

Economic Efficiency and Takeover Bid Regulation

Mark R. Gillen

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Abstract

In recent years a number of scholars have debated the economic efficiency of takeover-bid legislation and of permissible defensive tactics taken by the management of takeover target corporations. This article reviews and comments on this literature and draws attention to a number of empirical questions raised by the debate. It concludes that the important outstanding issues are: i) the degree to which takeover rules interfere with the deterrence of management inefficiency, and ii) the cost of allocating assets to their most highly-valued uses through competitive bidding as opposed to the likelihood and cost of retransfers of assets after takeovers without competitive bidding.

ECONOMIC EFFICIENCY AND TAKEOVER BID REGULATION

BY MARK R. GILLEN*

In recent years a number of scholars have debated the economic efficiency of takeover-bid legislation and of permissible defensive tactics taken by the management of takeover target corporations. This article reviews and comments on this literature and draws attention to a number of empirical questions raised by the debate. It concludes that the important outstanding issues are: i) the degree to which takeover rules interfere with the deterrence of management inefficiency, and ii) the cost of allocating assets to their most highly-valued uses through competitive bidding as opposed to the likelihood and cost of retransfers of assets after takeovers without competitive bidding.

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I. INTRODUCTION

When Campeau Corporation Ltd. made a takeover bid for Allied Stores Inc., Allied's shares were trading at \$48 U.S. per share before the bid. Campeau's bid was \$58 U.S. per share. In the wake of speculation and a competing bid, the final transaction was completed at \$67 U.S. per share.

At the time Gulf Canada Ltd. made a bid for Hiram Walker Resources Ltd., Hiram Walker shares were trading at approximately \$28 per share before the bid. Gulf Canada's initial bid was made at \$32 per share. When the dust settled after an intervening bid by Trans Canada Pipe Lines Ltd., the takeover price was \$38 per share.

The premium in the Campeau-Allied takeover was a 40% increase over the pre-bid price and the premium in the Gulf-Hiram Walker takeover was approximately a 35% increase over the pre-bid share price.

Are such premiums beneficial? This question has been extensively debated from an economic efficiency point of view in a number of articles in recent years.¹ An analysis from this perspective attempts to formulate a legal framework which allocates the limited resources available to uses from which society will derive the greatest value. The debate over the economic efficiency of takeover bid legislation and takeover bid defensive tactics generally considers the legal arrangement all shareholders² would choose in order to maximize their pre-takeover bid wealth. Such a legal arrangement will correspond with the economically efficient, or social welfare maximizing solution, as long as the shareholders receive all the benefits and bear all the costs of the legal arrangement.

One argument is that existing legal rules relating to takeovers interfere with those takeovers that would replace inefficient managements. On the other hand, it is argued that the legal interference is not significant. In fact, competitive bidding and high takeover premiums caused by the existing rules have numerous beneficial effects.

This article reviews and comments on this literature and draws attention to a number of empirical questions raised by the debate. It concludes that the most important outstanding issues in the debate are: (i) the degree to which takeover rules interfere with the deterrence of management inefficiency; and (ii) the cost of allocating assets to their most highly-valued uses through competitive bidding³ in takeovers, as

¹ D.R. Fischel, "Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers" (1978) 57 *Tex. L. Rev.* 1; F.H. Easterbrook & D.R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 *Harv. L. Rev.* 1161 [hereinafter referred to as Easterbrook & Fischel I]; F.H. Easterbrook & D.R. Fischel, "Auctions and Sunk Costs in Tender Offers" (1982) 35 *Stan. L. Rev.* 1 [hereinafter referred to as Easterbrook & Fischel II]; F.H. Easterbrook & D.R. Fischel, "Corporate Control Transactions" (1982) 91 *Yale L.J.* 698 [hereinafter referred to as Easterbrook & Fischel III]; L.A. Bebchuk, "The Case for Facilitating Competing Tender Offers" (1982) 95 *Harv. L. Rev.* 1028 [hereinafter referred to as Bebchuk I]; L.A. Bebchuk, "The Case for Facilitating Competing Tender Offers: A Reply and Extension" (1982) 35 *Stan. L. Rev.* 23 [hereinafter referred to as Bebchuk II]; L.A. Bebchuk, "The Case for Facilitating Competing Tender Offers: A Last (?) Reply" (1986) 2 *J.L. Econ. & Org.* 253 [hereinafter referred to as Bebchuk III]; R.J. Gilson, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers" (1982) 33 *Stan. L. Rev.* 819 [hereinafter referred to as Gilson I]; R.J. Gilson, "Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense" (1982) 35 *Stan. L. Rev.* 51 [hereinafter referred to as Gilson II]; A. Schwartz, "Search Theory and the Tender Offer Auction" (1986) 2 *J.L. Econ. & Org.* 2 [hereinafter referred to as Schwartz I]; A. Schwartz, "Bebchuk on Minimum Offer Periods" (1986) 2 *J.L. Econ. & Org.* 271 [hereinafter referred to as Schwartz II]; J.C. Coffee, Jr., "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 *Colum. L. Rev.* 1145.

² This includes both bidder and target shareholders since the arrangement considered here would be before the identification of a corporation as a target.

³ The literature often refers to promoting auctions interchangeably with a reference to competitive bidding.

opposed to the likelihood and cost of retransfers of assets after takeovers without competitive bidding. The article also concludes that the claim that competitive bidding is necessary to allocate assets to their most highly-valued use is the only claim in this debate which supports the need for a mandatory legislative auction regime. Part II provides a background for the debate and Part III reviews and comments on arguments made in the debate.

II. BACKGROUND

A. *Growth of Cash Takeover Bids and the Perceived Problems*

In the 1960s, there was a high level of acquisition activity,⁴ during which time the use of cash takeover bids⁵ increased substantially.⁶ In 1960 there were eight cash takeover bids on both the American Stock Exchange and the New York Stock Exchange. In 1965 there were twenty-nine cash takeover bids on these exchanges, and in the first half of the 1966 these exchanges recorded thirty-two cash takeover bids.⁷

As the use of cash takeover bids increased, concern over the effects of such bids on the shareholders of takeover target corporation grew. In the United States these concerns focused on the use of cash takeover bids to avoid the disclosure requirements of the *Securities Act of 1933*. This disclosure requirements would apply only in a share exchange offer.⁸

Academic literature and comments in the latter half of the 1960s suggested problems associated with cash takeover bids that fall into the following categories:

(i) Corporations and their shareholders need to be protected from corporate raiders and looters who seize control of, and liquidate, corporations.⁹

(ii) Offeree shareholders lack sufficient information to decide whether they should tender their shares in the hope of retaining a share

⁴ See F.A. Beams, *Advanced Accounting*, 2d ed. (Englewood Cliffs, N.J.: Prentice-Hall Inc., 1982) at 2, and Copland & Weston, *Financial Theory and Corporate Policy*, 1983, at 560. (Reading Mass: Addison-Wesley Pub. Co. c. 1983).

⁵ The Canadian terminology of "cash takeover bid" will be used throughout this article rather than the U.S. term "cash tender offer."

⁶ Copland & Weston, *supra*, note 4.

⁷ A. Fleischer, Jr. & R.H. Mundheim, "Corporate Acquisition by Tender Offer" (1967) 115 U. Pa. L. Rev. 317 at 317.

⁸ A share exchange offer would require a prospectus under the U.S. *Securities Act of 1933*.

⁹ See, for example, R.G. Swanson, "S. 510 and the Regulation of Cash Tender Offers: Distinguishing St. George from the Dragon" (1968) 5 Harv. J. Legis. 431 at 449; Fleischer and Mundheim, *supra*, note 7 at 324; comments of Senator Williams, 11 Cong. Rec. 27248-49, 22 October 1965.

in the corporation under new management, or in the hope of continuing with a share in the corporation under the existing management.¹⁰

(iii) The shareholder can, by tendering early in the offer period, have his shares locked-up such that he could not deal with the share until the offeror, under the terms of the offer, decides whether to take up the shares tendered.¹¹

(iv) The shareholders need time to assess the information that should be provided by the offeror.¹²

(v) In other contests for control, such as proxy contests or share exchange offers, the offeror is required by the *Securities Act of 1933* to make a disclosure of information. The lack of disclosure in cash takeover bids represented a gap in federal securities regulation.¹³

(vi) The practice of taking up tendered shares on a first-come, first-served basis as a technique for encouraging the early tendering of shares was considered to be inequitable by offeree (target) shareholders. As well, it was seen as open to fraudulent use.¹⁴

(vii) The practice of increasing the offer price as the offer period progressed in order to attract the tendering of further shares and then only paying the increased price on those shares tendered after the increase in price, was seen as inequitable to the offeree shareholders.¹⁵

The concerns expressed focused on the protection of target shareholders and legislation which would protect target shareholders with respect to these concerns was recommended.

In Ontario the Kimber Report recommended legislative measures to protect target shareholders. The Report noted that:

the primary objective of any recommendations for legislation with respect to the take-over bid transaction should be the protection of the *bona fide* interests of the shareholders of the offeree company. Shareholders should have made available to them, as a matter of law, sufficient up-to-date relevant information to permit them to come to a reasoned decision as to the desirability of accepting a bid for their shares.¹⁶

Thus the response to the growing use of cash takeover bids was a concern for protecting shareholders of target corporations.

¹⁰ See, for example, Swanson, *supra*, note 9 at 455; Fleischer and Mundheim, *supra*, note 7 at 326; and M.H. Cohen, "Tender Offers and Takeover Bids" (1968) 23 Bus. Law. 611 at 614.

¹¹ See, for example, Fleischer and Mundheim, *supra*, note 7 at 327.

¹² *Ibid.*

¹³ See, for example, H.L. Sowards and J.S. Mofsky, "Corporate Take-Over Bids: Gap in Federal Securities Regulation" (1967) 41 St. John's L. Rev. 499 at 507.

¹⁴ See, for example, Sowards and Mofsky, *ibid.* at 503.

¹⁵ See *ibid.* at 515.

¹⁶ *Report of the Attorney General's Committee on Securities Legislation in Ontario*, (the "Kimber Report"), March 1985 at para. 3.10.

B. *Law Relating to Takeover Bids*

In Ontario, the legislative response to the concerns for protecting target shareholders is in Part XIX of the *Securities Act*¹⁷ and Part IX of the regulations under the Act. The legislation provides for: disclosure requirements; bid delay periods; rights of withdrawal of tender by target shareholders; and provisions for equal treatment of target shareholders. There is similar legislation in other provinces and within the *Canada Business Corporations Act*.¹⁸

The disclosure requirements and the minimum bid period are the major source of argument with respect to the economic efficiency of takeover bid regulation. These requirements promote competitive bidding for takeover targets by requiring information disclosure, which in turn allows competing bidders to assess this information and make competing bids during the required bid period.

Under the Ontario *Securities Act*, a "takeover bid" occurs when: firstly, an "offeror"¹⁹ offers to buy the securities of a corporation from security holders in Ontario; and secondly, the securities which are the subject of the offer, when taken together with the offeror's presently owned securities which are the subject of the offer, will exceed 20 per cent of the outstanding voting securities of the company.²⁰ Although an important exemption is provided where the bid is made through a recognized stock exchange, these exchanges also have disclosure requirements and bid delay period rules similar to those of the *Securities Act*.²¹

A takeover bid circular is to be sent to each holder in Ontario of the security sought.²² The circular must reveal, among other things, the identity of the offeror,²³ and any material facts known to the offeror that would reasonably be expected to affect the shareholders' decision to accept or reject the offer.²⁴ A minimum twenty-one day period must elapse during which securities can be deposited pursuant to a takeover

¹⁷ *Securities Act*, R.S.O. 1980, c. 466 and R.R.O. 910/80. Subsequent to the writing of this article Part XIX was amended by S.O. 1987, c. 7.

¹⁸ *Alberta Securities Act*, S.A. 1981, c. S-61 Part 13, s. 131-145; *B.C. Securities Act*, R.S.B.C. 1985, c. 23, Part 11, s. 74-99; Manitoba, *The Securities Act* R.S.M. 1970, c. 550, Part IX, s. 80-99.1; *Quebec Securities Act*, S.Q. 1982, c. 48, Title IV, s. 110-147, amended S.Q. 1984, c. 41, s. 40; Saskatchewan, *The Securities Act*, R.S.S. 1978, c. S-42, Part X, s. 88-107; *Canada Business Corporations Act*, S.C. 1974-75, c. 33, Part XVI, s. 187-99.

¹⁹ *Ontario Securities Act*, *supra*, note 17, s. 88(1)(h).

²⁰ *Ibid.* s. 88(1)(k). The threshold under the *Canada Business Corporations Act*, *supra*, note 18, s. 88(1)(h).

²¹ *Ibid.* s. 88(2)(a).

²² *Ibid.* s. 89(1) 1. and s. 94(1).

²³ *Ibid.* s. 100.

²⁴ *Ontario Securities Act* Regulations, Ont. Reg. 478/79 s. 165; Form 31, items 11 and 16.

bid.²⁵ Securities deposited pursuant to a takeover bid can be withdrawn at any time during the first ten days after the date of the takeover bid.²⁶

Ontario Bill 156 would modify Part XIX of the Ontario *Securities Act*. As far as the debate herein is concerned, it does not make a significant change to the rules noted above. It would, however, increase the withdrawal period to twenty-one days from the date of the takeover bid and would provide for an early warning of potential takeovers. This would tend to further encourage competitive bidding for takeover targets.²⁷

The rules of the Toronto Stock Exchange require that offerors publish a newspaper advertisement stating the details of the offer and the names of the offeror and offeree companies.²⁸ The offeror must also communicate the information to each offeree shareholder in Canada.²⁹ A book for receipt of tenders will be opened after eleven clear trading days,³⁰ but this may be extended to twenty-one days in the event of a competing bid by way of a takeover circular under the *Securities Act*.³¹ The Exchange also reserves the right to extend the bid period in the event of a competing bid through the facilities of the Exchange.³²

In the U.S., which provided the context in which the debate reviewed in this article occurred, the *Williams Act*³³ contains rules for cash takeover bids similar to those in Ontario. The rules apply where the offeror will end up owning in excess of 5 percent of the outstanding shares of the class of shares sought.³⁴ The disclosure requirements are similar to those under the Ontario *Securities Act*,³⁵ and the minimum period to complete a bid is twenty days.³⁶ Shareholders can withdraw tendered shares as long as the bid remains open.³⁷

²⁵ *Ibid.* Ontario *Securities Act*, s. 89(1) 2.

²⁶ *Ibid.* s. 89(1) 4.

²⁷ Bill 156, 2d Session, 33rd Leg. Ont., s. 7 of which amends Part XIX of *Act* and provides for these withdrawal rights in s. 94 of the *Act*. Subsequent to the writing of this article Bill 156 was enacted (S.O. 1987, c. 7).

²⁸ T.S.E. by-law 23.02(9).

²⁹ *Ibid.*

³⁰ T.S.E. By-law 23.05.

³¹ T.S.E. By-law 23.10.

³² T.S.E. By-law 23.09.

³³ 82 STAT. 455 (1968); 15 U.S.C., s. 78n(d).

³⁴ 15 U.S.C., s. 78n(d)(1).

³⁵ 17 C.F.R. 240.14d-4, 240.14d-6 and 240.14d-100.

³⁶ 17 C.F.R. 240.14e-1(a).36.15 U.S.C.S., s. 78nd(d)(5).

³⁷ 17 C.F.R. s. 240.14d-7.

Various defensive tactics by target managements can both extend the bidding period and encourage competing bids. For instance, resorting to legal action by claiming a violation of securities legislation, or stock exchange rules could delay a takeover bid and allow further time for competitive bidding. Seeking a "white knight"³⁸ directly encourages the making of a competing bid. The position in Canada with respect to takeover defenses appears to be that directors can take steps to defeat a takeover bid if they have a *bona fide* and reasonable belief that it is in the best interests of the corporation to do so.³⁹ Under this test it is likely that a takeover defence that has the effect of raising the takeover premium will be permitted. In the U.S., takeover defenses have often been permitted under the business judgment rule.⁴⁰

The feasibility of successful takeover defenses is enhanced by minimum bid period legislation. These rules increase the time during which a takeover defence can be mounted. Thus, takeover bid legislation and the permissive approach to defensive tactics work in tandem to promote competitive bidding.

C. *Motives for Takeovers*

There are a number of reasons for takeovers. Takeover bid legislation should be considered in the context of its effect on various takeover motivations. A summary of theories on the motives behind takeovers is presented below.⁴¹

(i) Inefficient management

The target corporation's management may be inefficient. It may not be performing in the interests of shareholders to the extent which an acquirer could. Target management may not be as effective, as

³⁸ A "white knight" is a competing bidder sought by target management often to avoid the prospect of target management being replaced.

³⁹ See *Teck Corporation Ltd v. Millar* (1972), 33 D.L.R. (3d) 288 (B.S.S.C.), *Howard Smith Ltd v. Ampol Petroleum Ltd*, [1974] 1 All E.R. 1126 (P.C.).

⁴⁰ See, for example, *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.) at 293-95, cert. denied, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp. v. Internorth Inc.*, 634 F.2d 690 (2d Cir 1980) at 701-704; *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir 1980) at 294, cert. denied, 450 U.S. 999 (1981).

⁴¹ See Copland and Weston, *supra*, note 4 at 561-69, and see Bebchuk, "The Case for Facilitating Competing Tender Offers," *supra*, note 1 at 1030-34.

managers, as some other group might be, or target management might just be inept.⁴²

(ii) Synergy

A synergy is present where the value of combining two corporations is greater than the sum of the value of the corporations acting separately.

(iii) Market power

Increased market power from a combination of two firms in the same industry can create greater profits. Although the value of the combined enterprise will be greater than the sum of the values of the individual enterprises, and will thus present a synergistic gain, it is useful to distinguish the market power takeover motivation from other synergistic motivations. Pure market power motivations will be associated with a social loss while other synergistic gains will generally be associated with a social gain.

(iv) Tax considerations

Tax savings may result from a takeover by, for instance, permitting the business losses or capital losses of one firm to be applied against income or capital gains of another firm.

(v) Undervaluation

If a target is undervalued in the market, the acquirer can gain by buying and holding the undervalued target shares until they are properly valued.

(vi) Empire building or managerialism

Management may seek to acquire other firms to enhance the size of their firm, leading to increased prestige and compensation.

(vii) Looting

The acquirer may want to acquire sufficient control of the target to be able to purchase assets of the target through an affiliate at substantially less than fair market value.

⁴² An inefficient management may be inept in some absolute sense in that anyone could do better or it may be that there is a relatively more efficient management team. A management may be inefficient not only in the way they manage the productive capacity of the assets but may also be inefficient by consuming an excessive level of perquisites or inefficiently controlling the level of perquisites (in other words, incurring excessive agency costs — see M. Jensen & W. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305).

(viii) Hubris

The acquirer may be mistaken about the value that acquiring the target might provide.⁴³

The inefficient management, synergy, and undervaluation motives for takeovers are worthwhile in terms of allocative efficiency because they cause assets to be put to more highly valued uses.⁴⁴ The market power motivation is allocatively inefficient and the tax and empire building motivations may lead to allocative inefficiency and otherwise incur wasteful transactions costs without any compensating gains.⁴⁵

D. *A Summary of Empirical Evidence on Takeovers*

The available empirical evidence on takeovers underlies the theoretical debate on the economics of takeover bid regulation. Very briefly stated, empirical evidence on takeovers indicates, among other things, the following:⁴⁶

(i) Shares of target firms have significant positive gains of, on average, 30% beginning from about one month prior to a takeover, while shares of the bidder gain 4% on average;⁴⁷

⁴³ The hubris hypothesis is described by R. Roll in "The Hubris Hypothesis of Corporate Takeovers" (1986) 59 J. Bus. 197. The hypothesis claims that since the actual underlying value of the target is not known with certainty, observations about the value of the target will be distributed around the underlying value. An observation that the target is undervalued may just be an observation from the high end of the distribution and thus could simply represent an overestimation of the value of the target. An acquirer who does not have much experience with valuing and bidding for targets may not properly adjust its estimate of the value of a target for this tendency to overestimate the value. The acquisition may then occur not for any gains that can be achieved but simply on the basis of a mistaken belief that the target is undervalued.

⁴⁴ The correction of an undervaluation corrects the market price which affects the allocation of resources. By correcting the market price the allocation of resources will be improved. However, it may be that the private gain from correcting an undervaluation will exceed the social gain (see the text accompanying note 96).

⁴⁵ The sources of social gains from mergers are noted in D.W. Leebron, "Games Corporations Play: A Theory of Tender Offers" (1986) 61 N.Y.U.L. Rev. 153 at 204.

⁴⁶ Summaries of the evidence on mergers and takeover bids are provided by M.C. Jensen & R.S. Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J. Fin. Econ. 5; P. Halpern, "Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions" (1983) 38 J. Fin. 29; and M. Jensen, "Takeovers: Folklore and Science" (1984) Harv. Bus. Rev. 109.

⁴⁷ See Jensen & Ruback, *supra*, note 46, where an average is taken over studies by P. Dodd & R. Ruback, "Tender Offers and Shareholder Returns: An Empirical Analysis" (1977) 5 J. Fin. Econ. 351; D. Kummer & R. Hoffmeister, "Valuation Consequences of Cash Tender Offers" (1978) 33 J. Fin. 505; M. Bradley, "Interfirm Tender Offers and the Market for Corporate Control" (1980) 53 J. Bus. 345; G. Jarrell & M. Bradley, "The Economic Effects of Federal and State Regulations of Cash Tender Offers" (1980) 23 J. L. & Econ. 371.

(ii) Target firms perform poorly for, on average, two years prior to a takeover.⁴⁸ This is most consistent with an inefficient management motivation for takeovers;⁴⁹

(iii) Acquirers often perform well before takeovers;⁵⁰

(iv) The enactment of cash takeover bid legislation in the U.S. has increased tender offer premiums by approximately 32 to 53%. Gains to target shareholders have increased, while gains to acquirer shareholders have decreased.⁵¹

These results are based primarily on studies of U.S. data. Comparable studies have yet to be published in Canada.⁵²

This brief review of the concerns which prompted takeover bid legislation, the relevant legal rules, the motives for takeovers, and some of the empirical evidence relating to takeovers, provides a background for the review of the debate which follows.

III. REVIEW OF RECENT LITERATURE ON THE ECONOMICS OF TAKEOVERS

In this Part, the main arguments made in the debate over the economic efficiency of legal rules relating to takeovers, will be reviewed and commented upon.

A. *The Argument for a Passive Target Management Response and Avoidance of Competitive Bidding*

It has been argued that the permissive approach to target management responses to takeover bids and the delay and disclosure rules of takeover bid legislation are inappropriate because they discourage beneficial takeovers by encouraging competitive bidding for targets.⁵³

The argument proceeds as follows. Where a corporation's shares are widely held it will be difficult to replace an inefficient management. The cost to any one shareholder of organizing a dispersed group of shareholders to replace management through the proxy mechanism are

⁴⁸ See Dodd & Ruback, *supra*, note 47, and Kummer & Hoffmeister, *supra*, note 47.

⁴⁹ See Dodd & Ruback, *supra*, note 47, and Kummer & Hoffmeister, *supra*, note 47.

⁵⁰ *Ibid.*

⁵¹ See Jarrell and Bradley, "The Economic Effects of Federal and State Regulations of Cash Tender Offers" (1980) 23 J.L. & Econ. 371.

⁵² There is one published study on mergers in Canada by B.E. Eckbo, "Mergers and the Market for Corporate Control" (1986) 19 Can. J. Econ. 326.

⁵³ An argument as to the value of takeovers was made by Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Pol. Econ. 110. The main proponents of the argument against takeover bid legislation and target management defensive tactics which promote competitive bidding are Easterbrook and Fischel whose arguments have been made in the articles listed *supra* in note 1.

great. The gain is shared by all shareholders. Consequently, a relatively small share of the gain accrues to the shareholder who incurs the costs of organizing the dispersed group. Rather than incur the costs of organizing others, most shareholders can be expected to free-ride on another's organizing efforts. A takeover overcomes this by permitting the acquirer to reap a large share of the gains of replacing inefficient management, without incurring the costs of organizing shareholders. Takeovers are thus a useful mechanism for monitoring management inefficiency.

The empirical evidence suggests that a significant number of takeovers are motivated by the desire to replace inefficient management.⁵⁴ Further, since other motivations for takeovers are generally in the interest of both acquirer and target management, the takeover is more likely to occur in a friendly manner. Takeovers of inefficient management are thus likely to be hostile. The premium over the market price in a takeover indicates that there are private and social gains from the takeover.⁵⁵ Where defenses in response to takeover bids are successful, they prevent the potential social gains from being realized. The minimum bid periods, disclosure rules, and defenses, permit competing bids for the target. Competing bids effectively create an auction and raise the takeover premium. This reduces the acquirer's gains and thus reduces the number of takeover bids and the total number of socially beneficial takeovers.

Auctions, or potential auctions, discourage the search for targets. The first bidder incurs costs in searching for the target. In compliance with disclosure requirements, the bid discloses much information which the acquirer has paid to find.⁵⁶ Subsequent bidders get the benefit of this information without incurring the costs, and the minimum bid period rules permit them to respond with competing bids. This raises the takeover premium and consequently reduces the potential gain to the first bidder. With the reduced gain to first bidders, there is less incentive to incur

⁵⁴ See note 48. The evidence shows declining cumulative average residuals (which measure the stock price effects related to the takeover event after removing market effects and the effects of events other than the takeover) up to two years prior to the takeover event. Declining cumulative average residuals are only consistent with the inefficient management motivation for takeovers and thus indicate that a significant number of takeovers are motivated by the gains from the replacement of inefficient management.

⁵⁵ Empirical evidence suggests that there are net positive gains from takeovers — see M.C. Jensen & R.S. Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J. Fin. Econ. 5 at 22. The evidence, however, is not unambiguous — see R. Roll, *supra*, note 43 at 202-06 where evidence on the gains from takeovers is reviewed. More recent evidence suggests that there are net gains from takeovers — see M. Bradley, A. Desai & E. Han Kim, "Synergetic Gains from Corporate Acquisitions and their Division Between the Stockholders of Target and Acquiring Firms" [unpublished, University of Michigan, July 1986] at 45.

⁵⁶ The key piece of information revealed is the identity of the target. The size of the possible gain may also be revealed by other information that takeover-bid legislation requires the bidder to reveal.

the initial costs of searching for targets. When less search for potential targets takes place, fewer socially beneficial takeovers will occur. In other words, monitoring management inefficiency by takeovers will be reduced. To achieve the optimal level of investment in information about takeover targets, and consequently the optimal level of monitoring of management inefficiency by takeovers, the marginal cost of investment in information should equal the marginal gain to society from the investment. In order to achieve this, bidders, who make the decision on investment in information, must be given as much of the gains from takeovers as possible.⁵⁷

The argument against auctions suggests that takeover bid legislation such as the *Williams Act* should be repealed.⁵⁸ The argument also suggests that target managers should respond to tender offers passively; that is, they should not engage in defensive tactics in response to tender offers.⁵⁹

B. *Arguments in Favour of Competitive Bidding and Responses to the Arguments*

A number of arguments have been made in favour of creating auctions in takeover bids through takeover bid legislation and takeover bid defensive tactics. These arguments are presented below. Each section presents an argument in favour of auctions in takeovers, followed by responses by those opposed to such auctions. The author's comments follow the presentation of the argument and responses in each section.

1. The trivial effect of competitive bidding

(a) *Costs and returns of searches*

Competitive bidding, it is argued, does not significantly decrease returns from searching for targets since:

(i) The bidder can buy shares before making a bid and capture a substantial portion of the potential gain on those shares whether or not the bidder is ultimately successful in acquiring the target;⁶⁰

⁵⁷ This is demonstrated by Professor Schwartz, *supra*, note 1 at 236-37. Professor Schwartz shows that less search will occur if the gains to acquirers are reduced under three assumptions: (1) search costs are non-decreasing as search intensity increases and are not affected by takeover-bid legislation; (2) as search intensity increases more potential targets are identified but at a decreasing rate; and (3) the gains to acquirers from identifying targets are less under an auction.

⁵⁸ See Fischel, *supra*, note 1 at 24-26; Easterbrook & Fischel II, *supra*, note 1 at 15-17; Schwartz I, *supra*, note 1 at 230.

⁵⁹ See Easterbrook & Fischel I, *supra*, note 1, esp. at 1201-1204.

⁶⁰ Bebchuk, *supra*, note 1 at 1035 and Gilson I, *supra*, note 1 at 871.

(ii) The target may afford greater synergy or managerial efficiency gains to the bidder than it would to other bidders. The bidder will therefore be left with a surplus after the competitive bidding process;⁶¹

(iii) The first bidder has an advantage by having had more time to study the target. This gives the bidder an informational advantage and perhaps a strategic advantage over other bidders;⁶²

(iv) The search costs for bidders are small because searching is done by investment bankers whose fees are often less than one per cent of the target's value and largely contingent on the success of the acquisition attempt.⁶³

Further, if the number of potential targets identified diminishes as search efforts increase, then increasing the returns from searches may not significantly increase search efforts.⁶⁴ Consequently, it may be that competitive bidding has very little effect on the frequency, and thus the monitoring effect, of takeovers. If an increase in the returns from search is desirable, it is argued that this can be accomplished by raising the percentage of the target's stock which may be purchased without disclosure.⁶⁵

Two responses have been made to this argument. The first questions the claim that a bidder's search costs are small. It is argued that: management time spent searching is an opportunity cost (which includes the value of other projects foregone); many firms must be searched to find the one on which a bid is ultimately made; capital must be held at the ready; and the first bidder's capital is committed for the longest period.⁶⁶ First bidders are also subject to higher risk since they do not have access to internal documents of the target while one or more subsequent bidders may gain such access.⁶⁷ This causes first bidders to win when they bid too high, or, drive the price up when they bid too low.⁶⁸ Thus, it is not clear that the search costs of first bidders are small.

⁶¹ *Ibid.* Bebchuk at 1036. The surplus would occur because the winning bidder would only have to just outbid the second-highest bidder.

⁶² *Ibid.*

⁶³ *Ibid.* at 1036-37 and Gilson, *supra*, note 1 at 870. No evidence is presented to support the claim that investment bankers do most of the searching for targets.

⁶⁴ *Ibid.* Bebchuk at 1037-38. In other words, there may be diminishing returns from searching for targets since as more search is done and targets are identified there are likely to be fewer targets remaining and the rate at which targets will be identified will go down.

⁶⁵ *Ibid.* Bebchuk at 1038.

⁶⁶ Easterbrook and Fischel II, *supra*, note 1 at 6.

⁶⁷ The target may attract a competing bidder (a "white knight") to promote competitive bidding and raise the takeover premium, or, the target may attract a friendly acquirer to prevent a takeover by a hostile first-bidder who would replace target management. To encourage a competing bidder to enter, or to favour a friendly competing bidder, the target may reduce the risk to a competing bidder by allowing it access to internal target documents so that it can acquire better information at low cost.

⁶⁸ *Ibid.*

The second response to the claim that competitive bidding does not significantly reduce returns from the search process is that the ratio of available gains to search costs is irrelevant. The takeover bid is a case of protecting property rights in information in order to offer an incentive to produce that information. The efficient solution requires that the marginal social costs and marginal social gains of producing the information be equal. In other words, it is the marginal, not the total, gains and costs which are relevant. The inability to appropriate the full value of the information will lead to insufficient production of information, which, in turn, will reduce the number of takeover bids and the effectiveness of takeovers in monitoring managers.⁶⁹

Such is the state of the argument on the relationship between search costs and returns. Unfortunately, the average of total costs and returns of searching for and identifying a target are unresolved empirical questions. These questions, however, are not crucial. The important question is the effect of the premium on investing in the search for targets and the consequent frequency of takeovers. This question cannot be answered by examining total gains and costs since it is the gains and costs at the margin which affect the level of investment in search.⁷⁰

(b) *Takeover premiums and the frequency of takeovers*

Another argument in favour of auctions is that preventing them is only justified if it increases the value of target shares. The value of target shares will depend on the price of such shares in the event there is no takeover, plus, a premium for the gain in the event of a takeover. The gain in the event of a takeover depends on the probability of a takeover, multiplied by the takeover premium if a takeover occurs. Thus, it is argued that the value of target shares depends on the effect of auctions on both the probability or frequency of takeovers, and the takeover premium. Preventing auctions is only justified if the reduction in the takeover premiums is outweighed by the increase in the frequency of takeovers.⁷¹ In other words, if for a given reduction in takeover premiums there is a less than proportionate increase in the frequency of takeovers, then auctions will not reduce takeover frequency to a point that outweighs their positive effect on premiums.⁷²

⁶⁹ *Ibid.* at 4-6.

⁷⁰ The appropriate empirical analysis would be one which attempts to get some estimate of the marginal effect of a change in takeover premiums on the frequency of takeovers.

⁷¹ See Bebchuk I, *supra*, note 1 at 1038.

⁷² The "positive" effect which Professor Bebchuk refers to is the increase in gains to target shareholders. Target shareholders would gain from auctions if the percentage reduction in the frequency of takeovers (and thus the percentage reduction in the probability of a takeover) is less than the percentage gain in the premium they would receive upon a takeover.

This argument, it is said, implicitly assumes that investors can identify potential targets in advance of bids and thus will be interested in high premiums.⁷³ If investors cannot identify potential targets in advance,⁷⁴ they cannot incorporate higher takeover premiums into the stock price of these targets. Further, to the extent shareholders have diversified holdings, they will tend to hold both target and bidder stock and thus cannot gain from increased premiums, since what they gain on target shares will be matched by losses on bidder shares.⁷⁵

The following comments can be made with respect to the alleged positive effect of auctions on takeover premiums. The argument, by considering the balance between takeover frequency and premiums, focuses on an auction's effect on target shareholder wealth. Although *ex ante* target shareholder wealth will generally be consistent with social welfare, increasing takeover premiums may not be consistent with social welfare, if they cause investment in relatively inefficient uses of assets. If shareholders can identify potential targets, if increased takeover premiums do not significantly affect takeover frequency to the extent that target shareholders gain from increased premiums, and, if a significant

⁷³ Easterbrook & Fischel II, *supra*, note 1 at 8. Easterbrook and Fischel support this claim by noting that target share prices do not rise until very shortly before a takeover bid is announced. They quote Bradley, *supra*, note 47. It may be, however, that the share price already implicitly includes a value for some probability of takeover. Testing for whether a firm can be identified as having a greater than average potential of becoming a target may not lend itself to an event study.

⁷⁴ Bebchuk claims corporations can be identified as more likely to become either acquirers or targets. He notes evidence of characteristics of targets quoting A. Singh, "Take-Overs, Economic Natural Selection, and the Theory of the Firm: Evidence from the Post-War United Kingdom Experience" (1975) 85 *Econ. J.* 497 and Stevens, "Financial Characteristics of Merged Firms: A Multivariate Analysis" (1973) 8 *J. Fin. & Quant. Anal.* 149. These characteristics can provide a means of assessing a firm's likelihood of being taken over. He also notes there are firms with announced acquisition programs which are more likely to be acquirers. See Bebchuk II, *supra*, note 1 at 28 and note 15.

There are several recent studies that develop models to identify targets — see for example: J. Hasbrouck, "The Characteristics of Takeover Targets: q and Other Measures" (1985) 9 *J. Banking Fin.* 357; S. Schwartz, "Factors Affecting the Probability of Being Acquired: Evidence for the United States" (1982) 92 *Eco. J.* 391; R. Harris *et al.*, "Characteristics of Acquired Firms: Fixed and Random Coefficient Probit Analyses" (1982) *Southern Eco. J.* 164; J.W. Bartley & C.M. Borden, "Replacement Cost-Adjusted Valuation Ratio as a Discriminator Among Takeover Target and Non-Target Firms" (1986) 38 *J. Eco. Bus.* 41; A. Belkeoui, "Financial Ratios as Predictors of Canadian Takeovers" (1978) 5 *J. Bus. Fin. Acctng.* 93. With some exceptions these models explain only some of the variance and are generally poor predictors. Those that do show success in predicting takeover targets appear to be successful due to the use of non-random samples to estimate the models combined with non-random samples to do prediction tests of the models and arbitrary cut-off rates for the probability of the firm being a target — see K.G. Palepu, "Predicting Takeover Targets: A Methodological and Empirical Analysis" (1986) 8 *J. Acc. Econ.* 3.

⁷⁵ Easterbrook & Fischel II, *supra*, note 1 at 8-9. This assumes there are no gains from takeovers. In fact shareholders may gain on average if there are gains from takeovers (see, *supra*, note 55). Any reduction in the frequency of takeovers would mean a loss of these gains and thus shareholders holding portfolios balanced between acquirers and targets would lose on average if the frequency of takeovers was reduced.

number of takeovers are motivated by a desire to replace inefficient management, then increasing target premiums would increase the value of the target and thus encourage investment in firms with inefficient management.⁷⁶ Such an incentive could hardly be considered desirable.

Even when analyzing the problem from the point of view of target shareholder wealth, the argument ignores the effect of increased frequency of takeovers on the price of target shares, when targets are not taken over. In other words, by focusing on the effect on premiums, the argument ignores the effect of the increased threat of takeovers on the prices of shares generally. From the target shareholder's point of view, the takeover frequency effect which must be weighed against reduced premiums is not just the takeover frequency itself, but also the effect this increased threat has on the price of target shares when no takeover materializes.

The argument in favour of auctions, and response to it, raise the following empirical questions:

- (i) To what extent can investors identify potential targets in advance?
- (ii) For a given percentage reduction in takeover premiums is there a lesser or greater percentage reduction in the frequency of takeovers?
- (iii) What is the effect of a change in takeover frequency on the price of shares generally and on the shares of potential targets?

The first of these questions is not crucial to social welfare concerns, given that gains by target shareholders are simply wealth transfers.⁷⁷ However, the second and third questions are important in determining the effects of a change in the legal rules relating to takeovers. This is important for identifying the cost of trading off a higher premium for some other benefit. For instance, if there are benefits in increased

⁷⁶ The price of a share in the market should represent the value of the entitlement to the cash flows management can generate. When shareholders can expect a premium in excess of this value then it will be worthwhile to hold the shares even though their price is in excess of the net present value of the entitlement to cash flows management generates from the assets of the potential target. This premium will permit management to continue managing assets in an inefficient way. This is because normally more efficient managements will generate higher cash flows and will thus derive higher net present values from their investments. The more efficient managements can pay more for the assets related to a given investment than can less efficient managements. However, if there is an identifiable and expected takeover premium for firms with less efficient managements, then a less efficient management can pay a price competing with that paid by more efficient managements and which is in excess of the amount justified by the cash flows the less efficient management would generate. This negative net present value investment would not have a negative effect on the stock price to the extent it is compensated for by the expected takeover premium. To the extent less efficient managements can compete successfully with more efficient managements for assets there will be a misallocation of assets.

⁷⁷ Although social welfare may be affected by such wealth transfers it would be difficult to construct a distributive theory supporting such wealth transfers. To support a distributive theory in favour of target shareholders, it would presumably be necessary to distinguish the profile of target shareholders from the profile of acquirer shareholders and then show that persons who tend to be target shareholders are deserving of a wealth transfer in their favour. The first step will be difficult given that it is not clear that shareholders can identify targets in advance.

premiums, these benefits might be obtained at relatively low cost if the premium increase has little effect on the frequency of takeovers and the effect of a change in takeover frequency on share prices is small.

(c) *Auctions increase the returns from the search for takeover targets*

Professor Gilson has argued that for some producers of information concerning potential takeover targets,⁷⁸ competitive bidding may increase the return on investment in search. Gilson gives the following example:⁷⁹

Search costs	= \$2.5 million
Current share price	= \$50 per share
Share price upon takeover	= \$120 per share
Successful bid price without competitive bidding	= \$100 per share
Proportion of shares that can be purchased before the takeover bid rules apply	= 10%
Number of target shares	= 1 million

The costs in a takeover can be broken down into information or search costs (the costs in identifying a potential target), and implementation costs (the costs of securing control and implementing the value-increasing strategy). Assuming the information producer can avoid competitive bidding, if the information producer's strategy is to invest in both search and implementation then the investment costs \$97.5 million. This breaks down into \$2.5 million for search costs, \$5 million to buy 10% of the target's shares in the market, and \$90 million to buy the remaining 90% of the target's shares at \$100 per share. The return is \$120 million (the value of the target subsequent to the takeover). The gain is \$22.5 million, for a return on investment of approximately 23%.

The information producer might adopt an alternative strategy of investing in search but leaving the implementation to another party. The information could be passed along to another company after buying 10% of the target's stock. Upon completion of a successful bid at \$100 per share, the information producer would get \$10 million on the sale of 100,000 shares, with an investment of \$7.5 million (\$2.5 million for search costs and \$5 million to buy 100,000 shares at \$50 per share). This results in a return on investment of 33.3%. The information producer could also buy 10% of the target's shares and encourage competitive bidding by making the information public.⁸⁰ The ensuing auction would increase the price for the takeover to \$120 per share. The information

⁷⁸ Gilson II, *supra*, note 1 at 53; see also Gilson I, *supra*, note 1 at 872, note 187.

⁷⁹ Gilson II, *supra*, note 1 at 53.

⁸⁰ This assumes the information can be credibly revealed.

producer would then realize a return of \$12 million on an investment of \$7.5 million — for a return on investment of 60%.

Information production and implementation skills, it is argued, may not always be present in one entity. There is likely to be specialization in these activities.⁸¹ Where there is specialization, information producers would prefer competitive bidding, while implementers would prefer none. Not having an auction, according to the above analysis, may reduce the returns from a search for targets and thus reduce investments in information to a less than optimal level.⁸²

The information producer might sell the information rather than encourage competitive bidding. The sale, in terms of the example above, could be for some part of the \$20 million gain. This would increase the return to more than \$10 million and perhaps to more than \$12 million, thus permitting a return on investment greater than 60%.⁸³

The problem in both encouraging competitive bidding and selling information, it is argued, is verification of the information passed on.⁸⁴ How the information producer deals with this will depend on the relative costs of verification. Under the sale alternative, verification by bonding (such as making investments in reputation) could be used. Under a competitive bidding alternative, which may be used either by those who have not made prior investments in reputation or by those without the capital and time to adopt other verification techniques, the competitive bidding process can verify the information. The bidding process, it is argued, verifies the information because the announcement of the first bid creates an incentive for target management to select the ultimate acquirer (for instance by selecting a “white knight”), and to verify the information to that acquirer by allowing it access to the target’s internal documents.⁸⁵ So, depending on the relative costs of verifying their information, some information producers may benefit from auctions while others may not.⁸⁶

The response to the claim that auctions increase search returns counters that the claim has a number of problems. Firstly, it has been noted that searching for potential targets and implementing an acquisition are complementary inputs.⁸⁷ If the demand for takeover implementation

⁸¹ No evidence is offered to show that there is specialization.

⁸² Gilson II, *supra*, note 1 at 54.

⁸³ Easterbrook & Fischel II, *supra*, note 1 at 20.

⁸⁴ Gilson II, *supra*, note 1 at 57.

⁸⁵ See Gilson II, *supra*, note 1 at 59-61, note 22.

⁸⁶ *Ibid.* at 57-60.

⁸⁷ Easterbrook & Fischel II, *supra*, note 1 at 18.

decreases, the demand for its complement, searching for targets, will also go down.⁸⁸ The claim that competitive bidding may increase search returns appears to argue that as the price for targets rises, and consequently the demand for targets falls, there is a greater demand for information about potential targets. This, it is argued, is an unlikely result.⁸⁹

Secondly, Gilson's example has separated the two types of investments but has not disaggregated the returns on investment. In the example, the return on the production of information and purchase of 10% of the target shares is 60%, whether the information producer encourages competitive bidding or implements the takeover itself. In both cases, the value of the 100,000 shares purchased is \$12 million and the investment in the production of the information and purchase of 100,000 shares is \$7.5 million. The information producer could then consider a separate investment in implementation. This would involve a cost of \$90 million (according to the example) and the return on 900,000 shares purchased in implementing the takeover would be \$108 million (900,000 times the \$120 per share value ultimately realized). This would result in a return on investment of 20%. The combined return of searching and implementing is, as noted above, 23%.⁹⁰ However, in both the strategy of searching without implementing and the strategy of searching and implementing, the return on investment from searching is the same (60% in the example).

Thirdly, the implicit assumption in the example is that neither the information producer nor the implementer have a comparative advantage in identifying potential targets. Further, to compare returns, the risks must be the same for the two types of activity.⁹¹ Thus, no one would spend the \$90 million to implement the transaction but would continue to invest in information production to earn the higher return at the same risk. The example does not represent an equilibrium.⁹²

With respect to verification of information under a sale, as opposed to competitive bidding, it has been noted that vertical integration of search and implementation is one solution to the verification problem.⁹³ The

⁸⁸ Cars and gasoline are often used as an example of complements. If the demand for one goes down then the demand for the other will, *ceteris paribus*, also go down.

⁸⁹ Easterbrook & Fischel II, *supra*, note 1 at 18.

⁹⁰ The investment portfolio would have 7.5m/97.5m of the \$97.5 million investment invested at a return of 60% and 90m/97.5m of the \$97.5 million investment invested at a return of 20% for an average return of $(7.5/97.5) \times 60\% + (90/97.5) \times 20\% = 23\%$. Easterbrook and Fischel appear to note this problem in Gilson's analysis, see Easterbrook & Fischel II, *supra*, note 1 at 20.

⁹¹ The risks of information production and implementation may be different, but Gilson's example does not deal with this.

⁹² Easterbrook & Fischel II, *supra*, note 1 at 20.

⁹³ *Ibid.* at 19-20.

vertically integrated information producer and takeover implementer would gain more without competitive bidding and would thus engage in more monitoring of inefficient managements through takeovers. But even if competitive bidding increases returns to information producers, it does not mean that legal rules which ensure competitive bidding are necessary or appropriate. Information producers should be left with a choice of verification procedures so they can choose the technique which minimizes their costs. If an information producer prefers to promote competitive bidding, it can do so, it is argued, without legislative assistance.⁹⁴ However, it may be that information producers cannot effectively encourage competitive bidding without the assistance of legal rules. Even if this is the case, it does not mean that mandatory legal rules are necessary. The information producer should be able to decide if it wishes to adhere to these rules.

The information producer seeking an auction would require some form of rule to prevent a subsequent bidder from precluding a further auction by making a bid with a very short bid period. However, the legal rule could simply be a requirement that the information producer's rules be followed. With such a rule the information producer could set up the auction to verify its information in the most efficient manner. An available set of auction rules might reduce transaction costs to the information producer by reducing the costs of designing and promulgating the auction rules. However, the information producers should be able to opt out when they find it worthwhile to incur the transaction costs in order to provide for an auction that best suits them.⁹⁵

2. A social welfare perspective

(a) *Excessive search for targets*

From the standpoint of the socially efficient level of investment engaged in by actors in the market, it is necessary that the social gains and costs equal the private gains and costs. If net private gains exceed net social gains for a particular activity, then there will be an incentive for individuals to overinvest. It has been argued that private gains may exceed social gains in takeovers leading to overinvestment in takeover

⁹⁴ *Ibid.* at 20.

⁹⁵ For instance, legislation might provide that the takeover is voidable by the information producer if the information producer's rules are not followed. The legislation might require the information producer, at the time of identifying the target, to submit rules for bidding on the target to a securities commission and require the dissemination of those rules in financial news media. The legislation might provide a set of default rules which would apply to the extent the information producer did not opt out of the legislative set of rules. This could lower the costs to the information producer of providing a set of rules.

activity.⁹⁶ Four sources of this divergence in social and private gains are given:⁹⁷

(i) A takeover may be motivated by a prior undervaluation of the target. The acquisition may correct the price of the shares in the market but would not improve the efficiency of the use of the corporation's assets.

(ii) The gain may come from tax savings such that the acquisition has little or no affect on the efficiency of the use of the underlying assets.

(iii) The gain may come from enhanced market power in terms of gains from monopoly or the potential for cartelization. The result would be a social loss.

(iv) The acquirer's management may be motivated by a preference for expansion (empire building or managerialism). If this is the sole motivation, the expansion will not increase the efficient use of assets and may even decrease efficiency.

None of these motivations for takeovers would produce gains for society as a whole. Instead they would give private gains to the bidder who would consequently be induced to incur the costs of engaging in such takeovers.

The response to the claim that private gains may exceed social gains counters each of the four sources of divergence noted above.

(i) Prior undervaluation of target

Takeovers that correct the prior undervaluation of a target, it is argued, do produce a social gain in that the correction of the price leads to investment incentives that are more allocatively efficient.⁹⁸ Secondly, there will be very few exploitable undervaluations since sophisticated investors in the market will act to take advantage of undervaluations long before a takeover bid could be made.⁹⁹ Thirdly, if a bidder could identify inside information indicating that a target was undervalued, target management would have an incentive to reveal the information.¹⁰⁰ Further,

⁹⁶ Bebchuk I, *supra*, note 1 at 1046-47.

⁹⁷ *Ibid.* at 1047.

⁹⁸ Bebchuk replies to this saying that the value to society of a price correction of an undervalued target is smaller than the amount of the undervaluation leaving the private gain as still larger than the social gain — see Bebchuk II, *supra*, note 1 at 36. An undervaluation will cause the return required on sources of finance to be greater than it otherwise would be and this can deter investment in projects that would have a positive net present value.

⁹⁹ Easterbrook & Fischel II, *supra*, note 1 at 10-12.

¹⁰⁰ See Schwartz I, *supra*, note 1 at 241.

empirical evidence suggests that takeover bids are generally not motivated by attempts to capitalize on asymmetries in information.¹⁰¹

However, the claim that takeovers are motivated by a prior undervaluation of the target is said to depend not on the existing level of search for undervalued targets that would occur under the current legislative regime which promotes auctions, but on the level of search for undervalued targets that would occur under a non-auction legal regime.¹⁰² Under a non-auction regime, the gain from such search will be higher since the acquirer will be able to capture all of the gain associated with the undervaluation. Although there may be a social gain from search, not all of the gain to the acquirer will be a social gain.¹⁰³

The claim that takeovers are often motivated by an undervaluation acknowledges that if the target is undervalued and there is a threat of a takeover, target managers will have an incentive to release information to cause an upward revaluation of the target.¹⁰⁴ However, there may be inside information which managers are not able to reveal to the market in a credible way, especially in the short time available during a "Saturday Night Special"¹⁰⁵ bid for the target. Although the management of the acquirer may not be able to reveal the information to the market any

¹⁰¹ See M. Bradley, A. Desai & E. Han Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy" (1983) 11 J. Fin. Econ. 183. Cumulative average residuals (see note 54) would be expected not to decline after an unsuccessful takeover that was based solely on the target being undervalued. The takeover attempt would release the information to the market and the shares would be revalued by the market. The empirical evidence shows that the cumulative average residuals fall after an unsuccessful takeover attempt, implying that takeovers are not generally due to an undervaluation. Although it is still possible that some takeovers are motivated by an undervaluation, the undervaluation would have to be significant to justify the transactions costs of a takeover which have been estimated to average approximately 13% of the value of the target taken over. (See R. Smiley, "The Effect of the Williams Amendment and Other Factors on Transactions Costs in Tender Offers" (1975) 3 Ind. Org. Rev. 138.)

¹⁰² See Bebchuk III, *supra*, note 1 at 257-58.

¹⁰³ *Ibid.* at 257. See also Bebchuk I, *supra*, note 1 at 1033 and Bebchuk II, *supra*, note 1 at 36. However, one would expect competition in the search for information. This would drive the returns down to a normal level for the risk undertaken. With competitive returns it is not so clear that the private gains from investment in information will exceed the social gains. Further, there are clearly investors who benefit (or "free-ride") on the information revealed by the efforts of others. Such free-riding in information suggests that there may be a suboptimal level of investment in information. In short, it is not clear that the investment in information under a non-auction regime would be excessive even if the investment in information only sought to identify undervaluations.

¹⁰⁴ See Schwartz I, *supra*, note 1 at 241.

¹⁰⁵ A "Saturday Night special" is the jargon used for a bid which gives a very short duration between the making of the takeover bid and the expiry time for the bid. For instance, the bid might be made on a Saturday night with an expiry time sometime on the following Monday.

more credibly than management of the target,¹⁰⁶ the information will presumably eventually find its way to the market.¹⁰⁷

Further, it is argued that auctions will deter the search for undervalued targets more than the search for efficiency gains from takeovers.¹⁰⁸ This, it is argued, is because acquirers are likely to differ in the amount of efficiency gains they can produce. The winning bidder, bidding just marginally more than the value to the second-highest bidder,¹⁰⁹ will profit from the difference between the value of the target in its hands and the value of the target in the hands of the second-highest bidder. However, where the takeover is motivated by an undervaluation, the gains to various bidders will presumably be the same. In such a case there will be no difference between the value to the winning bidder and the value to the second-highest bidder and thus there will be virtually no gain to the winning bidder.¹¹⁰

In spite of these claims it still seems unlikely that the undervaluation motive for takeovers will cause a significant overinvestment in search. The empirical evidence on the significance of undervaluation as a motive for takeovers and the high cost of takeovers relative to the potential gain from undervaluation likely to be available in an efficient capital market suggests that the undervaluation motive is unlikely to be very significant.¹¹¹ Further, it is not clear that an undervaluation motive for a takeover would lead to an excessive level of search even under a non-auction regime.¹¹² Thus, the undervaluation motive for takeovers is unlikely to be a significant source of overinvestment in search.

¹⁰⁶ See Schwartz I, *supra*, note 1 at 242 where it is suggested that if target management can not reveal the information to the market in a credible way then acquirer management will not be able to do so either.

¹⁰⁷ See Bebchuk III, *supra*, note 1 at 260-61.

¹⁰⁸ *Ibid.* at 256.

¹⁰⁹ In an open ascending bid auction the winning bidder will be able to win by paying just marginally more than the amount the last competing bidder was willing to bid.

¹¹⁰ Bebchuk III, *supra*, note 1 at 262. See also Bebchuk II, *supra*, note 1 at 35. This argument by Bebchuk does not seem to be quite correctly stated since bidders will have different expectations as to the extent of the undervaluation of a target in any given takeover such that there will be a difference between the value the winning bidder expects to derive from acquiring the target and the value the second-highest bidder expects to derive. The acquirer in any given takeover can expect gains if it has adjusted properly for the tendency to overbid (the "winner's curse," see the discussion of the hubris hypothesis in note 43). However, the question for the searcher is what the expected gain from engaging in search will be. The expected gain from engaging in search may be lower where the gains from takeovers are due to undervaluations since the searcher will know that on average it will not value the target any more highly than other bidders and will thus not have gains as great as would be the case where it could derive a higher synergistic or other gain from acquiring a target than could other bidders.

¹¹¹ See note 101.

¹¹² See note 103.

(ii) Tax and market power motives

It has been argued that "these social costs reflect policy determinations better dealt with by adjusting tax and antitrust law than by modifying the laws concerning tender offers."¹¹³ In Canada, the recently enacted *Competition Act*, with its efficiency defence for mergers, attempts to deal with the market power motivation within the context of competition or antitrust law. There is also evidence that the market power motivation accounts for relatively few takeovers.¹¹⁴

(iii) Empire building

The response to this argument is that the evidence strongly supports the inference that takeovers produce real gains.¹¹⁵ The rejoinder to this is that unless the monitoring process is perfect the empire building motive can exist.¹¹⁶

With respect to the empire building claim, the following additional points may warrant consideration. The empire building motive probably has outlets other than takeovers, such as acquisitions of assets and other forms of investment. Increasing takeover premiums would tend to discourage the takeover outlet for an empire building motivation. However, to the extent a premium increase reduces takeover frequency it would tend to reduce the deterrent effect of takeovers on other forms of empire building.¹¹⁷ Where the balance lies depends on: the effect of increasing takeover premiums on the frequency of takeovers; and on the deterrent effect of takeovers on empire building. It would also depend on the significance of takeovers as a method of empire building relative to other methods, since increasing takeover premiums would only reduce the takeover method of empire building. Even if the balance lies in favour of increasing the takeover premium, it may be preferable to find a more

¹¹³ *Ibid.* at 10, note 22.

¹¹⁴ Some evidence that market power gains do not generally account for horizontal mergers has been provided by B.E. Eckbo, "Horizontal Mergers, Collusion, and Stockholder Wealth" (1983) 11 *J. Fin. Econ.* 241. However, the evidence was inconclusive. (See the discussion by P. Halpern, "Corporate Acquisitions: A Theory of Special Cases? A Review of Event Studies Applied to Acquisitions" (1983) 33 *J. Fin.* 297.) A more recent study by professor Eckbo provides stronger evidence that most mergers are not motivated by market power gains. (See B.E. Eckbo, "Mergers and the Market Concentration Doctrine: Evidence from the Capital Market" (1985) 58 *J. Bus.* 325.)

¹¹⁵ *Ibid.* at 11.

¹¹⁶ Bebchuk II, *supra*, note 1 at 37.

¹¹⁷ Since empire building by whatever method is indicative of inefficient management that will be monitored by the takeover threat, any reduction in the takeover threat will reduce the degree of monitoring of empire building.

precisely targeted solution to empire building than a premium increase which may deter other socially beneficial takeovers.¹¹⁸

The reasons given for private gains exceeding social gains suggest that some method of reducing the private gains should be employed. With respect to the tax and market power motives, a more specific method of reducing private gains is preferable to an auction regime which could deter other beneficial takeovers. The empire building and undervaluation motivations appear to be of little significance and may well be more effectively controlled by the discipline of the securities market or by techniques other than auctions.¹¹⁹ Consequently, the argument that private gains exceed social gains does not lead to the conclusion that auctions are necessary.

(b) *Other welfare effects*

It has been argued that promoting competitive bidding in takeovers has a number of effects that are beneficial from a social welfare perspective.

(i) Auctions move assets to their most highly valued uses

Promoting auctions in takeovers will increase the likelihood that the target will be acquired by the firm to which it is most valuable.¹²⁰ In other words, it encourages the movement of assets to their most highly valued use. Investment bankers receiving fees for the information they provide, which fees, according to the argument, are contingent on the success of the offer, would, with competitive bidding, search for the highest-valuing user.¹²¹ A potential buyer, recognizing it is not the highest-valuing user, will have an incentive to pass the information on to other bidders because competitive bidding will tend to give it a significant premium on the shares it purchases in advance.¹²² If the target's management initiates the acquisition, competitive bidding will reduce the potential for management to seek an acquirer other than the highest-valuing user to serve its own interest.¹²³

¹¹⁸ Empire building may best be controlled by the market. Managers subject to the discipline of an efficient market will have an incentive to reduce empire building to the point it is cost effective to do so. See M. Jensen & W. Meckling, "Agency Costs and the Theory of the Firm" (1976) 3 J. Fin. Eco. 305.

¹¹⁹ For instance, a tax on takeovers could be used to reduce private gains.

¹²⁰ Gilson I, *supra*, note 1 at 872 and Bebchuk I, *supra*, note 1 at 1048.

¹²¹ Bebchuk, *supra*, note 1 at 40.

¹²² *Ibid.*

¹²³ *Ibid.*

The counter argument claims that where there is no competitive bidding, even if the acquirer does not put the assets to their most highly valued use, the assets can either be resold together or can be divided up and sold to firms that can put the assets to their most highly valued use.¹²⁴ It may be that the value of many targets is highest if bundles of their assets are transferred to different firms, in which case competitive bidding would not avoid retransfer.¹²⁵ Indeed, there is empirical evidence showing that when firms divest a portion of their assets, an increase in value generally results.¹²⁶ The costs of competitive bidding may be greater than the transaction costs of retransfers where initial acquisitions are made without an auction.¹²⁷ This is an empirical question which has yet to be resolved.

It has been suggested that an empire building-acquirer management may not want to resell assets acquired through a takeover bid without an auction.¹²⁸ But, this claim seems unlikely when an empire building management prefers size of revenues. Such an empire building management would have an incentive to sell to a higher-valuing user and use the sale proceeds to increase the size and/or revenues of their firm. For instance, if the target's assets are worth \$5 million to an acquiring empire building management but are worth \$6 million to some other firm, then the empire building management could sell the assets for some amount in excess of \$5 million and use the profits to buy more assets to grow to a larger size and generate greater revenue.¹²⁹

Some claims, in the argument that auctions are necessary to allocate the assets of targets to their most highly valued uses, seem dubious. A legal regime encouraging competitive bidding does not seem necessary to give investment bankers and potential buyers an incentive to find and relay information to the highest-valuing user. Even where there is no competitive bidding, fees for the information are liable to be higher when the highest-valuing user is found.¹³⁰ Nonetheless, competitive bidding may be a more effective, less costly way of allocating a target's assets

¹²⁴ Easterbrook & Fischel II, *supra*, note 1 at 14.

¹²⁵ *Ibid.* at 14 and notes 31-32.

¹²⁶ See Hite & Owers, "Security Price Reactions Around Corporate Spin-Off Announcements" (1983) 12 J. Fin. Econ. 409 and K. Schipper & A. Smith, "Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-Offs" (1983) 12 J. Fin. Econ. 437.

¹²⁷ See Easterbrook & Fischel II, *supra*, note 1 at 14 and Schwartz I, *supra*, note 1 at 243.

¹²⁸ See Bebchuk II, *supra*, note 1 at 41-42 and Gilson II, *supra*, note 1 at 63.

¹²⁹ See Schwartz I, *supra*, note 1 at 243.

¹³⁰ See Schwartz I, *supra*, note 1 at 276. Bebchuk however claims that the difference between the value of an investment banker's information to the highest-valuing user and another bidder will be much greater under an auction regime because the other bidder will have little chance of winning an auction and so will be willing to pay much less for the information.

to their most highly-valued use. Consequently, the differences in costs between auctions and retransfers, as well as the degree of reluctance of acquirer managements to resell acquired assets, are important empirical questions to resolve. Auctions may thus be the most efficient way of allocating assets to their most highly-valued use. If this is true, then it would suggest that there should be a mandatory auction regime.

(ii) Auctions encourage initial investment in potential targets

It has also been argued that auctions encourage initial investment in potential targets.¹³¹ The potential gains from the acquisition of a target would not exist if there had not been an initial investment in the corporation that was ultimately identified as a target.¹³² These investments are encouraged when target shareholders are given a larger share of the gains from takeovers through the encouragement of auctions.

It has been noted as well that the argument depends on investors being able to identify targets in advance.¹³³ Even if targets could be identified in advance, why encourage investment in these firms where there is likely an inferior employment of production resources?¹³⁴

It seems unreasonable to encourage investment in an inferior use of resources, as is the case where target management is inefficient. Perhaps the argument for higher premiums to encourage prior investments in targets depends on another takeover motivation, such as the synergy motivation. If a firm producing a synergistic gain cannot be an acquirer in combining with another firm, then perhaps some allocation of gains in takeovers to targets is necessary to encourage initial investment in the target's synergy-producing activity. Again, this would require that the target be identified by investors long in advance of the target being identified by takeover bidders. It would require, with respect to the synergy motivation, that the initial investors identify these potential future gains from the assets when combined with those of another firm. If they can do this then why wouldn't bidders have been able to identify these potential future gains and invest in the assets themselves?

There is, however, an argument that a situation may exist in which shareholders can identify in advance a target likely to produce synergistic gains that acquirers are less likely to produce.¹³⁵ It is claimed that the

¹³¹ Bebchuk I, *supra*, note 1 at 1049.

¹³² *Ibid*.

¹³³ Easterbrook & Fischel II, *supra*, note 1 at 20.

¹³⁴ *Ibid*. See note 76 for a discussion of how an expected premium to target shareholders can lead to an inefficient allocation of assets if potential targets can be identified.

¹³⁵ Such a situation is described in D.W. Leebron, "Games Corporations Play: A Theory of Tender Offers" (1986) 61 N.Y.U.L. Rev. 153 at 210.

optimal firm size for invention is small.¹³⁶ Once a small firm produces an invention it may be better developed by a larger firm. It may also be that the most efficient way to provide for development by a larger firm is to have the larger firm and smaller firm combine.¹³⁷ Larger firms tend to be acquirers more often than smaller firms, implying that the smaller firm is more likely to be a target.¹³⁸ In such a case, shareholders may predict that a firm will be a synergy-producing target and they will have a greater incentive to invest in those firms, if those firms are given takeover gains.

If this and other situations favouring allocations of gains to targets exist, then a target should be allowed to set up a situation where it can reap these gains. This could be done by allowing appropriate pre-takeover amendments to the articles and by-laws of corporations.¹³⁹ It would not require a mandatory takeover bid auction regime, although an enabling statute (allowing a corporation to opt in or out *before* a takeover announcement) could be provided as a transaction cost-reducing mechanism.¹⁴⁰ Even if a situation exists in which firms destined to become targets produce takeover gains, it does not imply that an auction regime provided by mandatory takeover bid legislation is appropriate.

In summary, the claim that auctions are necessary to promote an initial investment in targets is only valid in the rare situation where the target produces synergistic gains and can be identified in advance as a probable target. Even in this situation, the claim does not favour a mandatory auction regime.

(iii) Auctions encourage target managements to search for acquirers

Target management, having incentives to increase the firm's value, it is argued, will search for potential acquirers if some of the gain can be appropriated to the target. Most of the gain will go to acquirers if they can proceed by way of a cash takeover bid at a low premium. This is because the maximum they will pay in a negotiated transaction

¹³⁶ See Leebron, *supra*, note 135 at 210 quoting Gilman & Siczek, "Optimization of Inventivity" (1985) Research Management, July-Aug. 29.

¹³⁷ See Leebron, *supra*, note 135 at 210.

¹³⁸ See Coffee, *supra*, note 1 at 1227, note 248 and see Baldwin & Gorecki, "Mergers and Merger Policy in the Canadian Manufacturing Sector: 1971-79" Economic Council of Canada, Discussion Paper No. 297.

¹³⁹ Leebron, *supra*, note 135 at 217-18 makes an argument along these lines.

¹⁴⁰ Leebron, *supra*, note 135 at 218 claims that an enabling statute would be appropriate.

will be the amount they would have to pay in a cash takeover bid.¹⁴¹ An auction, by raising the premiums expected in an acquisition of the target, increases the gain the target can get in either a negotiated transaction or a takeover bid and thus increases the incentive for target management to look for potential acquirers.¹⁴²

In response, it has been maintained that managers dedicated to shareholder interests would search for acquirers whether or not a takeover bid was announced. Once there is an announced takeover bid, the search may be ill-motivated. A rule requiring a passive target management response to announced takeover bids would only hinder the ill-motivated type of search.¹⁴³

The pro-auction proponents respond that the gains to shareholders from the search for acquirers by dedicated managements would be reduced if takeover premiums to target shareholders were diminished. The reduction in takeover premiums is likely to drastically reduce the target management's search efforts because they value their independence. Target management might, however, engage in search where there are substantial takeover premiums because they may have incentives to increase the firm's value.¹⁴⁴ It seems unlikely that target management would seek acquirers where the takeover is motivated by potential gains from the replacement of inefficient management. If this is the predominant motive for takeovers, then rules allowing target shareholders to get significant takeover premiums are unlikely to encourage search by target managements. Encouraging search by targets seems more appropriate when the takeover is motivated by potential synergistic gains. In this case, managers may have an incentive to undertake the transaction; they may be fortunate enough to remain a part of the resulting enterprise and reap the benefits. Where both potential acquirers and targets can be expected to engage in search, the appropriate allocation of the premium (from the standpoint of encouraging an efficient level of search) would be in favour of the party who can search at least cost.¹⁴⁵

It is not clear, however, that a target management's incentive to search is a function of the premium their shareholders get in the takeover.

¹⁴¹ If target management, in a negotiated takeover, demanded a higher amount than the prospective acquirer would have to pay if it proceeded by way of a cash takeover bid, then the prospective acquirer could be expected to discontinue the negotiations and make a takeover bid. Thus the premium in the cash takeover bid would be the maximum premium the target could demand in a negotiated takeover.

¹⁴² Bebchuk I, *supra*, note 1 at 1049.

¹⁴³ Easterbrook & Fischel II, *supra*, note 1 at 12.

¹⁴⁴ Bebchuk II, *supra*, note 1 at 38-39.

¹⁴⁵ This is noted in Bebchuk III, *supra*, note 1 at 264, note 7.

If they can remain with the combined firm,¹⁴⁶ target management may well reap the benefits of increased firm size and value regardless of the premium target shareholders receive. Thus, the likelihood of target management receiving benefits may be increased where there is more searching and a greater frequency of takeovers. This will be more likely to occur if acquirers get most of the gains from the takeover. Indeed, since target management's search efforts will be more likely to result in a takeover, they may search more if there is a greater frequency of takeovers.

However, even if a target management would have an incentive to search if gains in takeover bids were allocated to the target, it does not mean that a mandatory auction regime should be provided. A target could, under a permissive corporate law regime, put provisions in the corporation's articles prior to any takeover announcement, thereby allowing the target to obtain gains in a takeover. An enabling legislative auction regime could be provided to reduce transactions costs. The target could either design its own auction or adopt the legislative scheme.

(iv) Competitive bidding encourages useful exchanges of information

A further claim is that abandoning competitive bidding will induce bidders to proceed with immediate cash takeover bids rather than approach target management in order to obtain specific information about the target. Bidders would proceed in this way since an immediate cash takeover bid would eliminate the danger that target management will start looking for other potential buyers. This would discourage useful information exchanges and thus increase the risk of value-reducing rather than value-increasing takeovers.¹⁴⁷

The response to this is that it assumes that acquirers are irrational in suggesting that an acquirer is unable to assess when it should make friendly overtures to obtain information. Encouraging competitive bidding simply reduces the acquirer's options and puts the acquirer in an awkward position if friendly overtures are used as a signal for defensive actions.¹⁴⁸

This response is said to ignore the perspective of social wealth. From this perspective, it is desirable to reduce the risk of error, but a prospective

¹⁴⁶ It may be difficult for target management to remain part of the combined entity. Even where a takeover is not motivated by a desire to replace inefficient management, some management position may become redundant if the acquirer and the target are combined. A study cited by Coffee, *supra*, note 1 at 1239, note 281 found that on average 20% of a target's executives are gone within one year of a takeover, 36% are gone within two years, and 52% are gone within three years.

¹⁴⁷ Bebchuk I, *supra*, note 1 at 1050.

¹⁴⁸ Easterbrook & Fischel II, *supra*, note 1 at 13.

acquirer considers not only the risk of error but also the premium it will pay.¹⁴⁹ This might be further explained as follows. Suppose target management has non-public information relevant to determining the value of the target. Suppose this information would reduce the risk associated with a given estimate of the value of the target. Suppose further that the acquirers and investors in the market who will assess the value of the acquisition are risk averse. It is neither to the benefit of acquirers or society to have the acquisition proceed without the use of the information, nor to have the information wastefully reproduced by the acquirer. However, if legal rules do not promote competitive bidding, approaching target management to get information may encourage competitive bidding which would not have occurred otherwise. This may increase the takeover premium to the point where the risk reduction will not compensate for the reduced potential takeover gain accruing to the acquirer. The acquirer may thus choose not to approach target management for the information. If competitive bidding was already provided for, such that it would occur whether or not the acquirer approached the target, little or nothing would be lost by approaching target management.

The information exchange argument may have relevance where the takeover will not replace an entrenched target management. However, where the takeover is likely to result in the replacement of target management, target management, wishing to retain their management positions, will have an incentive not to release the information even if it will significantly increase the premium target shareholders would receive. Thus, the argument appears to have little relevance where the takeover is motivated by the gains from replacing inefficient management.

(c) *A summary of the social welfare perspective*

The search for takeover targets may be excessive where it is motivated by an undervaluation, tax or market power gains, or empire building. However, the tax and market power gains should be dealt with under other legislation which addresses those issues more specifically, and the undervaluation and empire building motives are probably insignificant and may not be best dealt with by intervening with a mandatory auction regime. The other welfare effects of auctions (with the possible exception of the claim that auctions will best move assets to their most highly-valued use) are doubtful sources of welfare gains. Where situations exist

¹⁴⁹ Bebchuk II, *supra*, note 1 at 44-45.

in which such gains are possible, the gains could be achieved without a mandatory auction regime.

C. *Other Diseconomies of Increasing the Frequency of Takeovers*

Professor Coffee notes other diseconomies that may occur or be exacerbated by an increase in the frequency of takeovers.¹⁵⁰

1. Empire building — inefficient transfers

(a) *The incentive for inefficient firms to take over efficient firms*

Coffee argues that there is a diseconomy from the potential for an inefficient bidder to acquire an efficient target for reasons that are in the best interests of the bidder's shareholders. Two stories are given as to how this might occur. Firstly, a corporation might improve its below average performance by acquiring a more efficient corporation. Small corporations have been found to be systematically undervalued (the "small firm effect"). A large corporation might improve its return by acquiring a small corporation. Secondly, the bidder may acquire a relatively large target that has a higher internal rate of return than the bidder.¹⁵¹

The first claim proceeds without an explanation of the small firm effect. An undervaluation of small firms does not necessarily mean they are more efficient. Indeed, other explanations for the small firm effect aside, if a small firm is more efficient and the market realizes this, then it will not be undervalued. The small firm effect is unlikely to arise because of its efficiency. For instance, it may be due to a liquidity effect; the small firm would have to provide higher returns to compensate for the difficulty of selling the firm's shares. It may also be due to the statistical problems involved in analyzing stock prices in thinly-traded markets.¹⁵² If there is an efficiency in smallness, then it will not behave a large firm to acquire the small firm and combine the two into a single firm. This would eliminate the potential gain from the smallness of the target. If the acquirer wanted the gain, it would simply hold the small firm's shares as an equity investment allowing it to operate as it had before with no reduction in the efficiency of the use of the underlying assets. In short, it seems highly unlikely that an inefficient large firm would

¹⁵⁰ Coffee, *supra*, note 1.

¹⁵¹ *Ibid.* at 1225-29.

¹⁵² These and other explanations are reviewed in G.W. Schwert, "Size and Stock Returns, and Other Empirical Regularities" (1983) 12 J. Fin. Econ. 3.

take over a small firm and make changes which would result in a net reduction in the sum of the values of the two firms.

The claim that an acquirer may have a lower rate of return than a target suggests that an acquirer can obtain a private gain from taking over the target that is greater than the social gain. Indeed, there is apparently a social loss since the acquirer's lower rate of return supposedly suggests it is less efficient. Coffee notes one study comparing returns on equity which found that returns on equity of targets were no lower than that of the bidders in all of eleven cases studied.¹⁵³ Coffee also notes another study in which in 19 of 41 cases studied in Britain from 1967 to 1970, the acquired firm was more profitable than the acquirer.¹⁵⁴ These studies were based on accounting data and do not take risk into account in the relative profitability or returns on equity. To be able to say anything based on a comparison of returns on equity, the risk would have to be held constant. If the target's return on the market value of equity is greater than the acquirer's for a given level of risk, then either the acquirer is overvalued, or the target is undervalued. If, for a given level of risk, the acquirer is overvalued and the target is correctly valued (in which case the return on the acquirer's shares will be lower than on the target's shares), there is no gain to the acquirer's shareholders from the acquisition unless there is some wealth-creating gain such as synergy or the replacement of inefficient management. These results would also be a social gain. If the target is undervalued, then the argument is reduced to the one discussed above concerning takeovers being motivated by undervaluation.¹⁵⁵

In short, the only explanation for an inefficient firm to take over an efficient firm is that the acquirer's management are engaging in empire building. Thus, the theory is the same as the one dealing with empire building discussed above.¹⁵⁶

(b) *Inferior external monitoring*

According to Coffee, internal monitoring will generally outperform external monitoring. His argument proceeds as follows. Generally, a corporate executive staff no longer makes operating decisions but instead has primarily a monitoring function that, in effect, performs the function of a miniature capital market. An attempt to replace this development with a capital market discipline seems to be a step backward.¹⁵⁷

¹⁵³ Coffee, *supra*, note 1 at 1227.

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*, see Part II B(2)(a).

¹⁵⁶ *Ibid.*, see Part II B(2)(a).

¹⁵⁷ *Ibid.* at 1230.

Coffee claims there is also potential for an ineffective transfer due to the acquirer making an acquisition based on information that is inferior to the information of target management. The premium offered by the bidder is based on the bidder's sole judgment rather than the collective judgment of the market which is presumably capable of digesting more information than any single decision maker. Competitive bidding requires a higher bid which would indicate considerable confidence in the bidder's judgment and would tend to reduce erroneous judgments.¹⁵⁸ Competitive bidding will tend to lead to a white knight, with considerably more information, winning the bidding contest.¹⁵⁹ Management are not infallible and will inevitably make errors even if they are otherwise efficient. An error which lowers the stock price may cause the management to be unnecessarily replaced. This risk would be reduced under a high takeover premium policy.¹⁶⁰

The argument that corporate executive staffs perform the function of an internal miniature capital market (which is apparently more efficient given the development of these internal miniature capital markets) is used to argue that the market which led to the development of these internal miniature capital markets should be precluded from reversing its decision in cases where the internal monitor performs poorly. The agency cost problem plagues the relationship between the internal monitor and those they monitor just as it plagues the relationship between the shareholders and the internal monitor. If a bidder can do a better monitoring job than the current internal monitors and can provide a net reduction in agency costs, then it will provide a social gain. In short, why not let the external capital market decide when it can do better than the internal monitors.

Perhaps, as Coffee argues, bidders in the external capital market will have inferior information to that of target management (the internal monitors). Bidders may make errors with their inferior information. This argument assumes that targets will not release their better information to the market. It might well be beneficial to society to have the information released. However, when this will not happen, such as when an inefficient target management refuses to release information that will assist in a takeover that replaces them, then, from a social welfare point of view, the takeover will have to be assessed on the trade-off between risk and return without the information. Given that the information will not be produced, Coffee's analysis does not show that the trade-off between

¹⁵⁸ *Ibid.* at 1231-32.

¹⁵⁹ *Ibid.* at 1233.

¹⁶⁰ *Ibid.* at 1233-34.

risk and return for a bidder differs from the social welfare-maximizing risk-return trade-off. Markets are not perfect. Mistakes in exchanges are made and are apparent with hindsight even though the decision was rational *ex ante*. The argument that higher premiums would make bidders more sure of their decisions would seem to apply to all markets where there is less than perfect information. It suggests that all prices should be raised to reduce the risk of error. The argument seems to be no different than the information exchange argument raised above.¹⁶¹

2. The impact on the managerial labour market

Coffee argues that increased compensation will be required in light of the reduced security caused by the increased takeover frequency that can result from a low premium policy. The insecurity will be significant where a firm has become a potential target and the increased compensation required will make it difficult for potential targets to rehabilitate themselves by acquiring new managers. There might also be a migration of existing managers to less vulnerable firms. Thus, increasing the effectiveness of the market for corporate control impairs the efficiency of the executive labour market. The labour market is likely to be a superior control over management inefficiency since it has lower transactions costs and less potential for resort to "shark repellent" techniques and since incumbent management is less likely to oppose this control.¹⁶²

The claim that additional compensation will have to be given to attract new managers and prevent existing managers from leaving requires that the labour market be capable of identifying which firms are potential targets. This is an empirical question. If potential targets can be identified by the labour market, then there remains the empirical question of the significance of the compensation demanded for insecurity and the degree to which managers will migrate to less vulnerable firms. Even if empirical evidence supports the claim, it can only cause an allocative inefficiency in the takeover process if the costs are external to that process. It is not clear that the costs of added insecurity to those who are or could be target managers are really costs externalized in the takeover process. Although these costs are not incurred by bidders, they are costs which are internal to managing inefficiently. If management is inefficient then

¹⁶¹ *Ibid.*, see Part II B(2)(b)(iv).

¹⁶² *Ibid.* at 1234-38.

it will incur these additional compensation costs.¹⁶³ This will deter management from being inefficient. This deterrence from the threat of takeover is one of the benefits of encouraging takeovers.

Perhaps Professor Coffee's claim is that the nature of human behaviour is such that this deterrence will be excessive in that it will put too much pressure on the management of firms causing them to perform less efficiently than they otherwise would.¹⁶⁴ Although bidders will not consider this alleged cost in any given takeover because it will be spread over all firms, it is a cost that will be faced by the managements and shareholders of firms. It will be in the interests of both shareholders and management to attempt to correct for this in the most efficient manner.¹⁶⁵ This might involve higher compensation or "shark repellent" corporate charter amendments or some combination of these and possibly other techniques. To argue that this problem should be dealt with by raising premiums through takeover bid regulation requires that this be shown to be a more effective or lower cost way of dealing with the alleged problem than can be arrived at by techniques adopted by managers and shareholders.

If insecurity is the problem, then it is unlikely that resort to the labour market, to the extent that it involves the replacement of inefficient management, will resolve the problem in a manner that incumbent management is less likely to oppose.

3. Excess deterrence and the problem of demoralization

(a) *Assimilation problems*

Coffee claims that employees leave firms at a high rate in the event of takeovers. It is hard to replace departed executives and differences in operating styles and assimilation problems decrease efficiency.¹⁶⁶ Coffee says, "[t]he rebuttal of the neoclassical economist to these contentions is predictable: if assimilation problems were indeed serious, the stock market would penalize bidders that attempted unpromising acquisitions."¹⁶⁷ He says there is no evidence that this is happening because:

¹⁶³ In efficient capital markets security prices will be discounted for the presence of agency costs in the management-shareholder relationship and thus the management of the security issuing firm will have an incentive to reduce these costs; see Jensen and Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305.

¹⁶⁴ This is noted by Coffee, *supra*, note 1 at 1238.

¹⁶⁵ See note 163.

¹⁶⁶ Coffee, *supra*, note 1 at 1238-43.

¹⁶⁷ *Ibid.* at 1241.

- (1) the market for corporate control is a competitive one in which white knights, who presumably experience fewer assimilation difficulties, typically win battles for corporate control;¹⁶⁸ and
- (2) bidders anticipating assimilation problems buy cash-laden companies where human capital is a less important factor.¹⁶⁹

The claim that those with fewer assimilation difficulties typically win battles for corporate control supports the predicted neoclassical economists' rebuttal. Those with fewer assimilation difficulties may typically win because the market values such acquisitions more highly. However, to the extent that legal rules permit target management to provide a "white knight"¹⁷⁰ with information giving them a competitive advantage in a bidding contest in exchange for protection or compensation of an entrenched inefficient management, it is clearly not beneficial.

Assuming that bidders focus on cash-laden companies and thereby avoid a human capital problem, they then appear to support the neoclassical economists' position. The focus on cash-laden companies is driven by the bidders' knowledge that the stock market would penalize them if they attempted unpromising acquisitions involving a human capital problem. It may thus be that the market response is currently controlling attempts at unpromising acquisitions.

(b) *An incentive for shirking and self-dealing*

Coffee further claims that once a takeover is imminent, there is a strong incentive on target management to shirk and engage in self-dealing. The problem is more pervasive under a low takeover premium policy.¹⁷¹

Consider the case where the takeover is imminent but no takeover bid has been made. The costs of self-dealing and shirking may be encouraged by an imminent takeover where management is likely to be replaced but the costs are a result, in the first instance, of management being inefficient. In efficient capital markets, these costs will be anticipated and will be borne by management. The costs will thus be a deterrent to inefficient behaviour by management.

Where shirking and self-dealing occurs after a takeover bid is made, the absence of takeover bid rules that delay the takeover will be beneficial. The short takeover bid period (where there are no takeover bid rules

¹⁶⁸ *Ibid.*

¹⁶⁹ *Ibid.*

¹⁷⁰ See note 38.

¹⁷¹ Coffee, *supra*, note 1 at 1242.

delaying the bid) will reduce the time over which this kind of detrimental behaviour will occur.

(c) *The shift toward risk preference*

(i) Debt and liquidity risk

Coffee argues that targets will engage in takeovers that reduce liquidity (by which Professor Coffee apparently means a reduction in working capital, particularly cash and marketable securities) and increase indebtedness to avoid being taken over themselves. The reduced liquidity and increased indebtedness augment risk and this risk increase is exacerbated by lower takeover premiums which would encourage such takeovers.¹⁷²

There may well be a point at which, or a range over which, the level of debt and the amount of working capital are optimal. Adding debt can increase the tax savings from the tax deduction of interest. These benefits will be constrained by the added risk of incurring bankruptcy costs. Adding to the level of debt may also reduce agency costs.¹⁷³ Working capital, in the form of accounts receivable, cash, and marketable securities, is said to be, at best, a zero net present value investment. Thus, the less working capital one has to have, the better. Again, the risk of incurring bankruptcy costs may be a problem with too little working capital, and having working capital reduces the transaction costs of raising interim financing. Thus, the level of working capital should be kept as low as possible while taking into account these costs.

There are, therefore, gains from increasing debt and reducing-working capital. Shareholders can benefit from these gains and deal with any added risk by adjusting their investment portfolios. Management, however, will tend to have a great deal of their income-generating capacity tied up in the enterprise they manage. They will thus be less able to adjust to the added risk of increased debt and reduced-working capital. Instead, they will avoid the risk, contrary to the interests of shareholders, by not increasing debt and reducing working capital. This will make the corporation less valuable in the market. An outsider may perceive that by buying the corporation, increasing the debt, and reducing the

¹⁷² *Ibid.* at 1243-44.

¹⁷³ The tax deductibility of debt gives an increased return from adding debt. Liquid assets can generally be argued to be, at best, zero net present value investments such that they should be reduced. The increase in debt and reduction in liquidity is, however, constrained by the increase in expected bankruptcy costs.

working capital, it can increase the value of the corporation, thus providing the outsider with a gain. This takeover threat, rather than cause too much debt and too little working capital, puts pressure on management to have an amount of debt and working capital more in accord with shareholders' interests.

(ii) Detriment to creditors

Coffee also argues that bidders will increase their riskiness by engaging in heavily debt-financed takeovers to the detriment of existing creditors. Because the hostile takeover bid is for cash, it provides a unique opportunity for taking advantage of existing creditors which is not offered by equity-financed mergers. Although large creditors can protect themselves, employees, suppliers, pensioners, and lower level managers cannot.¹⁷⁴

It is not clear that just because a hostile takeover bid is typically for cash, it is unique. Presumably, a merger or any other acquisition could be made with cash and be entirely debt-financed. The problem is thus a general problem that does not call for the isolated response of increasing premiums in takeover bids. Further, small creditors may well be protected by the need for the firm to make subsequent arrangements with the same or other small creditors who will make adjustments based on the firm's previous behaviour, resulting in reduced extension of credit or in higher interest rates on the credit advanced. This will lessen the firm's incentive to take advantage of existing creditors.

Unless employees and low level managers have significant outstanding amounts owing to them, it is unlikely that heavy debt-financing will cause them much of a loss. To the extent it does, it will have repercussions with respect to hiring new employees and management and retaining existing employees and management because they will demand greater compensation in light of the higher risk of non-payment. This will result in similar compensation cost repercussions to the extent that taking on added debt reduces the expected value of pension claims.

IV. CONCLUSION

Economic analyses of legal rules relating to takeovers have argued that takeover-bid legislation and permitted management defensive tactics interfere with beneficial takeovers by encouraging competitive bidding. Arguments, however, have been made in favour of such competitive bidding. It has been disputed that the interference is not great, firstly,

¹⁷⁴ See discussion in Coffee, *supra*, note 1.

because bidders get adequate returns and, secondly, because higher premiums may increase the returns to searching for targets whereas lowered premiums may reduce *ex ante* target shareholder wealth. Further, it has been argued that a number of motivations for takeovers lead to private, but not social gains, and that the absence of competitive bidding both reduces the likelihood that assets will be allocated to their most highly-valued use and discourages prior investments in targets, search for acquirers by targets, and useful information exchanges. Assertions have also been made that a low takeover premium policy will lead to inefficient transfers, interference with the managerial labour market's ability to respond to managerial inefficiency, excess deterrence and demoralization of management, and a shift towards unduly risky takeovers.

Given the above-noted responses and comments concerning the arguments in favour of competitive bidding, it is apparent that the most important outstanding issues in the debate are the magnitude of the problem, and the likelihood and cost of allocating assets to the most highly-valued uses through competitive bidding as opposed to transfers. Consequently, empirical work needs to be done to assess the effect of takeovers on management inefficiency. This would allow an assessment of the cost of trade-offs in favour of, for instance, encouraging competitive bidding to allocate assets to their most highly-valued use. Empirical work also needs to be done to assess the likelihood and cost of allocating assets to their most highly-valued use through competitive bidding as opposed to retransfers. Hopefully, further empirical work will shed new light on these outstanding issues.

With the exception of the claim that auctions are necessary to allocate assets to their most highly-valued use, none of the arguments in favour of competitive bidding lead to the conclusion that a mandatory auction regime is required. The benefits of auctions, to the extent they exist, can be achieved with legislation that allows targets or information producers to opt out of the scheme in favour of one more beneficial to their needs.

