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# CORPORATE CONTROL, ECONOMIC EFFICIENCY AND SHAREHOLDER JUSTICE

CENTRE 2000
303/40 MILLER STREET
NTH SYDNEY 2060
PH. 929 0423 – 92 1863

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# CORPORATE CONTROL, ECONOMIC EFFICIENCY AND SHAREHOLDER JUSTICE

Peter Dodd
and
R.R. Officer

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# The Authors

**Peter Dodd** has been Associate Professor of Management and Director of the Centre for Research in Finance at the Australian Graduate School of Management, University of New South Wales, since 1984. Before that he was Professor of Finance and Accounting at the University of Chicago and has taught at the Universities of New South Wales, Queensland and Rochester. His research and consulting interests cover a broad area of financial management with particular focus on takeovers.

**Robert Officer** is Professor of Finance at the Graduate School of Management, University of Melbourne. For ten years he was Professor of Accounting and Finance at Monash University and has also held academic appointments at the Universities of New England and Queensland. He is President of the Accounting Association of Australia and New Zealand and a member of the Federal Government's Industrial Property Advisory Committee. His research interests include takeovers, taxation, foreign exchange management and theories of regulation and control.

# Foreword

'Almost every week these last few years there has been a report of another 'hostile takeover bid', another stock market manoeuvre to take over, merge, or split up an existing publicly-held company against determined opposition by the company's board of directors and management . . . The new wave of hostile takeovers has already profoundly altered the contours and landmarks of the American economy. It has become a dominant force — many would say **the** dominant force — in the behaviour and actions of American management, and, almost certainly, a major factor in the erosion of American competitive and technological leadership.'

Thus writes Peter F. Drucker in a recent issue of *The Public Interest* (Winter 1986:3-24). The alarmist, not to say hysterical, note continues throughout the article. That a normally sober journal should lead with such an emotional piece is suggestive of the depth of passions aroused by the takeover issue in the United States. Nor are we Australians strangers to these passions, if we are to judge by reactions to the current takeover contest for BHP.

Drucker claims, *inter alia*, that the threat of takeover induces firms to sacrifice long-run profits for short-run performance; that the disruption of going concerns adversely affects other groups even if it benefits shareholders; that, indeed, corporations have broader responsibilities than simply to keep their shareholders happy; and that an unstable, performance-oriented, finance-dominated corporate sector will lose public support, and the firms comprising it will lack legitimacy.

Professors Dodd and Officer in the present study take a much more relaxed attitude to corporate takeovers. As theorists of economics and finance, they see takeovers in a broader perspective than most commentators. They see active competition for corporate control, via the takeover bid, as an essential means of promoting economic efficiency in the corporate sector. Such a view encompasses the popular social justification of the takeover — viz. that its threat checks any tendency by management to act in ways that are contrary to the interests of shareholders — but only as an extreme case: takeovers may replace good managements by better, not just bad by good. More generally, takeovers exploit complementary or synergistic relationships between corporate entities. The takeover is a form of investment, similar to any other, similarly motivated, and analysable in similar terms. Firms might therefore be expected to pursue expansion by takeover, merger, and/or by

internal expenditure, depending on circumstances. This perception of the finance expert is to be contrasted with that of traditional management, which tends to see the takeover as an unusual and unwelcome distraction from the 'real business' of running the company.

The present study is part of a larger CIS involvement in research on corporate takeovers. An empirical study of the effects of takeovers in Australia is being undertaken by Professors Dodd and Officer. A third volume on the legal aspects of takeovers, written by Professors Dodd and Officer along with Professor Robert Baxt, will be completed later this year. Finally, a volume of papers from two conferences organised by the CIS on takeovers, one in Sydney and one in Auckland, will complete the series. The present study is intended to provide a general theoretical background for the more detailed studies that will follow it.

**Ross Parish**

# Preface and Acknowledgments

This is the first of three planned studies of takeovers. In this volume we set out the theory of the role of takeovers in promoting economic efficiency.

The second study is an empirical analysis of takeovers. It provides a broad range of statistical analyses of the takeover phenomenon in Australia as well as evidence of the effect of takeovers on shareholders.

The final study is being conducted with Professor Robert Baxt. It will examine the history of takeover legislation in Australia including an appraisal of the current law. It will conclude with suggested amendments and perhaps substantial changes to the existing legislative framework.

A number of people have helped in the preparation of this volume. Colleagues at Monash, Melbourne and NSW Universities have contributed by way of discussions and specific comments on earlier drafts. We want particularly to acknowledge the assistance of Robert Baxt, Steve Bishop, John Coleman, Leigh Marrit and Ross Parish, although this is not to imply their complete agreement with the ideas and arguments presented in the study.

# CORPORATE CONTROL, ECONOMIC EFFICIENCY AND SHAREHOLDER JUSTICE

Peter Dodd and R.R. Officer

## I. THE IMPORTANCE OF COMPETITION

Any casual reference to the popular financial press will reveal an active market for the control of public companies, particularly listed companies. Headlines regularly announce proposals for corporate mergers and acquisitions. Takeovers have become a widespread and much-publicised means of changing the control of companies; moreover, larger and larger companies are being targeted for takeover.

The existence of a well-functioning market for transferring the control of corporations has important economic implications. To many casual observers, and no doubt to most incumbent managers whose jobs may be threatened by such developments, the wave of corporate acquisitions may seem to reflect a spectacle of managerial empire-building in which shareholders' interests are routinely sacrificed to management intent on enlarging its own corporate domain and influence. Further, the boards of directors of target companies usually view takeover challenges as an unwelcome and unjustified nuisance, interfering with their efforts to run the

company. To them, the takeover offer is divisive and hinders the operating activities of the company. However, despite these fears (which may be justified in some circumstances), the market for corporate control provides the mechanism by which company assets can be channelled to those who are most efficient in using them. This, in turn, contributes to the health and efficiency of the economy as a whole.

Clearly, a change in corporate control through a takeover is not the only mechanism by which resources are allocated more efficiently within the economy. There are many others and, on balance, it may be that takeovers are much less important than these other mechanisms. But in company circumstances where there is an entrenched management with a diverse shareholding, a takeover or the threat of a takeover may be the only way to persuade management to act in the interests of shareholders. It would be a mistake, however, to believe that the justification or reason for most takeovers is that the incumbent management is not acting in the interests of the shareholders.

The trading of assets in free and competitive markets allows assets to be placed with those who can most effectively use them. Those who can utilise an asset more effectively than its current owners can afford to pay more for it than it is worth to the current owners. Where management is unable to extract the most out of assets and inhibits their transfer to those who can, a takeover or a transfer of corporate control may be necessary to ensure that the assets finish up yielding their potential.

The importance of competition in capital markets, to ensure a 'better' (optimum) allocation of resources, is paramount to the analysis contained in this paper. Reliance on competition has its critics: for example, those who believe it is naive to assume that competitive capital markets are sufficient to rectify the ills of mismanagement, and those who believe that capital market behaviour is not consistent with the competitive model.

Competition is an elusive concept. It is naive to expect that markets always and immediately adjust to remove bias or other forms of resource misallocation. However, the opportunities for profit that arise when resources are misallocated — because of poor management, or misleading information, or a lack of information, or for whatever reason — give us confidence that in general competitive markets will operate to the general benefit. Those who argue otherwise must identify what is limiting or preventing competition and suggest remedies. It is not sufficient to say that,

because all the factors associated with an idealised view of competition are not present, the markets are not competitive.

Frequently, critics of the idea that competition ensures greater efficiency of companies and the resources they control point to the high cost of information as an impediment to a competitive market. Information is not a free good, and it is a mistake to believe that imperfect information negates the relationship between a competitive market and economic efficiency. Competition can be and usually is still present and effective when the market is not fully informed. With hindsight we can always point to errors in judgment or other problems that led to an imperfect result. However, the process of competition will penalise those responsible and open profit opportunities for those who have learned from the errors in subsequent decisions.

Proposals to remedy market imperfections usually involve regulation by government or its agents, and they usually create problems at least as great as those that were used to prove a breakdown in the competitive process. Our analysis of the importance of competition in the market for corporate control elaborates on these and related issues.

Takeovers can curb the self-interest of those managers who would prefer to pursue private goals at the expense of their shareholders. In these circumstances, the existence of an active market for control of corporations is perhaps the best reply to those who hold the popular belief that management acts independently and against the interests of its shareholders. Criticism of the separation of ownership and control in the modern company is usually based on the perception that the self-interest of management is in conflict with shareholders' interests. The mechanism of takeovers limits any conflict of interest between management and shareholders.

A market for corporate control contributes to the general economic welfare by providing the opportunity for firms to combine to form more efficient and more profitable entities. Whether it is through economies of scale, improving access to capital markets, combinations of complementary resources, or any of the other value-creating strategies that generally come under the term 'synergies', mergers and takeovers offer the probability of gains to stockholders of both acquired and acquiring firms, and in so doing increase the wealth of society as a whole. A market for corporate control also provides a self-regulating, monitoring mechanism which ensures that the interests of management cannot diverge too far from those of its shareholders.

## II. THE ECONOMICS OF THE MARKET FOR CORPORATE CONTROL

### Separation of Ownership and Control

The control of a corporation can be a nebulous thing: it does not require a shareholding greater than 50 per cent. In the limit, with a very diverse and perhaps uninterested group of shareholders, management may be effectively in control without owning any shares in the company. There is a long-standing debate in law and economics about the roles of management and shareholders in controlling public companies. Critics of unfettered corporate enterprise, like John Kenneth Galbraith, have leveraged the premise of 'separate ownership and control' into the claim that the form of the public company effectively confers absolute decision-making power on corporate managers, insulating them from more responsibility to shareholders.

Critics of the 'separation of ownership and control' in modern public companies correctly point out that the form of the corporation has changed a great deal since the 18th century 'joint stock companies' described by Adam Smith. The 19th century saw a rapid growth in the number of companies, but these were mostly closely held concerns, organised around and financed by a single entrepreneur or a small group of private investors who in turn managed the companies. When 'insiders' hold a large fraction of the outstanding shares (issued capital) of a company, ownership and control are effectively united, thus ensuring a strong common interest between management and shareholders.

Even today there are still many companies (in numerical terms, most companies) owned and managed by one individual or group of investors, who dictates the policies of the organisation. However, for most large public companies, the proportion of shares owned by management or insiders is small, and establishing who ultimately controls the company may be far from straightforward.

Beginning with the well-publicised arguments of Berle and Means (1932), many commentators have leapt from the observation that management holds only a small proportion of shares but controls the operations of a company, to the conclusion that shareholders are at the mercy of management. From such a conclusion it is but a short step to a prescription that corporate activities should be regulated in the interests of shareholders.

Both the conclusion and the prescription are wrong, but the most

glaring inadequacy of the reasoning is the failure to consider why public companies have survived, indeed prevailed, as a form of business organisation. Meckling and Jensen (1983) in 'Reflections on the Corporation as a Social Invention', observe that:

> Critics of the corporation are confronted by a striking historical phenomenon not readily reconciled with their views. The corporation has come to dominate production and commerce, not only in the United States, but in all of the world's highly developed nations. If the corporation is such an ineffective institution, how do we explain its chronicle of success? Freedom to choose among organisational forms provides an 'organisational' test of survival just as markets provide a survival test for individual firms . . . The organisational forms that survive and prosper will be those that satisfy consumer demands at lowest cost.
>
> Wherever competition amongst organisational forms is open and unfettered, the large corporation has demonstrated its strength and durability.

In proposing various forms of government control of the corporation, critics of 'big business' almost invariably ignore the cost of such intervention, including the cost of changing long-established institutional arrangements. These costs come in the form both of reduced economic efficiency, and of the direct costs of regulation, which include both the government's cost and the companies' compliance costs. Critics of public companies tend to ignore or overlook the importance of the effect of market pressures, which encourage organisations to evolve in the way that is most likely to satisfy the demands of the market at least cost. Companies that do not keep pace with economic evolution will fail, and conversely, the success of the corporate form indicates its stability and flexibility in responding to a variety of pressures for change.

## The Interests of Shareholders

Traditionally the company is viewed as a collection of assets owned by a group of shareholders. In fact, the large modern public company is an elaborate legal fiction, a complicated network of contracts binding a number of different parties to the production activities of the firm. Jensen and Meckling (1976) outline a structure

for interpreting the activities of the corporation in the context of management acting as an agent for the various parties involved in the company's production activities.

Shareholders are suppliers of risk capital. They contract to be residual claimants to the income and the assets of the company; that is, they receive income only after other inputs or factors of production, including other providers of capital, have been compensated or, in the event of the company being wound up, shareholders receive the remaining value of the assets after all creditor claims to the company have been met. Ultimately, the main concern of shareholders is that they receive the highest possible return, either in the form of income or in accretion of their share values, that is possible for the risk class of their investments. This means that their concern is with the efficient allocation of inputs so that, once the contractual obligations of the company are met to providers of factors of production, including debt capital, they (the shareholders) will be compensated with the greatest possible return.

The concern of individual shareholders with their returns does not necessarily involve them in the operations of the company, and in most modern corporations shareholders are not directly concerned with these operations. The ultimate device for monitoring how effectively the firm is utilising its resources is the return shareholders receive. Corporate decision making, then, is primarily the province of the professional managers hired to run the company. The development in the modern public company of a professional management class, in contrast to the owner-operator type of management, has occurred because companies can earn greater returns under professional managers than they can relying on directions from shareholders for day-to-day operations. The separation of share ownership from decision-making control is therefore a positive step in the evolution of the modern public company, resulting in greater economic efficiency and therefore greater returns to investors.

However, while we would argue that it is generally more efficient to have large companies run by professional managers than by shareholders, we would also maintain that the parties affected by management's decisions should have some protection. As a general rule, the most effective method of protection is to allow these other parties to freely contract with the management to ensure their interests are protected. With any failure to reach the contractual agreement either of the parties is free to remove its interest or investments in the company. The parties we have in mind are groups

such as employees, creditors of various types, and the providers of other factors of production, including capital, necessary for the firm to operate. The protection of groups that may be affected by the corporation's decisions but do not have direct involvement or interest in the corporation is discussed in a later section.

The board of directors of a company is ultimately responsible for ensuring that the management of that company acts in the interests of shareholders. In addition, explicit contracts or contracts implied under the *Companies Act* bind shareholders and management to act in certain ways. Other interested parties, such as employees and suppliers, are also protected by explicit contracts or implicitly through the legal, social and economic environment in which companies operate. Even though the parties may not have explicit contracts with each other, they know that in order to carry out their services or interact they must create a certain legal environment. If they are not happy to act within that legal environment then they have the option of not providing the goods or services. (Note that the legal environment of the *Companies Act* facilitates these transactions by offering a standard contract that the parties can rely on in place of repetitive and costly negotiations.) The level of protection provided by the contract, implicit or explicit, significantly affects the price at which different parties are prepared to offer their services. In the case of employees, it is the level, form and certainty of compensation that induces them to commit their 'human capital' to the firm. In the case of shareholders, the level of protection is reflected in the price they are prepared to pay for shares issued by the company.

## Management's Responsibilities to Shareholders

One of the by-products of the separation of share ownership and management is that often management has to provide the initiative for 'bonding' itself to comply with certain obligations in order to attract shareholders. For example, the independent audit of financial statements, which was common before it was a requirement of company law, is a form of guarantee by the management that the financial records of the company reflect its financial position. The stronger the bonding guarantees that management can provide, the greater the price at which the shares will be issued. It is in the interest of the public company that approaches the capital market for funds to convince the providers of such funds that the obligations implied or set out in prospectuses

for capital will be fulfilled. It will pay companies to find ways to increase investors' confidence in the corporation until the costs of such assurances or guarantees outweigh the benefits.

In addition to specific contractual provisions protecting the interests of the various parties involved in a public company, there are also markets available to which these parties can turn in the event that implied or explicit contractual obligations are not being met by a company. For example, shareholders are protected by the constraints imposed on management by the managerial labour market. Individuals both inside and outside the company compete for management positions, so that the existence of a managerial labour market provides managers with a powerful incentive to act in the interests of the companies and ultimately the shareholders. The way professional managers signal their value and availability to the managerial labour market is complex and it is rarely on the basis of a single dimension of skill or attribute. The presence of people such as personnel managers, responsible for assessing individuals within and outside the firm, and of groups such as executive recruitment companies, indicates that the managerial labour market is very real and active even though it may not conform to popular notions of what constitutes a market.

Much of the initiative for change in senior management positions comes from the board of directors of the company. The board is usually composed of both top management (senior executives) and directors from outside the company (external directors). Its responsibilities include overseeing the decision making of management and replacing or restructuring management that in the board's opinion has not adequately fulfilled its role. In addition to direct action, the board of directors also devises compensation schemes whose function is to ensure that management has the proper incentive to work in the shareholders' interest. Examples of such compensation schemes include stock options and bonuses tied to the performance of the company.

Where the management of a public company fails to act in the interests of shareholders, either through incompetence or through wilful disregard of the shareholders' interest, and the board of directors fails to rectify the problem, then the market for corporate control serves as a disciplinary mechanism — a form of last resort discipline on the company's management and board of directors. In this sense, a freely functioning market for corporate control protects shareholders' interests and is an integral part of an efficient corporate system of business organisation. The operation of this market, together with well-designed compensation contracts and

the labour market for management, ensures that the interests of management cannot diverge too far and for too long from the interests of the shareholders.

## The Role of Takeovers

An impression may be gained that the market for corporate control is to be used only as an ultimate disciplinary measure against incompetent management; however, this view is too extreme. Management need not be incompetent in some absolute sense, nor the board of directors neglectful of shareholders' interest, for takeovers to perform a useful, economically important role. Replacing one management team with another that is more effective in running a company is clearly beneficial to shareholders and to the efficient allocation of resources within the economy. Such a change does not imply that the previous management was incompetent or the board derelict in its duty; it simply implies that there was a more effective team available. In the same way that we may replace a piece of machinery that is operating quite well with a new and more efficient piece of equipment to the benefit of a company, so too can management be replaced.

A common cry from those who are critical of takeovers is that most of the companies targeted for acquisition are not in a state of decline and that the takeover is not justified on any 'failing-firm' criterion. Clearly this is true, but the fundamental objective of corporate management is to maximise the value of the resources under its control, not merely to maintain their value.

In a dynamic corporate world, managements are constantly seeking new investment opportunities with expected profits greater than existing investments or greater than the return they could get from the capital market as portfolio investors. Competition among managements for the control of corporate assets promotes efficient modes of production and distribution, eliminating processes and organisational structures that are less efficient. Reconditioning, restructuring and replacing real assets such as building and equipment for alternative uses occurs constantly throughout the economy. If a property developer believes that a piece of land could be more successfully utilised by a particular development than it is by the use the current owner is making of it, a trade will generally occur, typically of land for money, and both parties will gain. The same principle applies at the corporate level. Management may be generating satisfactory profits from assets in their current use;

however, entrepreneurs and competing managers may recognise potentially more valuable uses of these assets and try to acquire them, usually at a price greater than the value of those assets to their existing owners.

We must ask why many of the critics of takeovers are willing to accept free and unregulated trade in real assets but bridle at the notion of trade in the control of bundles of assets (i.e. firms). Of course, companies are more than just a collection of real assets. A crucial component of their value lies in the organisational structure and human capital necessary to produce the output for the firm from its assets. However, all these components, the organisational structure, the real assets, and the control of those assets, should be susceptible to change or replacement by a more effective or efficient entity. Economic growth and the equitable distribution of wealth is unlikely to occur unless the existing stock of wealth is put to its most valuable use.

The takeover market is a secondary market for the control of a company (in contrast to a primary market, where capital is raised by the company from the public, typically by way of a prospectus). In the same way that secondary markets for assets generally allow for the transfer of those assets to more effective uses, so does the market for corporate control enable bundles of assets, or firms, to be put to more effective uses. Often, the assets of the firm that has been taken over are not left intact on acquisition; in this case it is the redeployment of those assets that increases the value of the firm and makes the takeover worthwhile. However, it is a mistake to confuse the redeployment of assets with the destruction of assets. Too often critics of takeovers apparently believe that as a result of the takeover there will be fewer real assets available for society's use. This is wrong. Why would an acquiring company destroy assets that it has paid money for? Further, why would it pay more for those assets than they were worth to the former owners — the shareholders of the acquired company — unless it expected to be able to utilise or redeploy those assets in a manner that would give them greater value?

Even if, with hindsight, a takeover is judged to be unsuccessful, the real assets of the company are usually still available to be put back to their original use. If they are not, the penalty suffered by those responsible for making the bad takeover will be far greater than if they are. In short, there are penalties for taking over assets where the expectation that the assets could be utilised more effectively is wrong, and the greater the error in expectations, the greater the penalty. An entrepreneur who makes a number of poor

but not disastrous takeovers will slowly lose resources and the ability to acquire new companies, i.e. more assets. Whereas an entrepreneur involved in a disastrous takeover will lose significant sums of money and in all probability will not have (be given) the opportunity to undertake further takeovers.

Thus the overriding implication of the economic theory of takeovers is that these transactions are value increasing. This is precisely the same principle that governs transactions of assets in any market economy. On average, the combined value of two firms after an acquisition will be greater than the sum of the pre-acquisition values of those firms; alternatively, the value of the combined entity will be greater than if the entities were kept separate. The implication that the combined post-acquisition value is greater than the sum of the pre-acquisition values is testable, but the implication that the value of the combined entities is greater than the value of the separate entities **would have been** after the acquisition is not, although they are clearly related. In these circumstances, it seems reasonable to infer that if the post-acquisition value is greater than the sum of the pre-acquisition values, then the two entities' value will be greater than the sum of the values of the single entities would have been, and that takeovers are value creating.

There is now a substantial body of evidence from many studies around the world that is consistent with the hypothesis that **synergies** drive the market for corporate control, i.e. the combined value of firms after acquisition is greater than if the firms had been left as separate entities. We now turn to a brief examination of this evidence.

## III. THE EVIDENCE ON SHAREHOLDERS' RETURNS FROM TAKEOVERS

Our hypothesis is that the values of acquiring firms (offerors) are greater after the takeover than the simple sum of the values of the acquired firm and the acquiring firm before the takeover. Moreover, this increase in value comes from synergies resulting from the acquisition. Value is represented by the market value of the shares of the companies.

A test of this hypothesis may seem relatively straightforward, but it is not. The complication results from the requirement to separate the effect of the acquisition or takeover from other effects on the value of the company. Share prices are affected by many

different sets of information that alter the expectation of the future cash flows to be earned by the firm. We are interested in isolating that set of information that relates to the takeover. We require a control to enable us to separate the effect of the takeover on the value of the firms from all the other factors than can affect these values. Models and research methods developed in modern finance theory allow us to identify the effects of specific pieces of information on share prices. Most of the research into the effects of takeovers has been carried out in the United States, but there is some limited evidence from elsewhere including Australia, the United Kingdom, and New Zealand. A recent review of the US evidence has been presented by Jensen and Ruback (1983).

We will not go into the details of the various studies at this stage. However, the persistent finding, across many different samples, countries and time periods, is that investors holding shares in either acquiring or acquired companies before the takeover announcement will find, on average, that the value of their shares has increased after the takeover transaction is complete. Some aspects of this evidence deserve greater discussion.

## Acquired Companies

The unanimous finding of the research is that shareholders of companies acquired in a takeover get by far the larger proportion of the increase in the value of shares. Typically, shareholders of acquired companies receive something like a 30 per cent premium as a result of a takeover, but the premium varies substantially across transactions.

Further, a perhaps surprising result is that even when the offeror fails to take over the target, the shares of the target company frequently remain substantially revalued upward relative to the price before the offer was made. One interpretation of these results is that because of the takeover attempt there has been a significant release of valuable information about the target company, which leads the market to revalue it even though it was not successfully taken over. However, a recent US study by Bradley, Dessai and Kim (1983) has shown that this revaluation is sustained only if the target firm is subsequently taken over in a different transaction. Where the target firm remains independent and is not subject to a subsequent offer, the share price typically falls back to at least where it was prior to the initial offer. This evidence, which has not been duplicated as yet in Australia, strongly supports the notion

that takeover transactions are initiated to increase returns (and therefore the value of assets) and that the revaluation of target companies reflects the expected synergies of the combination of entities. When these synergies are not achieved, as in the case of unsuccessful takeovers, and the target companies remain independent, the initial revaluation is eliminated.

## Acquiring Companies

More contentious findings relate to the shares of acquiring firms. On average, it appears that these shares are not revalued upwards to anywhere near the same extent as the shares for acquired companies, and in many instances the market believes that acquiring firms have paid too high a price for the acquisition.

The question is whether these lower returns to acquiring company shareholders, which in some instances appear to result in losses, imply the need for regulation restricting takeovers. Is the economy harmed by such errors of judgment by the managements of acquiring firms? In general the answer is no. Even when managements of acquiring firms appear to pay too high a price for an acquisition causing the share price of their own company to fall, the overriding result of the research is that the gains to the target company shareholders far outweigh the losses to acquiring company shareholders. In short, the judgement of the capital market is that the overall value of the assets of the combined entities is greater than their separate values.

The second question that might arise in relation to these findings is whether or not the shareholders of acquiring companies require protection against their own perhaps 'over ambitious' managements. Takeovers are just another investment decision, i.e. the acquisition of real assets. Many investment decisions of companies are greeted adversely by the market place. The recent well-publicised decision of Coca-Cola to change the formula of its product was a case in point. There are many such examples; yet we do not hear, at least in economies that are not centrally controlled, calls for regulation of the day-to-day investment decisions of companies. When called upon to act in such cases, governments typically reply, correctly, that the company should bear the full responsibility for its own bad investment decision. There is no reason to treat takeovers, even though they are major investment decisions, differently from other investment decisions. It is true that takeovers receive a great deal more publicity than

most other investment decisions, typically because of their scale. However, the scale of the operation and the publicity surrounding a takeover is in many cases not very different from a major exploration decision made by a resource company. In these circumstances, the capital market is quite used to assessing the valuation consequences of discoveries or the lack of discoveries. Apart from certain disclosure requirements, there is no specific regulation and no second-guessing of exploration decisions by such companies.

## IV. ASSESSING THE EFFECT OF TAKEOVERS

The theory of takeovers does not indicate that each and every takeover will prove to be a good decision. There is evidence indicating that acquiring firms after a takeover have not always realised the gains that management expected to accrue from the takeovers. Should this be surprising? Of course not. All major investment decisions involve uncertainties. A well-researched investment proposal is expected to increase the value of the firm, but there can never be a guarantee. After the fact, many managements may come to rue their investment decisions. To justify regulating takeovers on the grounds that the post-takeover performance of companies is unsatisfactory, one would have to prove that the performance is poor, identify the cause, and be able to rectify it. Otherwise, how can regulation assist us when we have evidence that, overall, takeovers increase the value of assets and, from an investment perspective, are beneficial to the economy?

As well as the many studies that assess changes in the values of acquiring and acquired firms at the time of the takeover, other studies produce more general evidence that takeovers are wealth increasing activities. In particular, a US study by Schipper and Thompson (1983) shows that firms that announce a major strategic decision to expand via acquisition, and have some history of success, are revalued upwards upon that announcement. As these firms carry out this strategy and undertake specific takeovers, the incremental changes to share value are trivial since the expected value of the overall acquisition program is capitalised at the earlier strategic announcement. One would expect similar results for Australian companies that have strategically expanded via acquisition like IEL, Adelaide Steamship and the Bell Group.

This evidence is supported in another US study by Asquith, Bruner and Mullins (1983). They find that the valuation

consequences of takeovers are quite different for firms heavily engaged in acquisitions as compared with firms that make the occasional foray. The evidence shows that for an initial takeover the firm's shares are revalued upwards, reflecting some gains of the investment decision. However, once a firm has made three to four takeovers in a relatively short time span, the incremental revaluation is diminished.

Evidence of unprofitable takeovers does indicate that there is risk in trying to achieve the expected synergistic gains in takeovers. However, merely to conclude that these failures indicate that there are too many takeovers begs the question of how to identify, before the event, which takeovers are doomed to failure. In general, the capital market should not be assumed to work with such perfect foresight. People who could see into the future would be extremely wealthy by this time, or if they were not driven by a desire for wealth, their charities should be the recipients of their munificence. One would not expect regulators or regulations to possess such skill.

The claim that there are too many takeovers should be juxtaposed against other similar investment decisions. Under what circumstances do we hear it claimed that there is too much exploration, too much drilling for oil, too much real estate development, too much new product development? Such claims are typically made only when regulations or other conditions cause a bias in the investment decisions of companies. Can we identify such a bias in the regulations relating to companies? Unless we can, then claiming to know the 'right' takeovers or the right number of takeovers is like picking the card at a race meeting: it can only be successfully done for a Saturday meeting with Saturday evening papers. Moreover, if there is a bias, e.g. a tax incentive or the like, the correct stance is not to regulate the takeovers but to eliminate the condition that results in an excess of takeovers.

A number of studies have attempted to assess the effect of takeovers using the accounting rates of return reported in years subsequent to the acquisitions; for example refer to the results reported in Mueller (1980) and MacDougall and Round (1986). These studies suffer from at least two major problems: measurement, and an adequate control or frame of reference.

## Measurement Problems

One of the important roles for a company's accounts is stewardship. This role is to assess, for the capital providers of the company,

the effectiveness of management in maintaining the capital or assets of the firm. Accounts use a historical perspective since their primary role is to ensure that all the assets of the company are properly accounted for.

A secondary role for a company's financial statements is to provide information for investment purposes or valuation. It is the exception rather than the rule for the company accounts to be sufficient to provide a valuation for investment purposes. There are usually other factors affecting valuation, which are subject to considerable variability and uncertainty. Including such factors in the accounts would raise questions of the reliability and, more significantly, the comparability of accounts. Little information can be gained from a set of accounts looked at in isolation; we require a frame of reference. It is difficult enough with any one accounting system, e.g. historical cost, replacement cost, or realisable value, to ensure reliability for comparative purposes without introducing the additional, often subjective, factors usually required for valuation.

In principle it is possible to structure a set of accounts that would be suitable for valuation or investment appraisal purposes. However, the problem with accounts structured in this way is that they lack the consistency and reliability normally expected from an accounting system when its primary role is one of stewardship. There are too many company- and event-specific pieces of information that are relevant to valuation but cannot be captured in a set of accounts so that the accounts could be unambiguously interpreted by parties other than those preparing the figures. It should not be surprising then that investment appraisal and stewardship are often incongruent accounting goals. In short, we cannot rely solely on a company's financial statements to come up with a satisfactory and unbiased valuation of that company.

Similarly, measures of profitability based on accounting numbers are inadequate for any sensitive assessment of the merits of takeovers. The problems of accounting measurement are significant even at the individual firm level. But when we try to combine accounts, and where different accounting decisions are made by firms even when they are consistent with conventional accounting practice, the problems are compounded. For example, it should not be surprising to find a lower reported **accounting** rate of return for companies after a merger than before. The reason is that companies pay a premium to acquire target companies and the premium shows up in the accounts as goodwill. Such companies usually are required to amortise the goodwill over time through

the Profit and Loss Account. In doing this they also usually revalue the assets, so that the value of the assets of the company is not diminished. The consequence is that the denominator of the measure of the accounting rate of return, the asset value, is significantly greater than just the sum of the asset values of the acquired and acquiring firms prior to the merger. In these circumstances it would be a mistake to conclude on the basis of the accounting rate of return that companies did not involve themselves in takeovers because of profit opportunities or that the takeovers were poor investments.

To avoid the measurement problems associated with accounting numbers in assessing takeovers, we can turn to **capital market** rates of return. Admittedly, capital market rates of return suffer from their own measurement problems. However, we can be reasonably confident that the valuations made on the basis of share prices are unbiased estimates, because if they were not there would be profit opportunities for investors. Investors can take advantage of any bias through buying and selling particular stocks and in doing so they will eliminate the bias. We cannot be confident that such a bias is not present in accounting numbers since there is not any direct market discipline to correct for the bias.

## The Problem of An Adequate Control

As we noted above, to assess the effect of takeovers on the performance of companies we require a control or a frame of reference to isolate the effect of the takeover from all the other economic events that affect a firm's performance. Modern financial theory has developed such models for rates of return taken from capital markets, but similar control models have not been developed for the numbers reported in the annual accounts of companies. To create a suitable frame of reference would require restructuring the accounts of the companies concerned into a uniform accounting system, since even conventional accounting systems allow considerable variation in the treatment of different items of income and in how the value of assets and liabilities are recorded.

In an attempt to overcome this problem of finding an adequate control, researchers using accounting numbers to assess takeovers have usually compared the performance of a control group of companies that have not been involved in takeover activities with the performance of companies that have been involved in takeover activities. The comparisons of performance are made on the basis of reported accounting numbers after the takeovers. A common

finding of this type of study is that the sample of firms expanding by acquisition does not out-perform the control sample of firms, which presumably have been expanding by 'internal' investment, i.e. buying and selling real assets separately but not as bundles in the form of companies. This result is hardly surprising; in fact it is what we would expect.

If takeovers as an investment strategy were consistently superior to alternative forms of investment activity, we would expect companies involved in takeover activity to earn abnormal returns. This would attract other firms into such an investment strategy until any abnormal returns were eliminated. Where all firms had equal access to takeover investments, acquiring firms without specialised skills would not earn abnormal returns. Any such abnormal returns would be bid away by firms competing for these relatively valuable investment opportunities. This indicates that we would not expect to find that acquiring firms had earned abnormal capital market rates of return, after the acquisition. The expectations of synergy would have been capitalised into the share prices of the companies at the time the takeover was made public knowledge, even though the actual operation of synergies would not occur for some time.

Therefore, a sample of firms not involved in takeover activity does not provide an adequate control for a sample of firms that has been involved in takeover activity. They are, by definition, different samples with presumably different opportunities for investment. One group has chosen growth through acquisition, and the other may well have chosen growth through internal investment. Nothing in economic theory would suggest that one method of investment was superior to the other. In fact, we would expect that, on average, the returns to both strategies would be equal on the grounds that if they were not, firms would be attracted to the strategy that yielded greater returns until those excess returns were eliminated.

## V. SOME PRINCIPLES FOR REGULATIONS

We believe there are two legitimate grounds for government regulation in the market for corporate control — or indeed for government interference in any market. These are:

**Economic efficiency**. A market is economically efficient if resources are optimally allocated, i.e. for a given level of production a minimum amount of resources is used;

alternatively, for a given level of resource use the maximum amount of production is achieved.

**Equity**. In this context equity means the relative well-being of individuals. It encompasses the welfare aspects of regulation where government, through rules and regulations, redistributes wealth in all its dimensions among the individuals in society.

We argue that takeover legislation is an inappropriate form of intervention in the marketplace to redistribute wealth. The nature of sharemarkets and the anonymity of shareholders makes it very difficult to determine whether any particular regulation enhances or inhibits wealth distribution. For example, regulations are often advanced on the grounds that they protect individual shareholders against more powerful institutional investors. In fact, it may well be that the institutional investors represent many small investors whose average wealth is far less than the average wealth of individual investors. Problems of welfare or income redistribution are better tackled directly, by way of grants or subsidies to those who can be identified as requiring assistance.

The justification for regulations based on economic efficiency is that they will encourage the creation of more goods and services for society to consume. There are three circumstances in which a government is justified in regulating or intervening in a market on the grounds of economic efficiency. These are (1) to define, assign and uphold property rights, (2) to restrict or eliminate monopoly power, and (3) to produce goods and services where the government or its agents are genuinely more efficient than the private sector. We will discuss the first two circumstances in depth in relation to the takeover market; the third is not relevant to takeovers.

## Property Rights

Many of the regulations that lead to greater economic efficiency can be traced to the definition, assignment and policing of property rights. (In this context property rights are not restricted to physical property but also include intellectual and psychic property rights.) The establishment of property rights encourages people to increase their endowment and therefore increase their well-being, which in aggregate is society's well-being. Through regulation a government can have an important effect in determining the economic efficiency

of society in its investment, production and ultimately consumption decisions. A clear assignment of property rights is one of the most important factors determining relative economic efficiency.

If efficiency is to be achieved, decision makers must have security of tenure with respect to property rights. They must be sure that the consequences of their decisions, both the costs and the benefits, will ultimately reside with them. This means that property rights cannot be arbitrarily changed or usurped by mechanisms other than those in which decision makers have control over the transfer of their rights, for example, the market. The responsibility of government or its surrogates is not only to assign property rights and to make the rules governing the ownership of them, but also to police the rules to ensure their effectiveness.

Aside from the assignment and policing of property rights, economic efficiency is enhanced by free trading of rights and by the products arising from the possession of such rights. Economic theory shows that perfectly competitive markets are a sufficient (although not necessary) condition for optimal resource use with respect to economic efficiency — but not necessarily for equity. A market is a situation in which goods and services are exchanged. The motive for the exchange is the belief by those participating in the exchange that they will end up better off than they were before the exchange took place. If this was not true there would be no motivation to exchange. Further, if we have a clear assignment of all property rights related to the exchange, and if the market is competitive (we will discuss shortly the conditions for the competitive market), then there will be an efficient allocation of resources. No one can be made worse off as a result of the exchange and clearly someone is better off. This is known as a Pareto optimum.

There are basically four parties or groups whose property rights are directly affected by takeovers. These are shareholders, employees, creditors, and management (including the board of directors).

**Shareholders**. In a takeover, shareholders may exchange or trade their shares. Clearly, they would not be inclined to do so unless they thought they were going to be made better off by the exchange. Moreover, the evidence discussed above indicates that shareholders of both parties, acquired companies and acquiring companies, have their wealth increased. Therefore, any restriction on takeovers imposed by government that was not clearly part of the terms and conditions under which the shareholders acquired their shares (property rights) is the converse of what a government should be

doing to ensure economic efficiency. From the shareholders' point of view, the government's role in policing property rights is to ensure that they have the right to sell their shares when they believe the benefits from the sale are greater than the return or benefits that they were getting, or rather, expect to get, from ownership of the shares, and conversely for those who acquire the shares.

The evidence indicates that whether the motive for the takeover was to redeploy existing assets or to remove inefficiencies, the shareholders of target firms share in the ensuing revaluations. As for the acquiring firm's shareholders, the evidence indicates that the net benefits to shareholders are positive; moreover, it is unlikely that they would retain their shares if they thought they were a poor investment. Further, if the shareholders of acquiring companies were to become disenchanted with the strategies of the company their sale of shares would drive down the price of the shares. The fall in share price would restrict or prevent the company from gaining access to funds to engage in further or even current takeover activity. Therefore, there is no compelling reason for government to interfere with the market for corporate control on the basis of the property rights of the shareholders of both the acquired and the acquiring companies, other than to ensure that those rights are protected, which typically is done through the courts.

**Employees.** One party that has often claimed to be penalised in takeovers is employees. Employees are typically concerned about a takeover because takeovers often signal new directions that the company might take — directions in which employees may find themselves redundant. In this sense, the takeover is identical to an internal company decision to take on a new strategy in its investments. Divesting itself of some of its operations can make employees redundant. In these circumstances certain contractual rights, often wage determination decisions, soften the blow of redundancy to employees. Moreover, although there are adjustment costs involved, most employees find other employment.

The same is true for redundancies brought about through a takeover. Furthermore, employees are free to contract with the firm through their superannuation, retrenchment payments, retirement benefits and the like, to protect any firm-specific human capital — the same principles that apply to normal redundancies. If a business enterprise is prevented from developing new techniques and products and from introducing more efficient forms of production because they may cause a retrenchment of part of its labour force, then very clearly society as a whole is going to be disadvantaged. An economy would quickly regress under such a

regime. Similarly, if takeovers are restricted so as to protect employees from bearing the costs of moving their human capital to alternative enterprises, the economy and society at large will pay for this protection through less efficient production.

In short, employees are usually contracted for a limited term and their property rights do not extend to unlimited employment with the firm. Regulation that attempts to grant such a right infringes rights of the other parties in the company, especially shareholders. Finally, sight should not be lost of the fact that, by and large, the better a company does, the better off are employees.

**Creditors.** The creditors of a company are clearly interested in its value, which represents collateral for their loans. Moreover, formal debt contracts often have clauses protecting the creditors against any diminution of that collateral as a result of a takeover. There does not appear to be any reason to give creditors greater protection than they can achieve by contract and negotiation with the company at the time the debt is incurred.

**Management.** Finally we come to the incumbent management (i.e. executive officers) and boards of directors of target companies. In defended takeovers these groups play an important role in trying to block the takeover. It is not only in the shareholders' interest that such defences are mounted. Often the boards of directors and management have much more to lose as a result of any retrenchment that may result from a takeover. It would appear, on the basis of the behaviour of such groups, that they have more human capital that is specifically invested in the target company than other groups with an interest in the company. It should not be surprising, in these circumstances, that incumbent managements resent outsiders' attempts to take control. In fact, many of the arguments, including the most fallacious, used to support regulation of takeovers involve incumbent management and boards of directors. We will have more to say about this shortly, but the issue at the moment is whether or not the property rights of managements and boards of directors are violated by a takeover in an unfettered market for corporate control.

In principle the property rights of management and the board of directors are identical to those of other employees of the company. Management personnel and members of the board of directors typically have greater flexibility in setting the contractual conditions for their employment with the company, and thus bear greater responsibility for the terms and conditions of their employment. It has become increasingly common for companies to agree to contracts with management personnel that include

termination payments ('golden parachutes'). If the company is taken over and the incumbent management replaced, the company must pay relatively large sums to the members of management made redundant. The purpose behind such contracts is to provide a degree of protection to management against redundancy. Indeed many executive employment contracts explicitly provide for such payments in the event of dismissal even in the absence of takeovers. The golden parachute is a more specific form of such contract, which also ensures that management will act in the best interests of shareholders in the event of a takeover, in that they will have nothing to fear from possible redundancy as a result of the takeover because of the termination payment.

Therefore, there is no inherent violation of property rights of managers or boards of directors in an unencumbered market for corporate control. Indeed, the economic theory of takeovers suggests that replacing management is one of the more important reasons for takeovers. However, it is a mistake to believe that this is the only role for takeovers.

In the majority of takeovers it is not poor management performance that is responsible for the takeover but rather the opportunity to redirect the assets under the control of the firm to a more highly valued use. It is not surprising in these circumstances that managers who are replaced often feel that they have been unjustly dealt with when, by the standards set for them, they may have been performing quite competently. In these circumstances, it is understandable the lengths to which incumbent managers may go to when faced with an unwanted takeover. This has caused some commentators to argue that the only area of abuse in the market for corporate control is the availability of corporate resources for these incumbents to resist the transfer of management. There are, however, restraints on the availability of a company's resources to management, particularly when management is clearly not acting in the interests of shareholders and common law principles must be adhered to (the issue of how the common law principles on the duties of directors and management should be applied and interpreted is a subject of much debate in law and economics).

## Competition Policy and Takeovers

Economic theory makes it clear that monopoly power — the power to set higher prices and lower production than would occur under competitive market conditions — leads to a misallocation of

resources ('price' includes not only the price of the good but all the other dimensions of the transaction for the good or service such as quality, packaging, after-sales service, etc.). Takeovers that lead to a significant accretion of market power, i.e. a reduction in competition (which is not the same as a reduction in the number of competitors), are socially and economically undesirable.

The issue of whether or not a particular takeover or a merger of companies is likely to lead to a reduction in competition and a consequent increase in the market power of the proposed new entity is addressed by s.50 of the *Trade Practices Act*. The operative clauses of the section prohibit the takeover when 'as a result of the acquisition, the corporation would be, or likely to be, in a position to control or dominate a market of goods and services', or when 'the acquisition would, or would likely to, substantially strengthen the power of the corporation to control or dominate that market'. A proposed amendment to this section has been introduced in the Parliament. The amendment would delete the words 'control or' in order to lower the threshold of what constitutes any anticompetitive effects of a takeover or merger proscribed by the Act.

There is no question that it is economically legitimate to regulate to control anticompetitive mergers or takeovers. The question is whether the existing regulations are sufficient to cover the problem. The government believes that the current Act is liable to let through cases that would lead to an undesirable accretion of market power, hence its move to weaken the threshold in the amended legislation. In most cases it is not a clear-cut decision whether a takeover or merger will have anticompetitive effects. Ultimately, what we are concerned with is that the takeover does not result in any significant increase in or development of monopoly or discretionary market power, i.e. power to charge more and produce less. The problem is there is a wide range of discretionary market power.

For example, a corner milk bar has an element of discretionary power over those customers who are very close to it and would have to travel some distance to the nearest competitor. The inconvenience or cost of travelling further afield could lead the shop's customers to accept a lower than average standard of service, inferior stock, or even marginally higher prices before they would shift their patronage. All of these factors reflect an element of discretionary power brought about by the locational advantage of the shop relative to its customers. Alternatively, in some cases barriers to entry and other factors are so powerful that a corporation or entity

is a natural monopoly, i.e. there is room for only one firm in the industry.

These two examples reflect the range of discretionary power that can exist in an economy. The milk bar example almost fits the perfectly competitive market, whereas the natural monopoly is an example of the standard form of monopoly. Commonsense tells us that the natural monopoly should be constrained from exerting the full elements of its power, whereas the limited discretionary power of a milk bar should be ignored. However, the real question is where in this continuum of discretionary power should regulatory action be taken? What is the appropriate criterion for intervention?

The obvious economic answer to this question is that society should not expend more resources regulating discretionary power or constraining its potential use than it saves by preventing the use of the power. In short, society benefits from regulation only when the costs of regulation are less than the benefits from the regulation.

The criterion is obvious. The problem is making it operational. The wording of s.50 and the proposed amendment do not assist us greatly. It is true that the section, by requiring at least the domination of the market, will eliminate trivial forms of discretionary power from being included, but just where the demarcation is drawn is not indicated in the Act nor could we sensibly expect it to be — other than by framing the general economic criteria. Each case must be judged on its merits, with what one would hope is a heavy emphasis on the economic issues involved. Therefore, we conclude that any problems with respect to competition policy that might be caused by takeovers or mergers are adequately covered under the existing or amended s.50 of the *Trade Practices Act*. We do not believe further legislation is required, certainly not legislation outside of the domain of the *Trade Practices Act*.

## VI. SOME DUBIOUS ARGUMENTS USED TO PROMOTE REGULATION OF TAKEOVERS

Indirectly, we have already addressed a number of dubious arguments often used to promote takeover regulation. However, because of the persistence with which they are used to denigrate takeovers, we feel it necessary to specifically draw attention to a few of these issues.

## Takeovers Produce No Real Benefits, They Merely Shuffle Paper

The notion that the securities, representing claims to the assets, can be divorced from the assets reflects a failure to understand the logic of the balance sheet. The trade in securities is a trade in the title to assets. Profits made from such a trade represent profits from trade in real assets.

The critics of profits made from a trade in securities imply criticism of profits made from capital gains, whereas they would undoubtedly accept as reasonable profits made from an increase in operating income. The issue boils down to the principle of valuation. The value of an asset reflects the expected future benefits that asset will produce. Therefore a capital gain reflects changes in expected future benefits.

What could cause the change in expected income (benefits) and therefore the change in value? In a takeover if the future income of the entity is expected to rise as a result of actions taken by the acquirer then perhaps the criticism of 'paper profits' would dissipate. Such action could include taking overt steps to move the company into more profitable activities, or forcing the incumbent management to release information leading to a change in expectations about existing activities. From an economic point of view one action is inherently no more desirable than the other, other things being equal. Undervalued assets can cause resources to be misallocated just as much as inefficient production processes.

A variation of this argument against 'paper profits' is that share prices do not reflect the underlying economic value of assets. This could also indicate a failure to recognise the logic of a balance sheet. However, suppose security prices consistently underestimated the true value of their assets. This would be a clear signal to corporate raiders that securities are a good buy because they can lead to control of the assets, which can be stripped from the company and sold to those who place a greater value on them, i.e. sold for more than their cost. Alternatively, if securities consistently overvalued the assets on whose title they rest, investors in the sharemarket and any corporate raiders would get lower returns than those who by-passed the sharemarket in order to control the assets. It would pay to buy the assets in the asset market and sell securities against those assets.

Those who believe that share prices do not reflect economic values rarely attempt to explain what in fact they believe stock prices are based on, or why corporate managers continue to act as though

their firm's performance is reflected in share prices, or why annual changes in stock prices are strongly correlated with the subsequent announced earnings of companies, or why analysts and professional investors spend huge sums trying to forecast these earnings accurately and trade on their expectations, or why legions of investors continue to invest in professionally managed investment vehicles, or why governments, businesses and others look to the share market as a leading indicator of the economy.

Finally, those who doubt that the value of an asset reflects its future benefits or income must explain why fixed interest securities such as treasury notes, government bonds and the like are consistently priced according to the expected income from holding the security, i.e. according to the principles of net present value. What is the inherent difference, other than their relative risk, between fixed interest securities and share market securities that would require them to be valued on a different basis? Professional sharemarket investors consistently choose next year's profit figure as the most informative single future company statistic. This is consistent with the underlying link between share prices and economic performance that is implied in the theory of valuation.

## Takeovers Waste Resources

It is not uncommon to read in the press complaints about the 'pillaging of grand old companies', 'raping of companies by self-interested raiders' and the like. If there was any raping or pillaging of target companies we would expect the prices of their shares to reflect this: shareholders would suffer losses, not gains as they currently do.

A more sophisticated but no less fallacious variation of this theme is that incumbent managements and boards are forced to devote too much of their time and company resources to defending themselves against unwanted takeovers, and that this is not in the best interests of the firm (and implicitly its shareholders). It is also argued that managers who see a threat to their incumbency will alter their investment strategies to ensure that short-term profit performances are enhanced. Profitable investments in long-term activities, such as research and development, will be discontinued as managers search for short-term investments that will produce high immediate profits and convince investors in the sharemarket to inflate the price of the companies' shares. The punchline is that such action ultimately reduces the economic prosperity of the nation

as a whole and future generations will suffer because of today's corporate raiders.

This argument implies that the best defence against an unwanted takeover is a high share price. We have no quarrel with this; indeed one would hope that management is continually conscious of the value of the assets that it controls in the interests of its shareholders. The argument also recognises that long-term investment decisions such as research and development are, in some cases, value-maximising decisions, and if their positions were not threatened managers would undertake such investments. But now the fallacy emerges: we are meant to believe that managers will gain immunity from takeovers by opting for a series of short-term suboptimal investment policies in place of the higher valued long-term strategy. The logical flaw is that the long term must be the sum of short terms. Over the long term a series of suboptimal short-term decisions must result in poorer performance than the more valuable long-term decision. Are we to believe that the bubble will never burst? Unless the proponents of this argument can show that there is a series of short-term investment decisions that will accumulate over the long term to the equivalent performance, in which case there is no social loss to be concerned with, the suboptimality must emerge as the market's expectations are not achieved. Other firms not facing the implied threat of takeover will initiate optimal long-term investment strategies and their superior performance will expose those firms who adopted suboptimal strategies.

This focus on the short term suggests that takeovers occur because capital markets cannot recognise the inherent value of sound investment strategies. Such an argument contradicts the vast amount of accumulated evidence that indicates a persistent search for information for valuing shares, and the value placed on the shares of companies that are years off producing cash dividends. This is a highly competitive activity, because any bias in the market towards concentrating on the short term or any segmentation in the market between the short and long terms opens up opportunities for profit making by arbitrage. It is true that the threat of takeover probably forces the incumbent management to spend a lot more time trying to convince the sharemarket that it is doing the best by the company and that the share price being offered by the acquiring company is insufficient. This means the management will make more of an effort to provide the sharemarket and its shareholders with information that previously it had been disinclined to release (sometimes for a good reason, e.g. it did not want the information to get into the hands of competitors).

However, as we have already indicated, an undervalued share price leads to a misallocation of resources and society as a whole, as well as the shareholders of the target company, suffer. Therefore, we cannot conclude that it is a waste of time and effort for incumbent managements to spend time providing the market with information.

We have already mentioned asset stripping, which is another variation on this theme that takeovers waste resources. Acquiring firms are viewed as raiders gaining control of valuable assets, which are then sold off separately to reap profits for the raider. It is true that many acquiring firms choose to divest some or even most of the assets they acquire. But how is this different from other sales of real assets via transactions without takeovers? No one coerces buyers to pay higher prices for stripped assets, so apparently the assets are worth more apart than they are as a bundle in the firm. Asset stripping, in contrast to the popular notion, increases economic efficiency since it places assets with those who value them most, and who presumably can get the most from them. Therefore resources are being better allocated.

## Takeovers Promote Excessive Borrowings

Many takeovers are financed by borrowing against the assets of the acquired firm as well as by offering collateral from the assets currently controlled by the acquiring firm. This places the acquiring firm in a much higher risk class. Therefore it should not be surprising that occasionally, particularly when the takeover has proved unsuccessful, the acquiring company will be forced to liquidate assets or, in the limit, itself. However, this is an issue of concern to the acquiring company's management, shareholders and creditors in the takeover, not to the acquired company.

Takeovers, in this respect, are like any other investment decision financed by borrowing: the more highly geared a company the greater its risks, but also the greater its expected returns. The cost of errors of judgment will ultimately be borne by those responsible, their shareholders and their lenders. With hindsight it is easy to see where financial gearing has led a company into problems. However, excessive gearing will be reflected in the share price of the acquiring company, which in turn will usually make it more difficult to raise funds and therefore to consummate a takeover. In short, the market provides an adequate discipline for those that may be inclined to indulge in 'excessive' borrowing and does not require further regulation in the context of takeovers.

Another side of the excessive borrowing argument is that the money used is from overseas, which increases Australia's net indebtedness and therefore is undesirable. It is interesting to note that this is almost the inverse of the old call to 'buy back the farm', when governments were exhorted to prevent foreign ownership of Australian assets. The point that should be recognised is that borrowing and lending are both commercial decisions. Presumably those who are borrowing believe they can repay the loan, and those who are lending believe they will be repaid. Further, the acquirer of the assets believes they are worth more to him than the cost of the debt, and the seller of the assets believes he can do more with the capital acquired through selling the assets than he can with the assets. Any restrictions on borrowings will frustrate and perhaps block the benefits accruing to all these parties. Moreover, regulation of borrowings in a takeover context to preserve some macroeconomic goal (such as the level of national indebtedness) is hardly a sensible step. Such selective measures inevitably lead to internal resource misallocation where some investments are penalised and others are not.

Another objection to financing takeovers by debt is the use of what have become known as 'junk bonds'. The term originated in the US and refers to bonds (debentures in an Australian context) with high interest rates issued to finance a takeover. The high interest rates are required because of the high risk underlying the security, hence the pejorative title 'junk'. There are attempts in the US to proscribe the use of such bonds, specifically in company takeovers. In Australia there have also been calls for regulation to prevent the use of such financing in takeovers, before the method has even been developed.

What those calling for regulation of such bonds are recommending is an interest rate ceiling on debt securities, although they do not express it as such. Price controls for debt securities? Such controls have always led to the rationing of funds with the associated hidden and misleading costs, inequitable distribution and inefficient use of capital. The positive developments in the financial sector following the Campbell Report have all been in the other direction.

The point is worth reiterating: who bears the cost if a junk bond issuer defaults? The purchasers. Were they forced to purchase such high yielding bonds? No. Then why should they require protection? Indeed, could a government effectively protect them without a blanket prohibition on the issue of such debt? We do not believe so. In fact, the default rate among junk bond issues in the US has

been relatively low. Should all those who are satisfied with their investment in these high yielding securities suffer to protect the few who lose?

Much of the concern in the US with the use of junk bonds has been not as much for the protection of purchasers of the securities as concern that these issues expand the level of high risk debt in the economy. However, this need not be so. The issue of company debt to finance a takeover does not necessarily increase the level of indebtedness of an economy, since the recipients of the capital raised by the debt issue could always use it to retire debt. In fact, in Australia, much of the debt used to finance takeovers has been in the form of bridging finance until the company can raise additional equity.

In any event, the level of indebtedness of an economy is really a macroeconomic issue. If there is a bias towards debt financing it is not specifically restricted to takeovers, it will affect all forms of investment. The classical system of company taxation is a clear source of bias leading to greater debt than equity financing, but the proposed change to an imputation tax system will remove some of this bias.

## Shark Repellents, Poison Pills and Golden Parachutes

'Shark repellents' are clauses inserted in companies' Articles of Association as a deterrent to possible takeovers, at least contested takeovers. They typically provide that certain groups of shareholders be given voting rights in the event of a takeover but not otherwise.

Shark repellents tend to restrict takeovers and protect management. Therefore, at first sight, it would appear that they should be prohibited. However, while we are against regulation that takes the form of a compulsory shark repellent for all companies, we believe that companies have the right, providing it is consistent with their shareholders' wishes, to put in place such clauses. Providing the clauses are not forced on shareholders, or minority groups are not significantly disadvantaged in a vote by shareholders to insert such clauses in the Articles, one can only assume shareholders believe they will benefit from the clauses. The benefit is typically that management feels more secure. Shark repellents may be a relatively cheap way to retain management.

Also, the constraints on foreign ownership of Australian companies, in particular certain types of Australian resources, have

prompted some companies to limit the proportion of foreign ownership on their share registers. Providing this is done in an open manner with the assent of shareholders, then it has many of the same attributes as a shark repellent. The shareholders imply by their assent that the cost through a possible lower value of shares by restricting foreign ownership is less than the cost imposed on Australian shareholders if the company has a certain proportion of foreign ownership.

'Poison pills' are similar to shark repellents. They involve a provision in the Articles of Association allowing a block of shares to be allocated to a group of shareholders in the event of a takeover. The analysis of poison pills is the same as that of 'shark repellents': shareholders should have the right to use them if they wish.

As discussed earlier, 'golden parachutes' are compensation agreements with top management that apply in the event of a takeover in which management is retrenched. Managers typically receive some multiple of their annual salary, and usually the agreement must be approved by a majority of shareholders at a general meeting. Once again, by their assent shareholders are implying that they believe the cost of a golden parachute is offset by the benefit of having management acting in the interests of shareholders. In the event of a takeover, golden parachutes reduce management's antagonism, which might develop solely because of its fear of losing its position within the company and not because of any real threat to the shareholders.

This type of agreement, which is negotiated between management and shareholders' representatives on an individual company basis, is superior to the type of golden parachute that the arbitration system imposes in redundancy clauses and wage determination decisions. The golden parachute received by management can be tailored much more closely to the benefits and costs of individual companies, i.e. those who are paying for the award have a direct say or vote on who should receive the award and how large it should be.

An argument that has been advanced against poison pills, shark repellents, golden parachutes, and other such clauses in a company's Articles is that while current shareholders may agree to them it is not fair to future shareholders. This argument is quite fallacious. Future shareholders are not forced to buy shares if they find the clauses too onerous. It is no different from purchasing a piece of land with a covenant or an easement: the price of the land will reflect the covenant or easement so that an aware and willing purchaser cannot claim to suffer as a consequence. This

should also provide caution to those companies and managements who are rushing to insert such clauses in their Articles of Association. Ultimately, the more restrictions placed on shares the lower will be the share price. The apparent protection such clauses provide may simply make the companies and their managements more vulnerable to another source of threat to their control.

## VII. PARTIAL TAKEOVERS

Partial takeovers are takeovers that result in a less than complete transfer of shares but usually result in a transfer of control. There are two specific complaints about partial takeovers. First, there is typically a premium paid for the shareholding that bestows control of a company. Unregulated partial takeovers often result in this control premium being paid to only a select group of shareholders. The complaint is that all shareholders should receive the control premium.

The second complaint is that there is a coercive feature in a partial takeover that can present shareholders with a problem known in the economics literature as the 'prisoner's dilemma'. A shareholder may find the overall partial offer unattractive because he does not want to be a minority shareholder at the completion of the partial takeover. However, if the shareholder does not accept the partial offer but other shareholders do, so that the partial takeover is successful, the shareholder has missed out on receiving the attractive offer price for part of his shares. Where the shareholder has no confidence in the actions of other shareholders he will accept a partial bid even though it may not be in his best interests or indeed the best interests of other shareholders.

### The Control Premium

Suppose that 50 per cent of a company is sufficient for control. Suppose further that an acquiring company is interested in control of the company but not in the full acquisition. The acquiring company is likely to approach just enough major shareholders to achieve its 50 per cent interest with an offer that includes any premium for control of the company. The minority shareholders are left without an opportunity to participate in the offer. It is widely held that this situation is unjust and against the principle that each share should rank equally in participating in the benefits

derived from the company. The *Companies (Acquisition of Shares) Act*, through sections 59 and 60, attempts to ensure that any premium for control be vested proportionately in each voting share.

At present, the offeror company must offer to **pro rata** all shares that are offered to it at the offer price in order to achieve the proportion stipulated in the offer documents. For example, a company that has made an offer for 50 per cent of a target company might receive 80 per cent of shares on issue. To achieve their 50 per cent target they would accept five-eighths of those shares offered. It is believed that pro rata bids allow the control premium to be inequitably distributed and accentuate the coercive pressures on shareholders in a partial takeover. That is, shareholders may be inclined to accept not because they believe the offer is satisfactory, but because they fear that if they fail to accept, they will be caught in a minority shareholding without any chance of participating in a control premium. In addition, it is claimed that the pro rata acceptance method creates uncertainty about the number of shares that a shareholder will ultimately have sold to the offeror if he accepts the offer.

The Companies and Securities Law Review Committee, in a report to the Ministerial Council on Partial Takeover Bids in August, 1985, recommended **proportional** bids to reduce what they believe are the disadvantages in the pro rating of partial takeover offers. A proportional bid means that the offeror company must purchase a fixed proportion of all parcels of shares offered to it at the price set out in the offer documents. The Committee believes that this will reduce the coercive nature of pro rata bids and also remove the uncertainty about the number of shares each shareholder can sell to the offeror. Opponents of proportional bids believe that they will significantly increase the cost to offeror companies of partial bids and therefore reduce or eliminate such transactions.

At issue is the right to participate in a control premium. It is perhaps surprising, then, that nowhere did the Report of the Companies and Securities Law Review Committee examine what gives rise to a control premium in order to assess whether or not that premium should be vested equally in all shares or whether in fact a case can be made for vesting it in a particular group of shares.

A premium for control implies that there is some advantage to gaining control of the company through a particular block of shares relative to other shares (shareholders). The advantage may be a legitimate one, for example, directing a dividend policy so that it suits the objectives of the controlling shareholders. Alternatively,

the advantage may be illegitimate, for example, giving undue rewards to the board of directors appointed by those with the control or, through transfer pricing, directing profits to another company owned by those with the controlling shares. In either case, regulating partial takeovers and attempting to vest control premiums equally in all shares does not get at the source of the control premium.

Regulation of partial takeovers that does not uncover the source of a control premium does not ensure that shares are treated equally with respect to benefits arising from the company. Moreover, regulation may create an injustice where the control premium was built up by legitimate means but is not allowed to be traded. For example, a group of shareholders may take a controlling interest in a company in order to direct the operations of the company into more efficient and productive activities. One could argue that this group deserves the benefits associated with a control premium; otherwise what are the incentives for them to take such action? Moreover, other shareholders will benefit from the action as well, so long as the control is not abused. The rights of minority shareholders are protected under the *Companies Act*, which allows abuses to be rectified by application to the courts. Also, the capital market will severely treat any attempts by the company to raise capital if it is perceived that the controlling interest is misusing its position. In these circumstances, as with the establishment of any property right, trade should be freely available to those who have assembled the controlling interest.

To insist that all share equally in the benefits of this controlling interest is to allow freeloading on the efforts of those shareholders who have gone to the cost and effort of establishing control for the betterment of the company. Restrictions on their trade in this control premium will mean that it will not pay them to put the same cost (effort) into establishing control and directing the company to a more efficient set of activities. As in all areas of economic activity, freeloading leads to underinvestment.

The same type of argument can be used to produce a counter-conclusion. If the control premium arises from benefits gained at the expense of minority shareholders, but the methods by which these benefits arise are undetected or cannot be prevented, then reducing the control premium will reduce the benefits going to those acting in a manner detrimental to minority shareholders and therefore the effort or cost that they put into such misdirection of resources.

To conclude that we need regulation on the control premium

aspect of partial takeovers, we must be able to identify the source of the control premium and decide whether it is legitimate or not. Because the current discussion on partial takeovers has largely neglected this aspect, the conclusions drawn and the remedies recommended, such as a requirement for proportional offers, must be seen as questionable at best. It is not clear that the proposed rules would be any better or worse than the existing pro rata arrangements. The relevant question is whether, and if so, why, the existing common law protections are insufficient to ensure the minority does not fund the control premium by allowing illegitimate transfers to the controlling majority. Again, this aspect was ignored by the Committee.

## The Coercive Aspect of a Partial Takeover

Consider a company whose shares are selling at $1, which is an unbiased estimate of the value of the future cash flows (dividends) that will accrue to the shares. A maximum 50 per cent partial takeover offer is made for the company. In order to be successful the offer price must be above both the current share price of $1 and the expected share price after the completion of the partial takeover. For purposes of illustration let us assume that the company is not going to change operations after the partial takeover so that the expected future price of the shares on completion of the partial takeover is also $1 (clearly this example is overly simplistic and begs the question of why the bidder is prepared to pay the premium). An offer of $1.30 per share should be quite adequate to ensure the success of the partial takeover. In these circumstances shareholders of the target company are clearly made better off by the partial takeover.

However, let us now consider the possibility that those making the partial offer are expected to mismanage the company or to manage it in a way that is detrimental to the other shareholders. The share price after the partial takeover of 50 per cent of shares is expected to drop to 60 cents. The original shareholders now have the prospect of receiving $1.30 per share for half their holdings and 60 cents per share for the other half for an average share value of 95 cents — less than the original value of $1. Should shareholders reject the offer? Not necessarily. They suffer the 'prisoner's dilemma'.

If an individual shareholder rejects the offer but enough of the other shareholders accept to enable the offeror to gain 50 per cent,

then the shareholder has missed out on the offer of $1.30. All of his shares decline in value to 60 cents, compared to an average value of 95 cents if he had accepted the offer. On the other hand, if one shareholder accepts the offer but other shareholders do not, the control of the company does not pass to those offering the partial bid. The shareholder receives $1.30 for half his shares, and the remainder at the conclusion of the attempted takeover go back to $1.00. His shares average $1.15. Finally, if all shareholders could be encouraged to act in the group's interest and refuse the offer, their shares would remain at $1. Summarising:

| Individual Shareholder's Action | Remaining Shareholders' Action | Individual Shareholder's Avg Price/Share |
|---|---|---|
| Accept | Accept | 0.95 |
| Reject | Accept | 0.60 |
| Accept | Reject | 1.15 |
| Reject | Reject | 1.00 |

From the point of view of society and of the shareholders as a group, the optimal action is to reject the partial takeover. However, we can see from the table that there is a strong temptation for individual shareholders to accept the offer if there is no coercion for them to act as a group.

The recommendation by the Companies and Securities Law Review Committee Report for proportional offers as distinct from pro rata offers is an attempt to limit the coercive aspects of a partial takeover offer but, as the above example illustrates, it is insufficient. The question is whether tighter rules will overcome the coercive nature of partial offers. A related question is at what stage such rules will infringe on shareholder sovereignity and the optimal allocation of funds in the capital market.

At first sight the problem appears unsolvable without a complex set of rules that inevitably will transgress freedom of choice in the capital market and have adverse effects on resource allocation. Fortunately, however, a new set of regulations is not required. Competition in the market for corporate control will obviate the need for further legislation or other constraints on share trading with respect to partial takeovers.

Consider a partial offer where the sum of the value of the offer

plus the expected post-offer value of the remaining shares of the target company is less than the total pre-offer value of the shares of the target company. This is the type of offer that puts shareholders in the prisoner's dilemma. The bidder is paying less than the current value for the control proportion of the company being sought. As in other markets, one would expect the opportunity to purchase assets at less than their market price to attract competitive bids from other investors or investor groups and even from coalitions within the company through schemes such as management or leveraged buyouts.

The greater the difference between the net value placed on the assets through a partial bid and the current value, the more competitive bids there will be. New entrants will be encouraged into the market for the control of the company until the entry cost is equal to the current value of the assets. In light of the publicity surrounding such competition, companies or investors will be attracted to the takeover who believe they can operate the target company to yield returns greater than the existing operations earn. Such investors will be prepared to pay more than the current value of the company. In these circumstances existing shareholders will be unambiguously better off selling to such partial bidders. The threat of this competition will reduce the enthusiasm of those potential partial bidders who are tempted to try to achieve control of a company without paying the full price for control. Why bother to go to the expense of preparing a partial bid if the bid is going to be topped by someone who is willing to pay more?

Thus a competitive market for corporate control is sufficient to alleviate concern about the coercive nature of partial bids. Some people doubt whether there is sufficient competition in the market for corporate control to overcome the problem. But we believe the onus is on them to prove that competition is insufficient before they burden society and shareholders with a new set of regulations and their attendant administrative and compliance costs. If competition is lacking, it is probably due to overzealous current regulation, which limits the incentives to enter the market for corporate control by imposing high compliance costs.

However, it should be noted that if competition for corporate control was insufficient with respect to partial bids we would expect shareholders' returns to suffer compared to cases where there was no partial bid. The evidence is to the contrary.

Shareholders of target companies who participate in successful partial bids receive the offer price ($P_O$) for that proportion (X) of

shares sold to the bidding companies plus the after-takeover price ($P_A$) for their remaining shares:

$$X * P_O + (1 - X) * P_A$$

In order for the shareholders to be better off with the bid, the value of the shares represented by the above expression must be greater than the price of shares before the bid was contemplated ($P_B$), i.e.

$$X * P_O + (1 - X) * P_A > P_B$$

Empirical studies of the returns to shareholders from partial takeover bids, after adjusting for general market-wide movements in share prices unrelated to the bid, indicate that the above relationship holds and shareholders are better off with partial bids. The results of studies by Bradley (1980) in the US and Bishop and Dodd (1986) in Australia, although limited in the number of situations covered (both in time and circumstance), are consistent with the proposition that partial bids benefit shareholders and are inconsistent with the proposition that the coercive potential in a partial bid is detrimental to shareholders.

## VIII. WHO GAINS AND WHO LOSES IN THE REGULATION OF TAKEOVERS?

Takeovers seem to be viewed with some hostility by the public at large and generally have received poor press. Since most of the arguments used to support the regulation of takeovers are specious (with the notable exception of their possible effect on competition, which is already, we believe, adequately handled by the *Trade Practices Act*), the issue of the cause of the outcry for regulation must be addressed.

We do not find the call for restrictions on takeovers surprising even though those who benefit from takeovers far outnumber those who are disadvantaged and the aggregate benefits are greater than the aggregate losses. In essence, those who benefit most from takeovers, the shareholders, are a large and diverse group, which is difficult to organise as an effective lobby because of its diversity. Hence there is a problem of 'free riders'. That is, there is not much incentive to lead such a group because the benefits to specific individuals or groups are generally less than the cost of organising.

The incentive is for shareholders to stand back and let someone else do the work since they share in the benefits but not in the costs if they do not participate in the lobbying.

On the other hand, those who benefit from regulation tend to be a more closely knit and readily identified group whose costs of organising are much lower and individual benefits much higher. Also, it seems to be easier to excite the press into causes of compassion than causes of celebration. These issues deserve greater analysis and attention, particularly the reasons why those who are likely to suffer from regulation of takeovers are not more vocal.

The regulation of takeovers will increase the cost of acquiring companies by means of takeover. These costs include legal costs, costs of delays, and more particularly the costly disclosure of valuable information that may be used by other companies competing for the target. These higher costs, in turn, will lead to a higher price if the takeover is consummated. The result will be fewer takeovers. Therefore, the losers from these costly regulations will include the shareholders of acquiring companies who were dissuaded from a takeover because of higher costs, and the shareholders of companies that are no longer targeted for acquisition. Since these particular shareholders cannot be identified, the onus for any lobbying against the regulations would have to fall on shareholders in general. As we have already indicated, shareholders with diversified portfolios are not likely to spend resources on such actions, especially given the inherent free rider problem. Whether larger shareholders such as institutions are prepared to bear such costs remains to be seen.

Management as a group both benefits and suffers from takeovers. Those who suffer are the managers whose positions become redundant or who lose power and authority. On the other hand the managers of acquiring companies benefit by gaining power. In terms of numbers we might expect that, in aggregate, managers may be against takeovers because there are always outsiders who threaten existing management groups through takeover.

It is also possible that managers who are less active in the management of their companies, or managers of less active companies, will have more time to organise themselves into an effective lobby group. Moreover, it is these managers who are likely to be under greatest threat of takeover. In these circumstances, we might expect that those with the lowest opportunity cost of their time would be able to spend more time lobbying their cause for regulation of takeovers. Therefore, while management as a whole

is not likely to present a unified voice with respect to takeovers; it is likely that those who might be adversely affected by takeovers will be more vocal than those who may benefit.

Other groups who benefit from the regulation of takeovers are the bureaucrats responsible for administering regulations, and the lawyers, accountants and academics who give advice to both sides of the equation, i.e. the administered and the administrators of the regulations. Promotion, prestige, and pecuniary returns do not come to bureaucrats who are not active in the administration of their responsibilities, and more significantly, in the promotion and extension of those powers and responsibilities. The same is true of governments. Governments are not known for the edifices they did not build, and even the most aesthetically offensive can be got used to and accepted. In short, there is a tendency to regulate for the sake of regulation. Only when a specific group that is relatively easy to organise as an effective lobby is adversely affected, or when the weight of a regulation impinges on the whole of society to an unbearable degree, do we hear calls for reversals of the trend. But as we observe, it is much easier to call for deregulation than to put in motion a set of deregulatory strategies that will lead to a freer and more efficient economic environment.

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