place in that era, notably the fight between railroad magnates Hill and Harriman for control of the Northern Pacific in 1901.

The aims and effects of these early innovations in corporate control - the classic trusts and the holding companies and merged firms that replaced them - were controversial at the time and have remained controversial to the present day. Modern business historians, notably Chandler (1977), view the early acquisitions and mergers as part of the process by which 'the visible hand' of management was substituted for the invisible hand of arms-length market agreements, allowing greater efficiency in management. Modern legal historians have tended to view the cartels as, at best, mixed blessings (Hovenkamp, 1991; Freyer, 1992). Economists since mid-century have followed Stigler's (1950) analysis - discussed above - which emphasized the formation of monopolies through merger. Scherer and Ross (1990, ch. 5), who share this view, provide a representative treatment from the perspective of the late twentieth century.

One approach, which was popular early on only to be rejected in favor of the monopoly view, has recently experienced a revival. Early economists defended both the cartels and the mergers that often replaced them as efficient responses to the problems posed by high fixed costs, in particular the danger of 'cutthroat competition'. In more recent work, Bittlingmayer (1982, 1983, 1985) and Telser (1987, ch. 2) rely on the theory of cooperative games, in particular the theory of the core, to explain the widespread use of cooperative forms including merger in many industries marked by high fixed costs and fluctuating demand.

On this view, a competitive equilibrium is not possible with an 'empty core', leaving cartelization, tacit collusion, merger or single-firm monopolization as the only alternatives. This squares the circle, explaining how the early 'trusts' could have been both collusive and more efficient than the businesses they replaced.

On all three views of the late nineteenth- and early twentieth-century mergers - managerial, monopoly and empty core - the market for control provided a mechanism by which previously independent units achieved coordinated action. The managerial view also allows the possibility that merger facilitated the transfer of new, more efficient managerial methods and comes closest to embodying modern notions about the function of the market for corporate control.

7. The Emergence of Merger and Corporate Control as Policy Issues

Effective federal intervention in mergers and acquisitions began with President Theodore Roosevelt's celebrated 'trust-busting'. In response to the Great Merger Wave, 1898-1902, Roosevelt filed Northern Securities (1904), a case that originated in the battle for control of the Northern Pacific. His intention was to force a revision of merger policy. In a 5-4 decision, the Supreme Court reversed itself and placed merger under direct federal control. At the same time, Roosevelt established the Bureau of Corporations (the Federal Trade Commission's predecessor) and the Antitrust Division of the Department of Justice.

After a brief lull, Roosevelt used the government's new powers under the Sherman Act in late 1906 and 1907 in an aggressive effort to divest some of the most notorious 'trusts', including John D. Rockefeller's Standard Oil, American Tobacco and DuPont. These attacks were controversial and potentially immense if carried to their logical conclusion, since thorough 'trust-busting' would have meant a costly and protracted dismemberment of perhaps half of US industry. Indeed, public commentary at the time blamed Roosevelt's 'trust-busting' for the Panic of 1907, which was marked by a remarkably steep decline in stock prices and output. A similar discussion flared up during the less dramatic bear market and recession that surrounded President William Howard Taft's (1909-1913) attempt to break up US Steel. Though historians of the Progressive Era are aware of this controversy, economists have largely ignored it. Bittlingmayer (1993, 1996) has recently offered new supporting evidence, in particular a negative correlation between antitrust enforcement and changes in stock prices and output.

Despite sporadic and controversial successes and continued anti-big-business rhetoric, the federal government eventually abandoned the aim of divesting the large corporations formed in the 1898-1902 merger wave. Arguably, attempts to do so had proven too costly. However, big business and

in particular bank control of big business remained unpopular, and political attention turned to the later topic. The Pujo 'Money Trust Investigations' of 1912 drove banks off the boards of directors, thus undermining the role of banks as monitors of corporate performance (Roe, 1994, pp. 33-35). In recent work, Cantillo (1996) reports that the forced departure of banks from corporate boards depressed stock values of the affected corporations. Arguably, the erosion of bank power over corporations set the stage for management self-dealing and the emergence of alternative methods of disciplining management.

The political controversy surrounding the corporation was suppressed during the First World War and, after a brief flurry of anti-business sentiment following the war, suppressed again during the 1920s. The administration of President Calvin Coolidge (1923-1929) deliberately attempted to scale back enforcement of the antitrust laws, especially the laws against merger. In an echo of experience at the turn of the century, this period of extraordinarily lax merger enforcement again coincided with a large wave of mergers. General Motors, Curtiss-Wright, General Mills and many other companies grew substantially during this period. The high-growth and new technology industries of the era - automobiles, aviation, food processing, radio, motion pictures and electric utilities - experienced particularly extensive consolidation through acquisition and merger. Corporate growth and the booming stock market of the 1920s also contributed to the growth of the modern managerial firm, that is, a large firm owned by many small shareholders but run by professional managers. It was precisely this emerging 'separation of ownership and control' that Berle and Means (1932) criticized only a few years later in their classic, *The Modern Corporation and Private Property*.

The 1920s merger wave ended after the October 1929 stock crash. Perhaps the crash and 1930 recession ended the merger wave. This would be consistent with the view that merger waves are speculative phenomena or that merger waves are caused by business booms. Alternatively, and of some importance for our assessment of merger and takeover activity, and of the effects of swings in government policy, the boom and crash may have reflected swings in merger and antitrust policy under Presidents Coolidge (1923-1929) and Herbert Hoover (1929-1933). Coolidge's administration, which was widely regarded as being aggressively 'pro-business', filed very few merger cases and almost none against mergers involving publicly traded firms. Outside observers, among them America's leading economist at the time, Irving Fisher, regarded Hoover as simply continuing a policy favorable toward merger. This was a plausible inference in part because Hoover had been Coolidge's Secretary of Commerce. However, it has only recently come to light that Hoover in fact viewed the merger wave with suspicion, and that Hoover's attorney general announced a radical shift in antitrust policy in the middle of the October 1929 crash. The Hoover administration soon implemented a more restrictive policy, that

included a resumption of merger case filings (Bittlingmayer, 1993). Experience in 1929 is consistent with the evidence from the Panic of 1907, and with the October 1987 crash, discussed below.

8. The New Deal and its Aftermath

The presidency of Franklin Delano Roosevelt (1933-1945) left its mark on regulations affecting the market for corporate control, as it did on many other areas of economic life. However, most of the New Deal's explicit legal and regulatory changes affected the market for control indirectly - by requiring disclosure of stock ownership, placing restrictions on proxy contests (originally a matter of state law only), and by restricting the stockholdings of financial intermediaries. Especially at the end of the 1930s, political attention turned again to the ownership and control of business.

Though New Deal legislation contained few specific provisions dealing with the market for corporate control, the *potential* for federal intervention increased sharply. For example, the single most important piece of federal takeover legislation, the Williams Act, discussed below, was passed in 1968. It was an amendment to the 1934 Securities Exchange Act. Ultimately, the potential influence of federal legislation was also felt at the state level, because key states of incorporation, such as Delaware, defended their positions against federal encroachment. The danger to them stemmed from latent Securities and Exchange Commission powers under 1930s legislation, and from the possibility that Congress might extend that legislation. Other legislation from the New Deal had more direct effects on stock ownership. For example, the 1940 Investment Company Act, which was drafted by the newly founded Securities and Exchange Commission at the direction of Congress, limits mutual fund holdings of stock (Roe, 1994, p. 103).

The connection between corporate control and the monopoly problem surfaced again after the Second World War. Based on a relatively small merger wave, and a concern about a 'rising tide of concentration', Congress passed the 1950 Celler-Kefauver Amendment to the Clayton Act, thus closing the so-called asset loophole. The 1914 Clayton Act had prohibited anticompetitive acquisitions of stock, but left acquisitions of asset untouched. As a consequence of the new law, and new Supreme Court interpretations in the late 1950s and 1960s, horizontal merger policy became very restrictive. Horizontal mergers involving market shares of as little as 5 and 10 percent were largely ruled out, and even vertical mergers came under attack. Conglomerate mergers - mergers of unrelated businesses - were not entirely immune because of 'reciprocity' and 'potential competition' theories, but did enjoy a relatively safe harbor.

Not surprisingly, though mergers of all types continued to occur, the 1960s experienced an upsurge of conglomerate mergers. With hindsight many of these seem ill-advised. Why they occurred remains unclear. Antitrust policy favored them, but it did not compel them. Perhaps restrictions on the ownership of corporations by banks and other intermediaries and the development in state corporate law of the business judgment rule that gave wide discretion to managers and directors facilitated the formation of inefficient conglomerates. The origin of the conglomerates remains a riddle.

The 1980s and 1990s wave of mergers, acquisitions and restructurings quite likely had their origins in changed state and federal policies. The Supreme Court declared restrictive state antitakeover laws unconstitutional in 1982, and the federal government reversed course under the Reagan administration and practiced a relatively permissive merger policy. In addition, the development of new forms of financing, notably high-yield 'junk' bonds, probably contributed to the increase in merger activity, though their emergence may have been as much an effect as a cause of the high level of restructuring. The consequences for American business were substantial. Table 1 shows that over half of a sample of large firms in existence in December 1981 became the targets of takeover attempts or themselves undertook defensive restructuring during the following eight years. These changes generated a political reaction that is not surprising in hindsight. The states enacted new antitakeover laws that passed muster at the Supreme Court. In a sequence of events reminiscent of the Panic of 1907 and the 1920s boom and crash, the US Congress briefly considered federal antitakeover legislation that is implicated as a precipitating factor in the October 1987 crash (Mitchell and Netter, 1989). On the other hand, the American political process has tolerated well into the 1990s a pace of mergers, acquisitions and restructuring that would have been unimaginable in earlier decades.

Table 1
Frequency of takeover and restructuring over 1982-1989 for 1,064 large US firms in existence December 1981

Category	Number of firms	Percentage of firms	Percentage of market value
Friendly takeover target	286	26.9	13.6
Successful	268	25.2	13.0
Unsuccessful	18	1.7	0.6
Hostile takeover target	243	22.8	23.4
Successful	85	8.0	7.3
Unsuccessful	35	3.3	2.2
Unsuccessful followed by friendly takeover	87	8.1	7.0
Unsuccessful followed by restructuring	36	3.4	6.9
Defensive asset restructuring	78	7.3	11.8
Asset restructuring	64	6.0	9.0
Financial recapitalization	14	1.3	2.8
Remainder of sample	457	43.0	51.2
Total sample	1064	100.0	100.0

Source: Mitchell and Mulherin (1996, Table 2).

9. The Regulation of Takeovers

The emergence of the unsolicited, often unfriendly and sometimes hostile takeover in the 1950s and its subsequent growth sparked various attempts at regulation. Though intensively studied, many aspects of takeover regulation remain controversial to the present day. Should acquirers be forced to disclose their holdings? Disclosure raises the cost of the shares purchased and may give target management warning and an opportunity to mount a defense. On the other hand, knowledge that a bidder is acquiring shares may allow target management to encourage an auction for the asset at stake, namely control of the corporation. Should tender offers be open for a fixed period of time? A long open period again allows target management to mobilize a defense, but it may also encourage others to enter the bidding. Should non-tendering shareholders have options other than forced sale at a price below the tender-offer price? Such a forced sale may compel shareholders to part with their shares for a price less than their valuation or the true value, but a price equal to or greater than the tender dilutes shareholder incentives to tender in the first place.

9.1 Regulation of Takeovers by Exchanges

Though not well known, US stock exchanges themselves placed limits on takeovers in the 1950s and sixties. The New York Stock Exchange required listed firms to keep open offers for their own and other firms' shares at least ten, but preferably thirty, days, and tendered shares had to be taken up on a pro-rata rather than a first-come-first-serve basis (NYSE Company Manual, 1963, pp. A179-A180). The American Stock Exchange apparently had a similar informal policy (Fleischer and Mundheim, 1965, p. 330, n. 24). Such policies were limited in scope, however, because the NYSE and AMEX had no power over non-listed firms.

9.2 The Williams Act

Passed in July 1968, the Williams Act stipulated that tendering shareholders had the right to withdrw their tendered shares during the first seven days, and after 60 days it required pro-rationing of tendered shares, and specified that increased offers applied retroactively to shares tendered in response to earlier offers. It also stipulated that acquirers that had bought 10 percent of outstanding shares on the open market disclose their acquisitions to the US Securities and Exchange Commission, though this added little to existing disclosure requirements. The 1970 Amendment lowered the disclosure requirement to 5 percent.

Effects of the Williams Act A number of studies, among them Smiley (1975), Jarrell and Bradley (1980), Guerin-Calvert, McGuckin and Warren-Boulton (1987), and Asquith, Bruner and Mullins (1983) found that target firms experienced higher abnormal stock returns after passage of the Williams Act. Some of these early studies also investigated bidder returns and found that they were lower after passage of the act, suggesting that the legislation increased returns to target shareholders at the expense of bidding shareholders. Moreover, Schipper and Thompson (1983b) found that bidders who were engaged in merger programs experienced stock price declines with the passage of the Williams Act. Given the higher target premia and the lower bidder returns, the law arguably reduced the number of takeovers, though that proposition has not been tested. It is also unclear from this evidence whether the aggregate gains to all shareholders (all potential bidders and targets) were positive or negative. Other, more recent work even casts doubt on the conclusion that the Williams Act raised takeover premia and hindered the market for corporate control. Franks and Harris (1989) found that UK takeover premia also increased after 1968 in the absence of similar legislation. Nathan and O'Keefe (1989) place the increase in takeover premia at 1973-74, well after passage of the law.

9.3 First-Generation State Takeover Laws

The increased use of the hostile or unfriendly takeover had repercussions at the state level in the passage of so-called first-generation takeover statutes. Virginia led the way in 1968, the year Congress passed the Williams Act. By 1979, every state with a substantial share of corporate headquarters or a substantial share of incorporations had passed an antitakeover statute (Smiley, 1981). Romano (1985) documents the spread of these laws. The Illinois law, for example, prohibited acquisition of any firm with substantial assets in Illinois unless a state official approved. Jarrell and Bradley (1980) and Smiley (1981) found that these laws lowered takeover activity. However, the Illinois statute and with it most of the first-generation statutes were declared illegal in *Edgar v. Mite* 457 U.S. 624 (1982) because they interfered with interstate commerce.

9.4 Second-Generation State Takeover Legislation

The states responded to *Mite* with statutes more narrowly focused on corporate law, the traditional prerogative of the states. Not surprisingly, states that were leaders in the adoption of first generation statutes were also more likely to adopt a second generation statute (Romano, 1987, p. 114). These laws fell into three categories. For example, Indiana passed a ‘control share acquisition’ statute stipulating that the shares of acquirer cannot be voted without the authorization of the target’s board of directors or shareholders not affiliated with the bidder. A second set of states, following Maryland’s lead, passed ‘fair-price’ provisions that stipulate a minimum price in a two-tier takeover bid (involving an initial price for tendered and accepted shares, and a second price for any remaining shares in any ‘back-end’ transaction such as merger, liquidation, and so on). A third set of states adopted ‘freeze-out’ laws that restrict the ability of an acquirer to effectuate a business combination (merger) with the target firm unless the bidder obtains prior approval from the board of directors. The new laws were generally upheld.

One line of studies found significant negative, though generally small, effects on the share prices of companies incorporated in states adopting such takeover amendments. These include Schumann (1988) for New York, Ryngaert and Netter (1988, 1990) for Ohio, Sidak and Woodward (1990) for Indiana, and Szewcsyk and Tsetsekos (1992) for Pennsylvania. On the other hand, Romano (1987) finds no effects in Connecticut, Missouri and Pennsylvania, and Margotta, McWilliams and McWilliams (1990) conclude that the Ohio law had no effect. Similarly, Pugh and Jahera (1990) found no effects in Ohio, Indiana, New York and New Jersey, and Jahera and Pugh (1991) find no effect from the introduction of an antitakeover law in Delaware, the major state of incorporation.

To resolve these findings, Karpoff and Malatesta (1989) examine all second-generation of laws passed from 1982 through 1988 and find small but statistically significant negative effects of about -0.3 percent on average upon

publication of the first newspaper article that reported on the upcoming legislation. Surprisingly, Karpoff and Malatesta found that corporations headquartered but not incorporated in a state passing an antitkakeover law experienced similar stock-price declines. In their view, passage of a law reflects a state's willingness to help corporations doing business there to defend themselves against takeover. They also find that companies without takeover provisions in their corporate charters experienced significant negative effects, while those with such provisions did not.

Surprisingly, a recent study by Comment and Schwert (1995) find little effect of these state laws and firm-level antitakeover measures on the firm-level probability of a takeover. They found that the monthly rate of takeover offers for firms listed on the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex) was typically below 1 percent from 1975 through the mid 1980s. That rate increased above 1 percent in the late 1980s and early 1990s, and then declined below 0.5 percent in the early 1990s. (Note that a takeover rate of 0.5 or 1 percent per month implies a substantial cumulative risk of takeover over several years.) Comment and Schwert found that for a sample of over 20,000 firm-years covering January 1977 through January 1991, the existence of a state control share or business combination law had, if anything, a positive effect on takeover probability. However, the existence of such laws was related to the adoption of poison pills. The use of a poison pill in turn, taking into account other factors, including the existence of a state antitakeover law, did lower the likelihood of takeover. Comment and Schwert conclude that not state laws, but rather the adoption of firm-level antitakeover defenses and changing financial conditions may explain the decline in takeovers. The demise of the junk-bond market, a demise that arguably had political origins, may also have played a role.

9.5 The Politics of Takeover Legislation

Roe (1990, 1993, 1994) argues that political forces hinder effective control by shareholders in the United States. For example, the distinctively American opposition to centralized power has kept banks weak and prevented them from playing an active role in the oversight of large corporations. Similarly, the law places limits on financial intermediaries, including investment and insurance companies. Along similar lines, Pound (1992a) argues that the political reaction to takeovers will channel the struggle over corporate control from takeovers to shareholder activism. Clearly, mergers and takeovers generate forceful and volatile political reactions because of the dramatic way they create winners and losers. Jarrell (1992) chronicles the interaction of state law, Supreme Court decisions and firm-level defensive tactics during the 1980s.

10. Stock-Price Effects of Corporate Control Transactions

The stock-price effects of corporate control transactions have been intensively studied. Acquired firms typically experience dramatic increases in their share prices, while the share prices of acquiring firms show little effect on average. Unfortunately, the method is based on short-term stock reactions to the announcement of a merger or tender offer and does not yield direct information about the long-term effects of such transactions on variables of underlying interest such as managerial efficiency.

10.1 Acquired Firms

The early survey by Jensen and Ruback (1983) report average returns to US targets of 30 percent for tender offers, 20 percent for mergers and 8 percent for proxy contests. Franks and Harris (1989) find similar gains in the UK. Focusing only on tender offers, Jarrell and Poulson (1987) find returns to targets of 19 percent in the 1960s, 35 percent in the 1970s and 30 percent in the early 1980s. These studies routinely adjust for general changes in the market. In all of these cases, whether merger or tender offer, some of the gains may well have been anticipated. Consequently, these numbers probably understate the stock market gains to acquired firms or targets. In addition, systematic variation occurs across acquisition types. A recent study by Comment and Schwert (1995) investigates the determinants of the takeover premia in a sample of 648 successful takeovers. They found that high sales growth, low market-to-book ratio, the existence of multiple bidders, the use of cash and the use of a tender offer were associated with a higher merger premium. The existence of a poison pill and the existence of a 'control share' law also increased the premium.

The substantial increase in the stock value of acquired firms is open to various interpretations. If stock markets are efficient, the joint increase in value of the acquired firm and the bidder should reflect the expected value of future increases in joint profitability. As discussed below, bidder stock prices remain essentially unchanged with a merger announcement. Consequently, the increase in value of acquired firm measures the total joint gains, under the assumption of market efficiency.

If this interpretation is correct, from where does the extra expected profitability stem? Early work attempted to distinguish prospective monopoly gains from prospective efficiency gains. Given the very stringent horizontal merger policy of the 1960s and 1970s, large monopoly gains were unlikely. In those instances in which an arguably anticompetitive merger did take place, however, the stock prices of *rivals* to the merging firms should have gone up. (It must be noted though that even this inference may be incorrect if the announcement of a merger in an industry signals that other firms in that industry are 'in play'.) Stillman (1983) found that rivals' stock prices did not

increase in a sample that examined mergers that were subsequently challenged on antitrust grounds. Eckbo (1983), in contrast, found that for a sample of subsequently challenged mergers, the stock prices of rivals increased at the announcement, but that they did not decline when the merger was challenged and actually increased when the challenging agency was the DOJ. Taken together, the results offer little support for the monopoly view, even for these sorts of restricted samples of horizontal mergers.

Though monopoly seems largely ruled out, a number of other possible sources of increased expected profitability remain. One line of commentary argues that the expected gains measured by stock price changes came from various 'stakeholders'. These include workers, suppliers and even bondholders (in the case of mergers that involve increased leverage). This line of inquiry has received at best only very limited support from the data. However, one party may have been hurt by the increased leverage. Since payments on interest are tax deductible, one possible source of gains is the reduced payments going to yet another possible 'stakeholder', the US Treasury.

In response to the conglomerate mergers of the 1960s and 1970s, some researchers briefly speculated about risk reduction as a motive for merger. Today, most commentary views this possibility skeptically since investors can achieve risk reduction directly through portfolio diversification. Another strand of commentary rejects the assumption of efficient markets. Kraakman (1988) suggests that the shares of target firms may be discounted below their true, efficient-market value. Hence, stock-price gains may overstate the true expected gains in efficiency. In a similar vein, some commentary has argued that the merger gains come from slashing various current expenses that the stock market does not fully value: investment in physical plant, research and development, and the expertise of middle management. Market analysts and investors are fooled by the boost in short-term profits that result when these items are cut and they undervalue the future returns from these expenditures.

Other points also deserve mention. The size of the premium depends on the fraction of shares acquired. Bradley, Desai and Kim (1988) found that the supply of tendered shares has an upward slope - an increase of ten percentage points in the fraction of shares acquired resulted in a 1.7 percent increase in the merger premium. Hence, the premia in mergers and tender offers may simply reflect the higher price necessary to elicit a greater supply. Furthermore, control itself may have value even if the transaction does not result in any efficiencies. Consistent with this, control-share blocks trade at a premium. The possibility that a bid reveals previously private information about the value of the target is unlikely since blocked bids result in stock prices that revert to their old values.

10.2 Bidding Firms
Jensen and Ruback (1983) found that bidders on average experienced no net gain or loss as the result of merger activity. More recent work by Bradley, Desai and Kim (1988) and studies surveyed by Jarrell, Brickley and Netter (1988) found steadily decreasing returns to bidders from decade to decade from the 1960s through the 1980s. A changing regulatory environment more favorable to targets, the increased use of defenses that raise target premia, and greater competition for targets in a stronger merger market may explain this shift in financial gains. However, these results were still consistent with the notion that the market expects some bidders to increase and others to decrease corporate performance.

An intriguing study by Lehn and Mitchell (1990), 'Do Bad Bidders Become Good Targets?', found that bidders whose stock prices declined upon the announcement of their bid were subsequently more likely to become targets of bids themselves. Arguably, then, the market for corporate control may be a two-edged sword. On the one hand, it allows managers to indulge their penchant for acquiring businesses they are not able to manage well and to pay too much when they do so, but, on the other hand, it also provides the ultimate corrective. Clearly, however, this corrective force has recent origins since mergers, takeovers and LBOs of large firms emerged only in the 1980s and 1990s. Morck, Shleifer and Vishny (1990) present similar results, showing the bidder returns are lower when a firm diversifies, when it buys a rapidly growing target and when it has performed poorly before the acquisition. Lang, Stulz and Walkling (1991) find that bidders with large cash flow and low 'q' (the ratio of stock value to replacement cost) experience negative returns.

11. Economic Causes and Effects of the Market for Corporate Control

At the firm level, attempts to predict merger and takeover candidates have met with only modest success. For the US, Palepu (1986) found that firms are more likely to be acquired if they have had low stock returns, low growth and low leverage, and if they belonged to an industry with a history of recent acquisitions. However, the explanatory power of the model was low. Intriguingly, and not surprising on the efficient-market view, investing in likely targets would not have yielded abnormal positive returns. Though work on the US supports the view that poor performance leads to takeover, a recent study of the UK by Franks and Mayer (1996) found little evidence that targets of hostile bids performed poorly prior to the bid. Since even well-managed firms become targets, it seems unlikely that poor performance by itself would be a reliable precursor to takeover.

Plant-, division- and firm-level studies appear to support the view that mergers improve performance, on average, though the results are not uniform. The study by Ravenscraft and Scherer (1987) based on Federal Trade Commission Line of Business data seemed to suggest that bidders purchased units with good performance and lowered their return. However, their sample was largely composed of acquisitions made in the 1960s and 1970s, that is, during the conglomerate merger wave. Lichtenberg's (1992) study of plant-level ownership changes made in the 1970s and early 1980s found that plants with low productivity were more likely to change hands and that, having changed hands, they experienced increases in productivity. Other work based on relatively recent periods seems to confirm the impression that transfers of control raise productivity and profits. Palepu (1990) found that LBO firms experience increases in productivity and operating performance. Healy, Palepu and Ruback (1992) studied the post-acquisition performance of 50 large US mergers. They found increases in productivity and a strong relationship between the original stock price increase at the merger announcement and subsequent operating cash flow changes.

It bears emphasis that plant- or firm-level increases in productivity may represent only part of the contribution of mergers and acquisitions to economic well being. A healthy merger market gives entrepreneurs incentives to establish new business since they know that those businesses, once up and running, will find a ready market. It is possible that the market for corporate control performs this function even in the absence of any identifiable short-term increase in productivity linked with a transfer of control.

Though the effect of the market for corporate control on managerial efficiency has received the bulk of attention, it seems likely that we would still have mergers and acquisitions even in a world where the incentives of managers and stockholders were well aligned. The variation in merger intensity across industries suggests that merger and acquisition activity result from other factors, though what those factors are remains unclear. Gort (1969) explains the cross-industry variation with an 'economic disturbance' theory of merger. He finds that industries with high rates of growth and industries with a large fraction of 'technical personnel' - which he viewed as proxies for disturbances - had higher rates of merger. In more recent work, Mitchell and Mulherin (1996) find that 1980s takeover and acquisition activity clustered over time in particular industries. In addition, they find that deregulation, dependence on energy and a low ratio of R&D to sales were correlated with greater takeover and restructuring activity at the industry level. The last result, which contrasts with Gort's finding for technical personnel, is probably attributable to the increased use in the 1980s of high-yield or 'junk' bond financing, which requires tangible assets - that is, not intangible R&D - as backing. Arguably,

all three variables - deregulation, energy dependence and susceptibility to junk-bond financing - are proxies for shocks.

Another line of work views merger as the response to endogenous industry forces or endogenous characteristics. Telser (1987) posits that firms have differential success in their innovative efforts, that merger provides a mechanism by which successful innovations can be applied across firms and that merger has advantages over other methods of transferring information. This prediction explains Gort's results discussed above, as well as Telser's results that industry merger and growth rates are positively related. Bittlingmayer (1996) advances a 'merger as investment' explanation, according to which acquisition and merger are firm-level alternatives to new investment in tangible and intangible capital. At the industry level, merger intensity depends on the need to replace or augment the stock of capital assets and the degree to which independent development of assets and subsequent acquisition and merger provide a cheaper solution than development of assets within the firm. This explanation emphasizes the link between merger, that is, changes in the scope of a firm, and the theory of the firm. Bittlingmayer found that industry merger intensity was related to industry investment and growth of value-added per employee in the US, and to investment and productivity growth in Germany, offering indirect support for the view that the same factors drive merger and investment.

12. Concluding Comments

The purchase of corporate control by an individual, corporation or financial institution undoubtedly arises for a number of reasons. According to a former General Electric executive, GE chairman Jack Welch enjoys socializing with entertainers. That preference and Welch's effective control over GE as long as it remains one of the best managed corporations in the US may very well explain why GE owns the National Broadcasting Company (NBC). Undoubtedly, some of General Electric's other acquisitions have had more traditional strategic origins. Acquisitions by other companies may have been undertaken to improve the management of the acquired firm. Against this background, it would be difficult to conclude that the market for corporate control serves shareholders - and ultimately, the cause of economic efficiency - in each and every instance. Not just common sense but the record of the conglomerate merger wave of the 1960s supports a split verdict. However, if one accepts the view that the modern corporation has allowed substantial efficiencies in the organization and financing of business, and that the corporation gets things right on average and in the long run, it seems likely that - taking the good with the bad - the market for corporate control has aided the cause of efficiency. Perhaps the most suggestive evidence on the possible role of an active market in mergers and acquisitions comes from the historical

correlation between merger activity and economic growth - at the turn of the century, in the 1920s, the 1960s and again the 1980s and 1990s. Economists have typically assumed causation runs from business booms to merger, but it also seems possible that mergers and acquisitions are among the means by which industrial economies come to use resources more efficiently.

The importance of mergers, acquisitions and the market for corporate control is reflected in the volatile, often contradictory political reaction to them. Until the 1960s, discussion of mergers and acquisitions was dominated by the monopoly problem and the power of the corporation. Concern about the monopoly problem was probably overstated and seems to have been a pretext to slow the pace of economic change. Since the 1960s, the focus of discussion has shifted partly to the effects on employees and others connected with acquired corporations, reflecting the increase in hostile takeovers and radical restructuring. Ironically, restructuring was probably more severe because other, related political pressures had undermined effective control by shareholders, increasing the gap between potential and actual corporate performance, and thus increasing the extent of changes that were likely to ensue when a change in control did take place. Effective control mechanisms are the public's best protection against substantial changes stemming from an unrestricted market for corporate control.

Economists, lawyers and business historians have only slowly come to appreciate the consequences of legal intervention in the market for corporate control, and the subtle but powerful interplay between business, the presidency, the legislature and the courts. The initial effort to outlaw the trusts at the end of the nineteenth century hastened the growth of large firms through merger because the courts were reluctant to bring merger under the Sherman Act. Cartels were illegal but merger was not. Public opinion and public policy also opposed effective control by financial intermediaries, and state competition for corporate charters may have undermined effective control of corporations by shareholders. Episodes of lax merger policy stimulated merger waves, and the political reaction against those merger waves brought them to abrupt halts at the turn of the century and again in the 1920s. The effort to outlaw horizontal merger in the 1950s and 1960s aided the formation of inefficient conglomerates, a process no doubt hastened by other restrictions on effective shareholder control such as a cumbersome proxy machinery and limits on stock ownership. The states reacted to acquisitions of the 1960s with blatantly protectionist antitakeover laws, and the Supreme Court reacted by declaring those laws illegal. The Reagan administration's laissez-faire antitrust policies and reluctance to cater to political pressure in the face of the resulting 1980s takeover wave led states to adopt and the Supreme Court ultimately to approve a new generation of more subtly crafted antitakeover measures.

Three areas of research deserve more attention. First, what have been the effects of mergers, acquisitions and takeovers on economic efficiency? The existing evidence, based on plant-, division- or company-level data, is unlikely to capture the total effects. To put the matter differently, what would have been the effects on the efficiency of existing firms and on the formation of new firms of a complete ban on mergers? Second, what is the most efficient level of defense against an unwanted takeover? Some analysts say that no defense serves shareholders best, while others believe even aggressive measures serve shareholders. The socially optimal takeover defense deserves more attention. Finally, how will the political economy of takeover regulation change against the background of increasing public ownership of stocks, the internationalization of equity markets and greater use of equity markets worldwide?

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