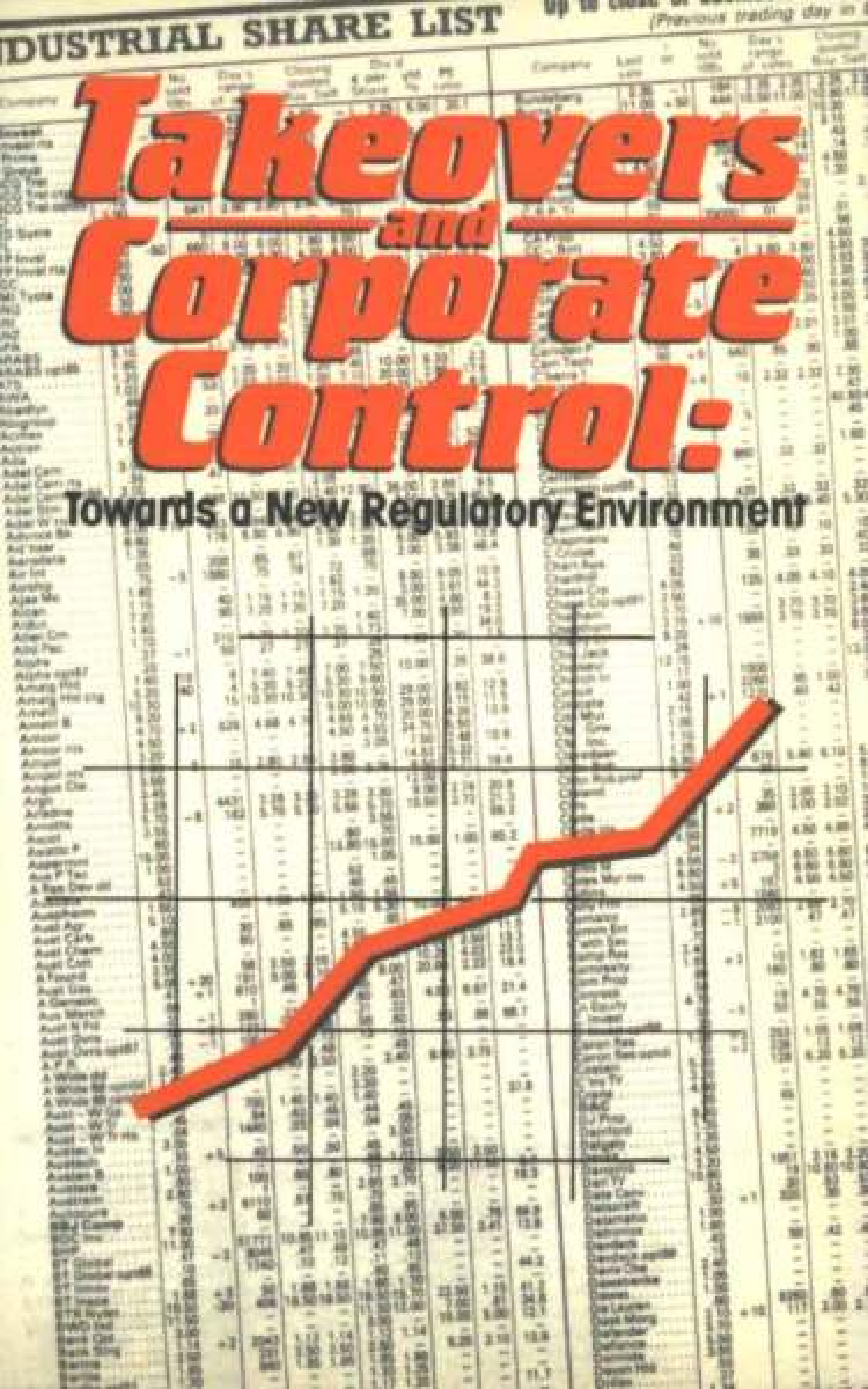
Takeovers and Corporate Control:

Towards a New Regulatory Environment



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Towards a New Regulatory Environment

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Foreword

In much economic and political discourse, the word 'market' is used in a very general and abstract sense, meaning the organisation of activities through voluntary exchange transactions. Thus 'the market' is shorthand for private economic activity in general, and stands in contrast to the bureaucratic or other methods of organising production and distribution. But 'market' also refers to the particular places and institutions whose purpose it is to facilitate exchange. We often take these for granted, forgetting that many are the product of centuries of evolution, and that some are more efficient than others. In recent years economists have come to devote more attention to real-world markets, attempting to understand better how they work, and to evaluate their performance.

The studies presented at the conferences reported in this volume belong to this genre. They are concerned with the 'market for corporate control'. The market places where transactions affecting the control of companies occur are the stock exchanges — without doubt the most highly evolved and sophisticated markets that we possess. Participants in stock and commodity exchanges are subject to numerous rules, which have been devised for the twin — and sometimes conflicting — purposes of facilitating transactions and protecting the parties to transactions. The possibilities for conflict between these desiderata seem to be particularly obtrusive in the case of takeover contests, presumably because of the all-or-nothing nature of takeovers: they are either successful or not, and in this respect are less akin to economic than to political decision making (i.e. to majority rule). In any case, one of the major policy concerns of the contributors to this volume is whether the rules governing the conduct of takeover contests are adequate and appropriate.

Another, and more fundamental, question debated at the conferences is the extent to which takeover activity is socially useful, reallocating resources in a more productive way; or whether it serves the interests, egos, and animal spirits of some members of the managerial class, and is of dubious economic benefit.

An enormous amount of empirical data has been distilled in some of the studies reported in this volume. The availability of sound factual information is indispensible to reasonable debate on these issues. But the facts are not enough — they have to be interpreted. In this connection the conference format is most useful, in that it gives scope for interpretations to be explained, challenged and elucidated.

Ross Parish

Editorial Note

This book presents the proceedings of two conferences, one held in Auckland and one held in Sydney. The conferences had the same title and theme, but they differed slightly in their content, and of course the discussion at each conference reflected the concerns of the participants in each country and the particular institutional arrangements in that country.

The papers by Peter Dodd, Gregg Jarrell, Christopher Chataway, and Peter Dodd and R.R. Officer were given at both conferences. At the Auckland conference, Colin Patterson and David Emanuel presented papers about the New Zealand situation. In Sydney, Henry Bosch, Fred M. McDougall, and Philip Brown and Andrew Horin gave papers on the Australian situation.

Gregg Jarrell presented a summary of the day's papers at both conferences. The Summation that appears here is an edited combination of his remarks in Auckland and Sydney.

The discussions were transcribed from recordings of the conference proceedings and have been kept separate for the two conferences.

Corporate Control: What Are the Issues?

Peter Dodd

Peter Dodd is Professor of Management and Director of the Centre for Research in Finance at the Australian Graduate School of Management, University of New South Wales. Previously he was Professor of Finance and Accounting at the University of Chicago and he 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 In 1985 Professor Dodd, Professor R.R. Officer and Steven Bishop were commissioned by the Centre for Independent Studies to undertake a major empirical study of the effects of takeovers in Australia.

Corporate Control: What Are the Issues?

Peter Dodd

Introduction

No single issue in business has attracted more media attention over the past ten years than takeovers.

While acquiring companies has always been a normal part of business activity, public attention has focused on the apparent increase in both the number of takeovers and the size of the firms targeted. The attempted takeover of BHP, the largest company in Australia, has been headline news and the subject of debate in public and private circles for several months.

The increased public profile of takeovers has stimulated a vigorous debate on their economic consequences. Many claims have been made in support of government intervention to restrict and further regulate takeovers. Such proposals are not new and there already exist a number of legislative provisions that embody a policy towards takeovers in both Australia and New Zealand.

Interestingly, the current public policy debate on takeovers is not restricted to Australia and New Zealand. Similar debates have arisen in the United Kingdom and the United States. Although some of the specifics relate to local regulatory provisions and to proposed policy options, there appears to be a good deal of common argument in the different countries.

At issue in the debate is whether takeovers as corporate investments create value and enhance resource allocation. If they do, regulation imposing costs on and restricting such investments is detrimental to the overall efficiency of the economy. If on the other hand takeovers are not value-creating investments but instead impede the market's efforts to allocate resources, regulation may well be warranted.

If regulatory policy toward takeovers is motivated by efforts to ensure resources are put to their most valuable uses, the conflicting arguments on the effects of takeovers must be subject to scrutiny and analysis.

These Conferences are a unique opportunity for such scrutiny. Opinions representing the different sides of the debate are on the program. The representatives of the securities commissions of Australia, New Zealand and the United States each hold well-publicised and contrasting views on the appropriate regulation of takeovers.

Since takeovers are international phenomena it seems odd that the overall regulatory policy of one securities jurisdiction would be so different from another. Clearly the alternative policies are based on very different premises regarding the economic role of takeovers.

One of the important issues for these Conferences is to discern and evaluate the competing premises underlying the opinions and regulatory proposals of the different securities commissions represented. Which view of takeovers is a more accurate portrayal of the economic reality, and therefore which regulatory course is more appropriate?

To establish a basis for today's discussion I propose to present a view of takeovers as investment decisions and transactions that facilitate the optimum allocation of resources in the economy.[1] This economic analysis argues that takeovers are important vehicles for creating value, which is available to the various parties who contract to share this increased corporate wealth.

This view of takeovers is not without its critics, who do not accept that the market for corporate control does all that is claimed. At one level the criticism argues that takeovers are nothing more than paper-shuffling transactions that generate profits from share trading without any real value being created. At another level, it is accepted that gains are made from takeovers but argued that without tighly defined government regulation these gains will be shared unevenly, which is bad, or earned only at the expense of unprotected and unwilling players in the takeover game. Some of the alternative arguments will be considered later in the paper.

The Economics of the Market for Corporate Control

The existence of a well-functioning market for transferring the control of corporations has important economic implications, and economic theory attributes great importance to the role of takeovers. To many casual observers, and no doubt to most incumbent managers whose jobs may be threatened by such developments, the wave of corporate acquisitions is a spectacle of managerial empire-building in which shareholders'

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[1]The arguments presented here are more fully developed in *Corporate Control, Economic Efficiency and Shareholder Justice* by Peter Dodd and R.R. Officer (Sydney: The Centre For Independent Studies, 1986).

interests are routinely sacrificed to a 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, economic theory argues that 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.

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 devlopment 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.

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 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 mediocre 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.

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.

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.

Before considering the role of evidence in the policy debate, we must recognise that many commentators dispute the above theory. They disagree not so much with the internal logic of the theory but with its relevance. Many argue that this model of takeovers is 'starry-eyed' and far too optimistic and idealistic a view of the motivations of managements initiating acquisitions.

These critics do not see takeovers as enhancing economic efficiency. Instead, takeovers are variously seen as wasting valuable resources by disturbing and splitting effective and efficient companies, or as mechanisms for shrewd entrepreneurs to generate substantial profits without enhancing real economic activity. Explicitly or implicitly, the critics contend that takeovers do not, on balance, create value. They believe that any gains are either accrued at the expense of incumbent target shareholders and managements or are financed unwillingly by shareholders of acquiring firms whose managements pursue takeovers for reasons other than the search for profits. Some even argue that the gains come from the pockets of taxpayers in general.

Anti-Takeover Theories and the Promotion of Regulation of Takeovers

Many of the arguments used to denigrate takeovers and promote further regulations restricting corporate acquisitions are, on closer inspection, dubious. Some of the more popular include the following.

Takeovers are just trades in paper securities that do not produce any real benefits. 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. Clearly, 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 such a trade 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 the 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 overt steps by the trader (or raider) to change the company into more profitable activities, but it could also include 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 cause resources to be misallocated just as much as inefficient production processes.

It is apparent that the failure of many critics to perceive how the increased value is to be derived motivates much of their scepticism. Perhaps the most common regulatory proposal in all three securities jurisdictions is a rule to force acquiring firms to disclose what they intend to do with the acquired assets. As well as failing to recognise that entrepreneurship is a scarce resource, such proposals fail to recognise that information costs money; it is not a free good. How long would you play a game where you spent money discovering ways to create value from a given set of assets only to be forced to give up your knowledge to all and sundry for no recompense?

A variation of the argument against 'paper profits' is that share prices do not reflect the underlying economic value of assets. This could also reflect a failure to recognise the logic of a balance sheet. However, suppose security prices consistently underestimated the true value of the 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 could be stripped from the company and sold to those who place a greater value on them. Alternatively, if securities consistently over-valued the assets on whose title they rest, investors in the sharemarket and any corporate raiders would get lower returns than those who bypassed 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 accurately these earnings and trade on their expectations, or why legions of investors continue to invest in professionally managed investment vehicles, or why governments, business 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? Given the choice of being informed on a single future company statistic (apart from the future share price), 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.

Corporate 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. Clearly, if there was any 'raping' or 'pillaging' of target companies we would expect the price 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 preparing defences against unwanted takeovers, and that this is not in the best interests of the firm (and implicitly its shareholders). The argument is extended to a statement that managers who see a threat to their incumbency will alter their investment strategy to ensure that short-term profit performances are enhanced. The argument runs that 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. I have no quarrel with this; indeed one would hope that management is continually conscious of the value of the assets 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 the 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 line are prepared to argue 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 the optimal long-term investment strategy and their superior performance will expose those firms who adopted the 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. This is 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 term 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 its best by the company and that the share price being offered by the acquired company is insufficient for control of the company to be changed. This means the management will be spending a lot of time providing 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 the incumbent management's time and effort spent providing the market with information is wasted.

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 acquired assets, 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 can presumably get most from them. Therefore resources are being better allocated.

Corporate takeovers promote excessive borrowings. Many takeovers are financed by borrowing against the assets of the acquired firm as well as offering collateral from the assets currently controlled by the aquiring firm. This places the acquiring firm in a much higher risk class, and therefore it should not be surprising that occasionally, particularly where the takeover has proved unsuccessful, the acquiring company will be forced to liquidate assets or, in the limit, itself. However, this is an issue concerning the acquiring company's management, shareholders and whoever is financing them into the takeover, and not an issue that should concern those related to the acquired company.

In this respect, takeovers 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 also the lenders. With hindsight we can see where financial gearing has led a company into problems. However, if it is the concern of the acquiring company's shareholders, excessive gearing should be reflected in the share price of the company, which in turn will usually make it more difficult to raise funds and therefore 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 argument that has been used in the context of excessive borrowing is that the money used is from overseas, which increases a country'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 local assets. The point that should be recognised is that the borrowing and the selling of the assets are both commercial decisions. Presumably those who are borrowing believe they can repay the loan, and those who are lending believe that 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, regulating borrowings in a takeover context to preserve some macroeconomic goal (such as the level of national indebtedness) is hardly a sensible way of pursuing such a goal. 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 perjorative title 'junk'. There are attempts in the US to proscribe the use of such bonds, specifically in company takeovers. Even in Australia, for example, there have been calls for regulation to prevent the use of such financing in takeovers, before the method develops.

What those calling for regulation of such bonds are recommending are interest rate ceilings on debt securities, although they do not express it as such. Price controls for debt securities? Where else can we point to such a control that has not 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 has already been made: who bears the cost if a junk bond issuer defaults? Clearly, 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? I do not believe so. Therefore, are all those who are satisfied with their investment in these high yielding securities to suffer to protect a few? The default rate among junk bonds in the US to date has been low, less than 2 per cent.

Much of the concern in the US with the use of junk bonds has not been so much for the protection of purchasers of the securities but 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 be using 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 but affects 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, and therefore, at first sight, it would appear that they should be prevented. However, while I am clearly against regulation that takes the form of a compulsory shark repellent for all companies, I believe that companies have the right, providing it is consistent with their shareholders' wishes, to put in place such clauses. Providing such clauses are not forced on shareholders or that minority groups are not significantly disadvantaged in a vote by shareholders to insert such a clause in the Articles, one can only assume shareholders believe they will benefit from such a clause. The benefit is likely to come, typically, from the greater security management may feel as a result. Shark repellents may be a cheaper way to retain management than offering other rewards.

Also, the constraints on foreign ownership of Australian companies, in particular certain types of Australian resources, has prompted some companies to limit the proportion of foreign ownership on their share register. Providing this is done openly with the assent of shareholders, then it has much of the same attributes as a shark repellent. The shareholders clearly 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 in that they involve an insertion 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 appropriate for shark repellents is applicable to poison pills and shareholders should have the right to insert them.

As discussed earlier, 'golden parachutes' are compensation agreements with the top management that apply in the event of a takeover in which managers are retrenched. Typically, they 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 the individual companies — those who are paying for the award have a direct say or vote on the size of the award and who should receive it.

An argument that has been advanced against poison pills, shark repellents and golden parachutes in a company's Articles is that while current shareholders may agree to them, it is not fair to future shareholders. The 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 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.

The Role of Evidence on Takeovers in the Policy Debate

The importance of sound analysis, with particular attention to the collection of evidence on the effects of takeovers, is a theme found in the published views of all the major speakers at these Conferences. The bodies responsible for securities regulation in Australia, New Zealand and the United States are each represented, and each has in its own way called for an appraisal of the economic consequences of takeovers.

In the US, many studies of takeovers have been prepared over the past decade and the accumulated evidence is vast. Dr Gregg Jarrell, Chief Economist of the Securities and Exchange Commission (SEC), will argue that there is a strong consensus in the evidence used to formulate the current SEC policy on takeovers. That evidence has proven a reliable base for evaluating alternative theories on takeovers and has led the SEC to reconsider and retract the anti-takeover stance that had been popular in the previous decade.

In Australia and New Zealand the evidence has not been as readily available. An important objective of these Conferences is to provide a forum for the public discussion of recently completed studies on the effects of takeovers.

It must be noted that some of the impetus for the emerging research on takeovers owes to the initiative of the Australian National Companies and Securities Commission and in particular to its Chairman, Mr Henry Bosch. Mr Bosch has publicly endorsed the importance of basing regulatory policy on sound analysis and evidence. This endorsement is to be commended and it is hoped that assessment of the available evidence will become a more important input to policy deliberations in the securities area. Too often regulations over securities markets and other aspects of business have been promulgated with little attention to whether or not reliable evidence is available to support the perceived ills that the regulation is aimed at fixing. The recent call for the regulation of partial takeovers in Australia is an obvious example of evidence ignored.

As is to be expected there is competition in the research market. Different studies use different and competing research methods, and it is not unusual to find results across studies that appear quite inconsistent. This is the case with the evidence on takeovers to be discussed here.

It should not be inferred, however, that the discrepancies negate the usefulness of the studies. Indeed, on closer inspection it is usual to find a great deal of similarity between studies. One of the issues for these Conferences is to identify consistencies in the results, and where there are differences to decide whether those can be explained by the differences in the methods and research designs utilised. The task is then to agree upon which results are robust and if necessary direct further research to obtain consensus about the results and the policy implications to be drawn from the theories they support.

Clearly the time constraints imposed on these Conferences make it impossible to achieve a thorough critique of the various studies. It is possible, however, to decide whether the differences in results can be reconciled. Of course at the end of the day a judgment must be made as to which of the results in the studies can be considered evidence on the effects of takeovers.

Having established the nature of the evidence, and only then, is it possible to assess the implications of that evidence for policy. The connection between evidence and policy prescription is often a leap that is at best tenuous and sometimes untenable. Although conclusions and implications may be forcefully presented, the reliability and relevance of the evidence is the crux. Questions about sample coverage, adequate controls for extraneous events, as well as the basis used for measuring the effects of the transactions are all issues that cloud the link from evidence to conclusion.

I believe that there is a good deal of consistency in the results of the studies presented here. Even though Fred McDougall utilises a research design very different from that used by Bob Officer and David Emanuel, the consistencies can be detected and the differences in results can be reconciled by taking into account differences in samples covered and the metric used to assess the impact of the takeovers. It is possible for a consensus to emerge from an objective evaluation of the results of the three studies, and I believe that consensus has very clear implications for regulatory policy on takeovers.

I do not, however, see much consistency in the conclusions drawn from the studies by the various authors. It is for these Conferences to decide whether the results and research methods of each study can substantiate the conclusions drawn. If not, incorporating those results into policy deliberations is clearly dangerous, even though the conclusions may be appealing. The more robust the evidence the more it can contribute to policy debate.

The history of economic regulation is littered with examples of incomplete analyses being used as excuses to bolster preconceived views on appropriate regulation. The ultimate test of any theory is its ability to withstand empirical investigation. If the policy deliberations on the appropriate regulatory framework for takeovers are to be based on sound premises, studies such as those presented today are important inputs. It is just as important, however, to guard against automatically assuming that the results do justify the conclusions reached.

Empirical results must be evaluated in terms of a framework, in this case a theory of takeovers. Again an issue at hand is the relationship of the results to the alternative theories of takeovers. The most powerful framework that explains the results of takeovers should be the one to influence regulatory policy.

Regulating Hostile Takeover Activity: An Interpretive History of the US Experience

Gregg A. Jarrell
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Introduction

In January of 1986, the Commissioners of the SEC voted on a wide range of new regulatory initiatives to limit or curtail tender offer activity. This extraordinary vote marked the culmination of at least two years of often contentious debate over the need for new regulation of takeovers. During this time, takeover critics had pressed their case for new regulatory constraints based on novel theories of capital market inefficiency. Prominent among the forums for debate of these issues had been the SEC's roundtables and the 1983 Advisory Committee on Tender Offer Policy.

The January meeting was extraordinary, not because it marked new regulatory initiatives, but rather because it embraced a free market philosophy towards tender offer activity. The Commission, often by unanimous vote, rejected further consideration of the following proposals:

- to require that all acquisition attempts be made in the form of any-or-all offers to target firm shareholders;
- to require bidders to obtain approval of their shareholders before launching an acquisition attempt;
- to require conditional acceptance of any acquisition offer by the target's independent (that is, disinterested) directors;
- in the event of rejection by target directors, to require majority approval of the acquisition by vote of target shareholders;

- to require that in partial offers, target shareholders be provided with an opportunity to vote on the offer in addition to tendering their shares;
- to prohibit or limit two-tier offers;
- to prohibit or limit anti-takeover amendments to corporate charters;
- to prohibit the granting of golden parachutes;
- to prohibit 'lock-ups' by target companies;
- to prohibit greenmail transactions;
- to require that bidders have 'firm' financing commitments prior to commencing tender offers;
- to prohibit the use of junk bonds to finance tender offers;
- to regulate the activities of arbitragers during acquisition contests.

The Commission's decision to reject these proposals reflects a major shift in tender offer policy that has occurred over the past six years. The shift is remarkable when viewed in the context of the previous 20 years, which had seen active intervention by both federal regulators and state governments in the acquisition arena.

In fact, to the degree that the SEC is currently considering new regulatory initiatives in tender offers, the focus is on abusive defensive tactics. This is also in direct contrast to the pre-1980 environment, which focused mainly on restricting the activities of bidding firms. The agency's attention is currently focused on three possible regulatory changes: preventing open market purchases during tender offers, which have been used by several targets to defeat unwanted bids (e.g., Carter Hawley Hale in 1984); requiring that 'poison pills' be subject to shareholder approval; and requiring that all tender offers be made to all shareholders equally, in order to prevent exclusionary offers, used virtually exclusively as a defensive measure by targets (for example, Unocal in 1985). In January 1986, the Commission revised the tender offer rules to eliminate the timing advantage that targets had previously enjoyed in self-tender offers that competed with third-party bids.

This new focus reflects the growing influence of the voluminous academic literature on merger activity in the policy arena. In this paper, we summarise this evidence, and relate its emergence to the evolution of federal and state regulation and court decisions on tender offers over the past 20 years.

The 1960s: The Emergence of the Tender Offer Debate

Until the early 1960s, tender offers were infrequent and usually negotiated. They were seldom used to gain control over the objections of a recalcitrant target management. In the late 1960s, overtly hostile bids, although still considered distasteful among Wall Street practitioners, became more prevalent, and often generated vivid news coverage. Prominent were 'Saturday night specials' — that is, first-come first-served offers, with short durations and high premiums to those shareholders who responded in time.

These vivid developments gave rise to a growing unease over tender offer tactics, and a perception in policy circles that certain classes of shareholders were being disadvantaged in these hostile control contests. These fears were fanned by managements who suddenly perceived themselves as vulnerable in an environment in which they could be replaced with virtually no notice. These forces gave rise to an emergent political coalition comprising many managements, shareholder activists, federal regulators, and the more conservative elements of the Wall Street community. During the late 1960s, a series of hearings ultimately resulted in the passage of the Williams Act in 1968, imposing disclosure and delay regulations on all cash-only tender offers.

The response to the initial Williams Act restrictions was a marked shift away from cash transactions, towards 'funny money' — that is, exchange-based tender offers, which were exempt from the 1968 Act and thus subject only to the restraints embodied in the 1933 Act. This shift quickly prompted the 1970 amendments to the Williams Act, extending the Act's provisions to cover all tender offers, regardless of the medium employed.

Critics' charges during this period, which were largely responsible for both the original and the amended Williams Act, focused on giving market participants sufficient time and information to make a rational choice among competing management teams. The short, speedy takeover was portrayed as the work of 'pirates', who financed the premium offer for control by expropriating the assets of the non-tendering minority. The prospect of expropriation was argued to stampede shareholders into tendering, regardless of the economic merits of the offer and the economic consequences of a change in control.

In response to these charges, the major provisions of the Williams Act regulated three major aspects of corporate control activity. First, Section 13(d) requires large (originally, over 10 per cent) purchasers of a public corporation's stock to disclose, within ten days, their identity, their stockholdings, and their intent (that is, investment purposes or control). Additional disclosures are required in the event of either changes in holdings or changes in intent. Second, the Act regulates tender offers directly, by requiring a minimum offer period (originally, ten days), withdrawal rights, and rules for pro-rationing of oversubscribed partial and two-tier offers. Finally, the Act also contains broad anti-fraud provisions that give target management explicit standing to sue for injunctive relief from the perceived ill effects of false or misleading disclosures. (Many courts had denied managements who were not buyers or sellers of securities such standing under previously existing law.)

In 1970, amendments to the Williams Act made three important changes. The threshold percentage of stock ownership that triggers the various disclosure requirements was tightened from 10 to 5 per cent. The scope of the law was expanded to cover exchange as well as cash offers. Finally, the SEC's power to make new rules under 14(*e*), designed to prevent fraudulent and manipulative activities, was expanded significantly.

The purported intent of the Williams Act was to protect target shareholders from abusive bidder tactics — allegedly used by 'pirates' — by providing target shareholders with sufficient information and time to decide whether or not to participate in any particular tender offer. It was reasoned that effective disclosure requirements, coupled with greater time for deliberation and a virtual guarantee of fair participation (the result of pro-rationing and withdrawal rights rules), would remove the supposed tactical advantages that had previously allowed bidders to stampede target shareholders into accepting an inferior or suboptimal offer.

The regulations were also argued to balance target defensive advantages, by requiring formal disclosure before target managements formally respond to hostile bids. The Act was more neutral than many advocates wished it to be, staying away from imposing long, restrictive minimum offer periods, merit regulation of offers' fairness, and advance disclosure of block ownership. Nonetheless, despite lip service to neutrality, the Act's overall effect was to tip the scales against the perceived 'pirates' making hostile bids.

The piracy theory, if true, implies major inefficiencies in the market for corporate control. Indeed the theory suggests that front-end-loaded, first-come first-serve offers can succeed by forcing target shareholders to accept offers having blended premiums inferior to expected future values. In the extreme, piracy tactics could succeed even when pirates offer no value-increasing changes in corporate policy. Were this the case, clearly, uneconomic acquisitions would occur.

A reading of the congressional debate on the Williams Act reveals an even stronger concern, with inter-shareholder equity, that guided lawmakers. The concern was that some shareholders — those with differentially poorer information or at some distance from a control contest — would be effectively denied the opportunity to participate in a tender offer. It was this concern — that some shareholders would be disadvantaged by speedy, secretive takeovers — that led to the codifying of pro-rationing, withdrawal rights, and minimum offer periods. Even the disclosure requirements are largely justified by this equity concern.

The corporate piracy myth, which served as the economic (as opposed to distributional) justification for the Williams Act, was in fact not based on any solid empirical evidence. The Williams Act hearings were dominated by debate involving many allegations of economic inefficiency, usually brought by besieged target managers, but virtually no systematic tests to prove the allegations. There was also no concern for the potentially chilling effects on the incentives to bidders that disclosure and delay regulations would inevitably bring.

Indeed, nearly a decade passed before economists began to study these problems. They eventually produced careful empirical tests of the economic effects of tender offers, explicitly testing the piracy theory and the ultimate effects of the Williams Act. Three of the first important analyses, performed by Bradley (1980), Jarrell and Bradley (1980), and Dodd and Ruback (1977), directly tested whether piracy was present in the tender offer market in the period before, as well as after, the passage of the Williams Act. They find that piracy was non-existent in both periods. The piracy theory is tested by examining the average market value of non-tendered shares in the wake of successful tender offers. Bradley (1980) states: 'The fact that the post-execution price of the target's shares is 36 per cent higher than the pre-announcement level indicates that corporate "raiding" is not an important explanation for interfirm tender offers'. In other words, the piracy theory neither had nor has any basis in fact.

There is both casual and scientific evidence that the Williams Act has had a profound distributional effect. It has shifted a significant portion of the gains from tender offers from bidding to target shareholders. The effects of disclosure and delay regulation have been to foster multibidder, or auction contests, and pre-emptive bidding. According to Jarrell and Bradley (1980), average blended premiums (that is, average gains per share) paid to target shareholders increased from about 25 per cent above previous market price to about 52 per cent. Concurrently, net-of-market stock price gains to bidding shareholders decreased from about 9 per cent to less than 6 per cent.

This evidence raises concern among economists that these distributional shifts, from bidding to target shareholders, may excessively discourage productive investment in takeover activity. Indeed the speedy, secretive, pre-Williams Act tender offer, which cannot be attributed to piracy, appears instead to reflect a crude market solution to the bidder's problem of avoiding expropriation of valuable, takeover-related information. With enforced delay and disclosure, bidders are assured before they start of a lower return on investments in takeover-related information.

The social price of expropriation is measured in terms of the sacrifice of incentives to bidders to make productive, efficiency-increasing investments in takeover-inducing activity. To the degree that takeovers reflect desirable competition among management teams, the Act's promotion of auction-style contests may in theory seriously dampen incentives for socially valuable investments in takeover-related information by potential bidding firms.

Jarrell and Bradley (1980) document evidence that suggests significant deterrent effects from the Williams Act, inferred from a measure of the value of cash tender offers relative to new business investment through 1977. They conclude that: 'The general impression is that acquisition activity reached a peak in 1968 and 1969, when measured absolutely (total value of acquired firms) and relative to new investment (value of acquisitions as percentage of new investment). The total number of tender offers (cash and other) also peaks around 1968, and then falls dramatically in 1970 through 1972'. Thus the Act has had dramatic distributional effects, reallocating takeover gains from bidding to target shareholders.

Overall, it is clear that the Williams Act has also had equity effects **among** target shareholders — thus addressing what appeared to be the chief concerns of its architects. It clearly provides for more equal treatment than might have obtained in some tender offers before its passage (although most oversubscribed tender offers before the Williams Act were pro-rated in accordance with New York Stock Exchange rules). But the question remains: at what social price have these equity effects been bought?

The 1970s: Courts and State Legislature Question the Stock Market

The Williams Act, while reducing the level of tender offer activity, did not eliminate the developing phenomenon of hostile control contests. In fact the Act encouraged drawn-out, litigious, multiple-bidder contests, by giving targets and potential rival bidders sufficient time and information to challenge initial bidders. Thus in the early 1970s, the 'newsworthy' takeover bid became far more commonplace than it had been in the 1960s.

From the perspective of embattled target managements, and their Wall Street advisers, the Williams Act did not go far enough in erecting barriers to unwanted takeover attempts. Managements under siege sought protection by the state and federal courts, while broader management coalitions sought further pre-emptive regulation from state legislatures. Both groups relied on similar, new theories of potential economic inefficiency in the takeover market, and the result of their efforts was a patchwork of legal and legislative response working to further curtail hostile tender offer activity.

In the legislative arena, by the end of 1978, 36 states had passed statutes governing takeover activity that were widely viewed as much tougher on aspiring acquirers than was the original Williams Act itself. State tender offer laws based their jurisdiction over tender offers upon a combination of factors, including the target's state of incorporation, its principal place of business, and the location of its major assets. Almost all state statutes exempted tender offers that had the approval of the target's board of directors — eloquent testimony to the often direct influence of management coalitions in the crafting of these laws.

Generally, state laws require more stringent disclosure than does the Williams Act, well in advance of the tender offer (usually ten to 30 days before announcement). Further, they require longer minimum offer periods, and more liberal withdrawal rights than does the Williams Act. The most important defensive provisions of the state laws, however, were their administrative procedures, by which hostile tender offers could be significantly delayed or prohibited outright. This amounted to de facto merit regulation of hostile bids. These laws empowered state securities commissioners to seek an injunction against any offer believed unlawful, and made violations a criminal offense in addition to requiring compensatory treatment of target shareholders. This process resulted in long delays for many control bids, and probably deterred many others from ever taking place.

While state legislation provided a developing framework of bidder restraints, courts also showed sympathy for the perceived plight of target managements, and other so-called 'constituencies' of the corporation. The 1970s are replete with examples of court-granted injunctive relief for target management. Grounds for relief range from simple Williams Act disclosure violations, to trumped up antitrust prohibitions erected at the behest of the target. (Legal and economic experts have pointed to the irony of a potential beneficiary of monopolisation pleading for court-ordered relief from increased profitability.) During this period, litigious targets were very successful in obtaining, at a minimum, significant delays in the execution of unwanted offers, from the courts, state security administrators, and numerous federal agencies.

Supporting most of these new interventions into the operation of the takeover market (save, of course, antitrust), was the contention that companies often became takeover targets simply because they were literally mispriced — undervalued — by the stock market. It was contended that because targets were undervalued, a savvy bidder could offer substantial premiums for target firms, while still paying far below the intrinsic value of the corporation. By this theory, it became the duty of target managements to defend vigorously against even high-premium offers, in order to protect shareholders' true interests. Remaining independent, it was argued, would offer shareholders greater rewards over the long term than were offered by opportunistic bidders seeking short-term gains.

Thus a new, less extreme version of the 'piracy' theory was developed in the courts and the policy arena, based not on stampeding shareholders with (now illegal) 'coercive' offers, but on a fundamental inefficiency in the stock market. Again, virtually no systematic evidence was offered by undervaluation proponents to validate this theory. However, this did not dampen its reception in legislatures, courts, and the public arena. It is impossible to know whether this theory, per se, was decisive in influencing the development of legal and legislative opinion, or whether it was simply an expedient excuse for bowing to local political pressures. But the undervalued target theory become the prominent rationale for increased state regulation and relief for target firms by the courts.

Over the course of the 1970s, evidence began to accumulate on both the effects of state laws, and the relevance and accuracy of the new undervaluation theory. Not surprisingly, as was the case with the original Williams Act concerns, undervaluation found little support in rigorous economic tests. State laws appear to have had a further dampening effect on bidder incentives, extending the effects of the original federal statutes.

The evidence supporting the deterrent effects of state laws is found in the work of Jarrell and Bradley (1980). Specifically, they find that average premiums for targets covered by state laws increased to 73 per cent, as compared to 52 per cent premiums for targets covered by the Williams Act alone. Bidder premiums declined from 6 per cent to 4 per cent. In addition, there is direct evidence of deterrence, shown by the relative frequency of takeover bids against targets with and without state protection. The frequency of all takeovers, both friendly and hostile, for in-state corporations declined significantly after states passed anti-takeover statutes.

Concurrently, strong evidence against undervaluation and in support of an efficient market for corporate control was published by several authors. This evidence is based on analyses of the stock price performance of targets that succeeded in defeating unwanted takeover bids. Analyses by Bradley, Desai, and Kim (1983), Jarrell (1985), and Easterbrook and Jarrell (1984), all show that targets defeating hostile bids lose virtually all of the value increase caused by the tender offer. Their post-defeat values revert to approximately the (market-adjusted) level obtaining before the instigation of the hostile bid.

This evidence shows that the market does not, on average, learn anything new or different about target firms' intrinsic values through the tender offer process, despite the tremendous attention lavished on targets and the huge amounts of information traded among market participants during takeover contests. The evidence thus strongly suggests that these target firms were not languishing undervalued and ignored in the market prior to the onset of unwanted takeover activity. If undervaluation had indeed been present, then the deluge of new information on targets' intrinsic value would cause fundamental price corrections even in the event of takeover defeats. In over 85 per cent of cases studied, there was price reversion, not correction, for defeating targets.

Thus, again in the 1970s, there occurred new policy initiatives to limit tender offer activity, provoked in no small measure by the concerted efforts of managements who, feeling themselves threatened, turned to the political process for relief. Policy proposals were supported by new, anecdotal and unproven theories of inefficiency in both the takeover market and the stock market generally. Evidence on the validity of these theories was slow to develop, but as was the case in the 1960s, ultimately served to reject the theoretical justifications for the new market restraints.

The 1980s: Reliance on the Market and the Waning Influence of Business Interests

By the late 1970s, a marked shift can be seen in the evolution of legal opinion on takeover activity, particularly on defensive strategies employed by hostile targets. The decade produced a large number of cases in which court-imposed delays resulted in considerable harm to target shareholders. In some cases, court sanctions ended hostile raids, with commensurate damage to target shareholders, who lost large takeover premiums. In other cases, court-imposed delays carried clear, vivid costs that were of no obvious economic merit.

An excellent example is the protracted, two-year-long contest between Ronson Inc. and Liquigas SpA. Ronson launched overlapping court challenges to the Liquigas tender offer in virtually every available jurisdiction, obtaining not one but over a dozen separate, court-ordered delays and extensions. Ultimately — at the end of what had become a virtual circus of litigation — the Liquigas offer was found, by all courts, to violate no laws or regulations.

As a result of these contests, by the late 1970s the courts were beginning to reverse their long-standing tendency to grant temporary injunctive relief virtually automatically. They began to resent the constant pressure from target managements to serve as merit regulators of takeover activity. Increasingly, legal opinion hewed out a narrower interpretation of both legal and regulatory constraints, reflecting a growing appreciation of the harm that was arising from legally-imposed delays.

These trends are illustrated by the fact that since 1980, one cannot find a single case in which litigation alone has been sufficient to defeat an unwanted takeover bid. This is in marked contrast to the early 1970s, when defeats based on permanent court injunctions and interminable court-imposed delays were frequent. Thus while managements' discretionary defensive tactics were still generally upheld in the courts, it became virtually impossible to use legal blocking as a defensive tactic in and of itself.

Increasingly frustrated in the courts, managements seeking relief from takeovers and the threat of takeovers turned to the legislative arena with renewed intensity. Their efforts were fuelled by a newly booming market in merger activity, caused by factors including financial deregulation, the increasing leniency in the interpretation and administration of antitrust laws, and innovations in the financing of large-scale acquisition bids.

Coincidental with the boom in takeover activity was the demise of state anti-takeover laws. This occurred because of the pivotal 1982 Supreme Court decision in *Edgar* v. *Mite*. This landmark case struck down the Illinois takeover legislation, and thus by precedent invalidated virtually all other state anti-takeover laws. In their ruling, the Justices embraced a sweeping free market philosophy in assessing the market for corporate control. Justice White wrote that the Illinois law distorted the 'reallocation of economic resources to the highest-valued use, a process which can improve efficiency and competition'.

In striking down the Illinois Act, the Court held that the law violated the commerce clause in addition to the supremacy clause. The commerce clause is violated because state anti-takeover laws regulate many transactions with nationwide implications, thus seriously interfering with interstate commerce. The supremacy clause is violated because state laws effectively infringe on federal prerogatives as set forth in the Williams Act.

Only now, four years later, are some states making a concerted effort to erect new laws to deter takeovers while not violating the Supreme Court's view of constitutional prerogatives. Experts contend that these new laws remain highly vulnerable, and may be subject to invalidation by the high court in the near future. The SEC is on record as opposing several of the more prominent of this new generation of state laws (e.g. those in New York and New Jersey), and will almost certainly assist in challenging their constitutionality.

By the 1980s, the confluence of these factors had focused virtually all attention and pressure at the federal legislative level. Managements' efforts at the federal level were given a huge boost by the public spectacle of the first drawn-out hostile contest involving large contestants and many innovative and confusing offensive and defensive tactics. Public and policy opinion became somewhat galvanised by the monumental debacle of the Martin Marietta-Bendix-Allied-United Technologies free-for-all, which publicised such novel tactics as pac-man defences, massive self-tender offers, and golden parachutes, and fostered an appearance of impropitious and indeed predatory bidder tactics.

This battle was a direct factor in the convening of the 1983 SEC Advisory Committee on Tender Offer Policy, which brought together prominent members of the financial, legal, and academic communities to address perceived abuses in the market for corporate control. The Committee reflected the widespread, if unsupported, policy concerns fostered by these newsworthy but idiosyncratic cases, returning a report to the Commission containing over 50 specific recommendations for new regulatory initiatives. Although the report professed a desire to retain neutrality in the regulatory structure, almost all the regulatory initiatives proposed centred on new restraints against unwanted, hostile bids. Three prominent examples were requiring 13(d) ownership notification to be filed before passing the 5 per cent ownership threshold; requiring all acquisition programs for more than 20 per cent of a corporation's outstanding stock to be effected by tender offer; and imposing differentially more burdensome minimum offer periods (and other rules) on partial and two-tier bids.

Although the Committee's report contained no systematic empirical evidence to support the need for new regulations, the SEC was sufficiently swayed to introduce a legislative proposal embodying several key Committee recommendations. These included prohibiting the adoption of golden parachutes during takeover contests; shortening the maximum allowable 13(d) filing time after crossing the 5 per cent threshold; prohibiting self-tenders and stock issuances during open tender offers; and prohibiting so-called 'greenmail' unless approved by a shareholder vote. The SEC also adopted rule changes, again inspired by the Committee report, intended to improve the fairness of the prorationing process in oversubscribed tender offers.

Concurrent with these SEC initiatives was a flurry of congressional action proposing new restraints on corporate control activity. Literally dozens of bills were introduced during the 1983 and 1984 sessions dealing with the entire spectrum of takeover tactics. Proposals ranged from modest to sweeping moratoriums on hostile takeover activity; most proposals centred on further restraining bidders' options during hostile raids.

This new activity was supported by new arguments about the motivations for hostile takeovers, again focusing on possible sweeping inefficiencies in the stock market. The Business Roundtable, in its role as a stalking-horse for threatened, large business interests, propounded the management view with vigour in congressional and SEC forums.

The new management view concentrated on an alleged pervasive short-term focus by the stock market in valuing corporations — specifically, a myopic focus on earnings — and a resultant tendency to undervalue corporations engaged in long-term activity. It was alleged that market participants, and particularly institutional investors, are almost exclusively concerned with the short-term earnings performance of corporations in which they hold stock. As a result, any company pursuing long-term activity — that is, planning for long-term development — will become undervalued by the market, as its resource commitments to the long term will depress short-term earnings.

Institutional investors were argued to abet this process in two ways. Not only did their focus on short-term, quarterly performance results intensify the market's focus on the short term; but institutions' need to outperform the market was alleged to mean that they would accept virtually any premium over the current market price for shares. Thus institutions were accused of working actively, in concert with 'takeover entrepreneurs', in order to engender takeovers of any corporations selling below true value — that is, any corporations concentrating on the long term.

This new theory carried conveniently perverse implications for corporate strategy, suggesting that the best way to become a takeover target was to concentrate on long-term, productive, efficiency-increasing activity. It played into the growing fears among policy-makers about the consequences of American industrial decline and the growing threat of foreign competition. Congressional hearings on takeover activity often developed into circuitous debates about the international competitiveness of American industry.

Again proponents of these new theories offered no concrete evidence to back up their claims. In the past, the confluence of new takeover developments and the rise of a vivid new theory charging abuse had always resulted in a new wave of restrictive regulation. This was primarily due to the very long lags that had ensued between the introduction of such theories into the policy arena, and the subjecting of the theories to careful test by disinterested analysts.

However, in the post-1980 environment, several new constraints worked against quick and uncritical acceptance of these new charges by those in the policy arena. One major deterrent was the existing amassed body of evidence on the efficiency of the market for corporate control. While not addressing the new theory directly, this evidence on overall efficiency both encouraged scepticism of new charges, and provided a vivid reminder of how far off the mark critics' previous charges had proven to be when subjected to rigorous testing.

A second factor significantly mitigating the impact of the new charges was the increased focus of economists generally, and the administration in particular, on providing timely reaction to, and testing of new theories as they emerged. Thus within twelve months of the initial ascendence of the 'short-term' theory, several important studies had emerged that provided strong evidence against the main contentions of critics. Among these were two studies by the SEC's Office of the Chief Economist, and similar studies by several prominent Washington policy institutions and outside academics. These studies provided data on the coerciveness of two-tier and partial bids, and tested directly the charge that takeover targets were characterised by higher commitment to long-term activity and that takeover fears cramped long-term investment activities. The studies found that critics' charges had no support in fact.

Recent evidence has dispelled several myths. Among the more important findings are:

- Two-tier and partial tender offers do not result in lower blended premiums than any-and-all offers and do not stampede shareholders into accepting inferior offers (SEC: 'The Economics of Two-Tier, Partial, and Any-and-All Tender Offers').
- Takeover targets are not more long-term oriented than are their industry peers (SEC: 'Institutional Ownership, Takeover Activity, and Long-term Planning'; Investor Responsibility Research Center (IRRC): 'Are Takeover Targets Undervalued?').
- Institutional investors do not foster takeover activity, nor do they react negatively to long-term planning (SEC: 'Institutional Ownership...'; IRRC: 'The Effects of Institutional Investors on Takeover Activity').
- Takeover targets do not have lower debt levels or cleaner balance sheets than do other firms in the market (IRRC: 'Are Takeover Targets Undervalued?').
- By several measures, takeover targets do not appear to be 'unfairly undervalued' by the market prior to takeover (SEC: 'Institutional Ownership...'; IRRC: 'Are Takeover Targets Undervalued?').
- Shareholders, using existing state corporation law, do a creditable job, through voting, of weeding out potentially harmful anti-takeover provisions. However, when the voting prerogative is abridged, as is the case with so-called poison pill defenses, shareholders are harmed on average. (SEC: 'Shark Repellents'; IRRC: 'Antitakeover Amendments' and SEC: 'Poison Pills').

In 1985, the administration's view that the market for corporate control should not be further regulated was embodied in Chapter 6 of that year's Economic Report of the President. In that same year, the administration view was pivotal in ensuring that no new regulations governing takeover activity were passed by congress — despite the introduction of over 50 bills aimed at curtailing hostile takeover activity. The SEC has withdrawn its earlier proposals for further restrictions of takeovers, and is instead concentrating policy attention on potentially abusive defenses by target managements, including, most prominently, defensive open-market purchases and poison pills.

Indeed the only major new restriction on takeover activity promulgated in the past year has come from an unlikely source, in the form of the Federal Reserve Board's move to limit the use of so-called 'junk bonds' in tender offer acquisitions. It is remarkable that this initiative provoked an almost universal negative reaction from federal agencies with authority over tender offer activity, including, prominently, the SEC and the Department of Justice's Antitrust Division. In light of the dramatic trends of the past five years, it is likely that this initiative represents the last policy attempt that will be seen for some time at the federal level that carries the obvious intent to further constrain takeover activity.

Conclusion

Over the past 20 years, a remarkable consensus has slowly developed regarding the economic consequences of hostile takeover activity. The economy benefits from an unfettered market for corporate control. This notion has evolved from an unproven theoretical hypothesis to a widely-confirmed economic fact, which stands as the bulwark supporting current federal tender offer policy.

The path to this broad-based consensus has been rocky. It has been characterised by an ebb and flow of new coalitions militating for protection from competitive forces in their own self-interest, as well as genuine, if misguided, concern over the possible consequences of hostile raids. Each new set of concerns has prompted new restrictive policy proposals.

Only in the 1980s has the accumulated weight of economic evidence been sufficient to break the cycle of increased takeover activity leading to new, unproven anti-takeover theories and ultimately, new regulation. While the future path of legal precedent remains somewhat unclear in the state courts, there is a noticeable trend at all levels of policy making towards relying on the market and shareholder judgment to police adequately the market for corporate control, and to determine the outcome of hostile takeover attempts.

The benefits from this new, market-oriented approach probably spill beyond the obvious gains that takeover activity creates for shareholders. They include widespread corporate restructuring, in response to deregulation and market evolution, and the maintenance of incentives for corporate managements to focus their efforts on maximising economic efficiency through maximising shareholder value.

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Takeovers and Corporate Control: The New Zealand Experience

Colin Patterson

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Takeovers and Corporate Control: The New Zealand Experience

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Among the functions of the Securities Commission, which was set up under the Securities Act 1978, are the following:

> To keep under review the law relating to bodies corporate, securities, and unincorporated issuers of securities, and to recommend to the Minister any changes thereto that it considers necessary,

and

> To keep under review practices relating to securities and to comment thereon to any appropriate body.

Within the scope of these functions, the Commission has statutory powers of enquiry to obtain evidence (including the production of documents) in particular cases. Usually we proceed informally and privately, but sometimes, if the nature of the matter requires it, we proceed formally and publicly.

The Securities Comission and Takeovers

One of the main purposes of the Act was to begin a reform of the law regarding the process of offering new securities to the public. A takeover offer within the meaning of Part I of the Companies Amendment Act 1963 is expressly excluded from those provisions (s.3(2)). Thus we are mainly engaged with the 'primary marketing' of securities; we are able to give only limited attention to takeovers and the secondary markets.

The Commission does not regulate takeover activity. We do not have jurisdiction corresponding with the jurisdictions of the Securities and Exchange Commission in the United States of America, the various commissions established in Canada (I have especially studied the jurisdiction, functions and operations of the Ontario Securities Commission), or the National Companies and Securities Commission and the several commissions established in Australia. Nor do we administer a code of practice such as the City Code administered by the Take Over Panel of the City of London.

In relation to takeovers, we have been described as a 'watchdog without teeth'. That is a fair metaphor in a particular sense. We do not have power to order people who are involved in takeovers to do or refrain from doing any particular thing (except to tell us about it). We do not, as an act of authority, approve or consent to offers, defences or statements about them. Our interventions in takeover activity are limited to enquiry, consultation and comment. It has also been said that we operate a 'public pillory', which is also a fair metaphor in a sense. We can use our powers of enquiry to 'investigate in depth a particular takeover or attempted takeover' when it is in progress and afterwards. This was settled by the Court of Appeal in the case of *City Realties Limited* v. *Securities Commission* [1982] 1 N.Z.L.R. 74, where one of the participants in a takeover objected to the pointedly specific terms of reference we had defined for ourselves in that matter. The objection was rejected by the courts, which confirmed our inquisitorial powers and added a warning that the safegurds against abuse of them are 'the standing and sense of responsibility of the Commission, the rules of natural justice, and the duty to act with reasonable care' (p.79). These are sobering words to keep in mind.

So our role regarding takeovers can be described as two-fold. First, we attempt to influence behaviour by informal and formal enquiry, recommendation and comment. We have done this in many cases. Some examples are included in the review publication I will mention in a moment. Second, we are concerned with the state of the law on the subject, and have proposals for law reform under consideration.

Takeover Law in New Zealand

In October 1983 the Commission published a study for a review of New Zealand takeover law. The publication is in three parts. Volume 1 describes the present law in New Zealand and contains proposals for reform. As the paper makes plain, the proposals were put forward to focus discussion. They have certainly done that. Although we expressly said that the proposals did not represent the views of the Commission, they were, no doubt inevitably, referred to as 'the Commission's proposals'. I want to make it clear that our purpose in putting forward the proposals was, as we said, to focus discussion. We have yet to reach our own conclusions. Volume 2 of the study contains the Commission's reports on enquiries we had made into three specific takeovers. Volume 3 is a comparative survey of takeover law in the overseas jurisdictions to which we usually refer in studies of this kind.

The proposals in Volume 1 were substantially modelled on the provisions of the Companies (Acquisition of Shares) Acts enacted in Australia under the cooperative scheme adopted by the Australian Commonwealth and the states. That legislation, so it seems to us, reflects the principles of the laws of the United States of America and of Canada, and the principles that underlie the City of London Code. An arresting feature, both of the legislation and of the London Code, is the complexity and diversity of the particular provisions. It does not seem to be possible to deal with this subject, whether by law or by code of practice, in plain terms. No doubt this is due to the fact that securities are 'intricate merchandise'. Nowhere is the intricacy more plainly displayed than in the steps taken in the various jurisdictions both to regulate takeovers by law and to avoid the regulations.

Through a chapter of accidents, New Zealand has a substantially unregulated takeover process. Our law on the subject is found in three statutes: the Companies Act 1955, and especially the Companies Amendment Act 1963; the Overseas Investment Act 1973; and the Commerce Act 1986.

We reviewed the legislation in our publication. Apart from noting that the Commerce Act 1986 has superseded (in substantially the same terms) the takeover provisions of the Commerce Act 1975, which we referred to in the publication, I do not intend to take your time in discussing these statutes. We have more important work to do, because I want to test some principles with you.

I will explain, however, my reference to the 'chapter of accidents'. It appears that some members of the Company Law Advisory Committee that recommended legislation in 1963 intended that it should apply to all takeovers, with some very limited exceptions. The Committee did not publish a report, and we have been unable to ascertain exactly what it was that the Committee recommended. One member of the Committee, appearing as counsel before the Court of Appeal in the leading case on the Act, submitted that the Act that emerged from the process — the Companies Amendment Act 1963 — did apply to all takeovers (except as exempted) and that, as a general rule it required takeover offers to be made in writing after notice. Convention requires that we should not think that was his view. The Court rejected the argument, and held that the Act applies only to takeover offers that are made in writing. If there is no offer in writing, the Companies Amendment Act 1963 does not apply (*Multiplex Industries Limited* v. *Speer* [1966] N.Z.L.R. 122). This ruling has been carried to its logical conclusion recently in the case of *Tatra Industries Limited* v. *Scott Group Limited*. The High Court held that the Act of 1963 did not apply to transactions on the Stock Exchange. The judgment has not been reported in the New Zealand Law Reports, but it has been preserved for posterity by the industry of the Commerce Clearing House, and it can be found in 1 N.Z.C.L.C. 95079. Consequently, activity on the New Zealand Stock Exchange has been very much enlivened by takeovers. That is not to say that takeovers are usually made through the Exchange. On the contrary, the significant transactions usually take place off the Exchange by direct negotiations between the offerer and significant shareholders. If they take place by word of mouth, as they usually do, the Companies Amendment Act 1963 does not apply.

The Stock Exchange Code

The Stock Exchange has adopted a takeover code essentially on the lines of the Code of the City of London. Members of the Exchange and listed companies are obliged to observe its provisions. This code was put under stress in a passage at arms involving Goodmans, N.Z. Forest Products and Watties. The Exchange suspended trading in the shares of N.Z. Forest Products on the grounds that it had not complied with a provision of the code. One might think this a curiously inept sanction, but it is the only one available to the Exchange. The High Court granted an interim injunction against the suspension. The companies concerned later reached agreement and were not interested in pursuing the matter any further. However, the interim judgment cast very great doubt upon the status of the Stock Exchange code, and the matter could not be left there. Accordingly, the Exchange took further proceedings, which were removed into the Court of Appeal. That court held that the takeover code, with the other listing requirements, operates in contract between the Exchange and listed companies, and does indeed enable the Exchange to suspend trading in a listed company's shares where the company does not observe the code (*New Zealand Stock Exchange* v. *Listed Companies Association Inc.* [1984] 1 N.Z.L.R. 699). The code does not, of course, apply to companies that are not listed on the Exchange.

The Securities Commission has approached the reform of takeover law in two steps. In 1982 we recommended to the government that the law should require persons who hold substantial interests in listed public companies to disclose their identities. We took the view that it was important for the securities markets to know the identities of the persons who control the voting power in a company that has issued shares that are traded on the public market. Our recommendations were opposed. The government of the day decided to defer action until we could complete our review of takeover law as a whole. The present government has adopted the same view. So we are undertaking a full review of the takeover law.

At this point I must say that the rest of this paper presents for discussion views that the Commission has under consideration. The Commission has not reached a conclusion at this time. Please do not infer from what I say that any of us have reached closed positions. We are moving towards them, but at this time all issues are open.

Allocating Resources

It is fascinating that the subject of takeovers is contentious in all jurisdictions, and that in no jurisdiction can it be said that the issues are settled. In this state of affairs we turn to first principles. The arguments we have heard go to the very foundations of economic activity. There are many aspects of them. For the purposes of this conference I will open only one. It is a large one from which attention tends to wander. The literature on the subject is theoretical, somewhat abstruse, built upon articles of faith and decorated with the cabbalistic symbols of the mathematician's craft.

I invite you to consider how resources within an economy are, and should be, allocated among the people who want to use them.

I suggest this raises one of several proper approaches to takeovers. An accomplished takeover transfers the control of the resources held by a company from one group of persons to another group. (Of course, some people may be in both groups.) The two groups are composites of people with diverse interests — shareholders, directors, managers and employees — in their various capacities. In a takeover, there is a transfer of control of the corporate resources: a new majority of members removes the directors in whom control of the resources was formerly vested and installs new directors. By this process, control of the resources of a company is transferred, not by unanimous consent of every person who has an economic interest in the company, but by the decision of a person (which, of course, includes a company or group of persons) who has acquired enough of those interests to carry the necessary resolutions at a meeting of the company.

Here, I believe, we isolate one of the singular features of takeover activity. In no other commercial transaction does the control of an entirety (the parcel of resources held by a company) pass by conveyance of something less than an entirety (some, but less than all, of the voting shares in the target company). I want you to join me in pondering some of the implications of that.

In New Zealand we are experiencing a dramatic resurgence of opinions that come to us from the work of the great Scottish and English thinkers of the 18th century. Adam Smith is required reading today. The tie of the Centre that sponsors this conference commemorates him with veneration. Like most of you, I agree that the best method of allocating scarce resources within an economy is by competition in an open market. The 'invisible hand' of competing private self-interests usually advances the public welfare. Smith referred to 'the private frugality and good conduct of individuals, by their universal, continued and uninterrupted effort to better their own condition'. This effort, he said, 'protected by law and allowed by liberty to exert itself in the matter that is most advantageous, ... has maintained the progress ... towards opulence and improvement in almost all former times ...' (*The Wealth of Nations*, Book 2, Ch. 3, p. 36).

On this basis, I believe most economists agree, the interests of society as a whole are usually advanced when competing private self-interests guide resources to their most profitable applications. It is worth reflecting upon the process of reasoning for that view. I suggest the following propositions:

(1) Naturally as a lawyer I believe that the reasoning begins with an ancient legal rule. It is a general principle of law, to which there are only a very few exceptions, that the voluntary consent of the owner is necessary for an effective transfer of his property. The rule was recognised in the Magna Carta. No doubt it was developed from ideas of merit or right arising out of the capture or production of the property in question, and in that respect the rule was based on events in the past.

(2) The rule operates, however, in the present and in the future. In that respect, it seems to me that the rule is supported by an interesting economic theory (or rationalisation) about the behaviour of owners, buyers and sellers of property. That theory seem to me to rest on three elementary assumptions:

- It is assumed that the owner will not consent to a transfer unless he is satisfied that the benefit to him from consenting will not be less than the benefit he expects to derive from keeping the property. Accordingly, so the theory goes, when a price is offered to him, he compares the offer with his estimate of the value to him of retention. Some theoreticians suggest that he adopts the Capital Asset Pricing Model of the economist Sharpe. Maybe he does, but it seems to me safer to say this. The owner's estimate expresses his judgment upon the present value of the potentials of the property (which include the possibility of sale in future) while he owns the property. His estimate reflects the information known to him, whether or not that information, or any item of it, is known to anyone else.
- It is assumed that each person who is interested in acquiring the property and offers a price for it will have made his assessment of the present value of the benefits he expects to derive from buying the property. His offer reflects the information known

to him, whether or not that information, or any item of it, is known to anyone else.

- It is assumed that all the opinions implicit in offers will be responsibly formed after enquiry, because the offers are made with a view to commitment. They are more than mere valuations.

(3) The various sets of information about a particular item of property that are held by owners and each offerer respectively will usually be different. Each person has his private information, personal preferences and aversions, and all do not have the same perceptions of the uses that might be made of any particular item of property.

(4) The peculiar merit of a competitive market as a means of allocating resources, therefore, seems to me to be this. The market process enables a wide range of different sets of information and opinions to coalesce in bargaining a price for a transfer of property without requiring the disclosure of any particular piece of information or opinion.

(5) Therefore, so the argument goes, the setting of prices in a competitive market throws up the best opinion, expressed as an offer and ultimately as a price, that 'impounds' (a term much used by economists) the results of more or less widespread but separate and private consideration by many people of the profitable use of the property in the future.

(6) Looked at in this way, every price for an item of property can be regarded as a responsible opinion of the present value of the potential for profitable use of the property in the future. That interpretation appears to hold, even in the case of everyday items for which there is an active market. There can be no absolute certainty that, in future, anything will be bought or sold for any particular price. There is only a potential, or degree of probability. A competitive market, by bringing more than one opinion to bear upon the business of setting the price, increases the probability that the best opinion of the profitable use of the property in future (expressed only as a current price) will emerge in the bargaining.

(7) At least three different kinds of potentials may be recognised as open to realisation from ownership of a particular item of property. First, there is the potential realisable by the present owner; second, the potential realisable by anyone at all who owns the property; and third, the potential realisable by a particular buyer who has a special need or use for the property.

(8) The potential realisable by the present owner may be limited by factors peculiar to him (such as indolence, lack of skill, or shortage of money), but he has the right and ability to sell the property to a buyer who may not be so inhibited. On that ground, a competitive market

(and a rational valuation of the property) usually disregards the limitations peculiar to the present owner that inhibit him from making full use of the property. Similarly, the purchaser with special needs is usually disregarded because he needs to pay only marginally more than the price available to the owner from any other buyer. These considerations are very familiar to experts involved in property valuations for various purposes. A memorable expression of them is recorded in the evidence of Lord Plender about the open market value of shares in a company, that 'he did not exclude anybody or include anybody in particular; he considered the matter generally' (*Inland Revenue Commissioners v. Crossman* [1937] A.C. 26).

(9) Accordingly, it seems, the legal rule serves economic efficiency in the beneficial allocation of property within the economy. First, the legal rule prevents transfer of property whenever an offerer is not willing to pay a price acceptable to the owner. It may be inferred that, in that situation, it is unlikely that the offerer will make better use of the property than the owner. Furthermore, in that situation, resources are not wasted on the cost of transactions that are unlikely to produce better results than the status quo. Second, the legal rule enables transfer of property whenever the owner considers that the price offered to him is at least equal to his estimate of the benefits he expects to derive from retaining the property. It may be inferred, in that case, that it is likely that the purchaser will make better use of the property than the vendor.

(10) The legal rule assumes that the owner is the person best qualified to make the decision whether or not to transfer his property. This seems to be a valid assumption, because the owner is the person in possession of the information, published and not published, that is needed to assess the benefits he may reasonably expect to derive from keeping the property. Speaking generally, an owner of property is not required to disclose information about his use of it in the past, present or future. Likewise, an offerer is not required to disclose his intentions for using the property. Nevertheless, in a competitive market for property, a particular item of property will stay with, or pass to, the person who considers he can extract the most benefit from having it.

(11) The theory I have baldly described applies to co-ownership. In this case, the legal rule requires unanimous consent by every co-owner to a transfer of the property. Likewise in the case of partnerships. Indeed, in these cases it may be assumed that the requirement for concurrence strengthens the probability that a proposal to sell the property will receive full consideration. It seems reasonable to infer that the co-owners or partners will argue among themselves, enlightened by complete knowledge of past, present and probable future uses of the property by the owners or partners, and some knowledge, including the published information, about other potential uses of the property and the likely demand for it.

I will be grateful if you will think about these propositions. They seem to me to spell out the chain of reasoning that is usually inarticulate in the expressed preference of economists for the allocation of scarce resources within an economy by means of a competitive market. If these propositions, or something like them, can be agreed, we can proceed to consider the application of the theory to the allocation of resources held for the time being by companies.

Applying the Theory

I have some criticisms of the theory described above. First, it seems to be more logical than experience suggests. Decisions to buy or sell property are no doubt sometimes addressed with the precision indicated by the theory, but in practice we seem to observe other motivations, sometimes intuitive and impulsive, producing decisions. In land valuation cases, for example, the courts have recognised that decisions are sometimes motivated by 'whim or extravagance' (*Valuer-General* v. *Manning* [1952] N.Z.L.R. 700). Another potent motivation is the wish to avoid paying tax. There are difficulties in seeing the avoidance of tax as an allocation of resources beneficial to society.

Second, it is possible for the present owner to make a mistake in assessing the value to him of keeping the property. So may a potential buyer be mistaken. The risk of error, however, seems to me to be minimised by the acute self-interest of the parties concerned. On balance, I am inclined to think that the theory offers valuable assistance in the quest for a principle, or set of principles, that should guide a reform of takeover law.

Let us consider, then, how this reasoning applies to the re-allocation of the resources that are held for the time being by a company. I suggest the following propositions:

(1) The decision-making process that the theory attributes to a sole owner (or co-owners) is, I think, attributable to the management and directors who have the power to decide to sell or retain the company's property. It may be assumed that they will have all the information about the item of property that a sole owner would have. While they do not have the pecuniary interest of a sole owner, it seems reasonable to assume that they will make their decision to sell or retain in much the same way as he would make it. That assumption rests on the obligation, well understood and generally (though not always) observed, that directors' and managers' decisions must be made for the benefit of the company. Accordingly, it seems to me that where an offer to purchase an item of property owned by a company is made to the company through its management and directors, the result, as an allocation of the item as a resource within the economy, should be, as

nearly as possible, approximate to an allocation by consent of a sole owner.

It is not always so. Especially in the days of takeovers of the 'asset-stripping' kind, and of stringent price control based on 'historical cost plus', companies held resources that could have been used more profitably. The effects of price control on takeover activity seem to me to warrant special study, especially in view of the fact that the acquirer was entitled to introduce the takeover values as his historical costs. Another point made by some authorities is that incumbent boards of target companies sit on resources without making full use of them. Takeovers have a disciplinary effect, goading incumbent directors to use assets profitably. There is, I have no doubt, such a disciplinary effect, but I think the subject requires much fuller study than it has received. The argument's emphasis on short-term considerations worries me

But taking the broad theme, and assuming that directors do act as they should, it seems that an allocation of property by consent of the directors is, in theory, near enough to an allocation by consent of a sole owner.

(2) When we look at the process of allocating the resources held by a company by means of a takeover, a different picture emerges. The division of rights, powers and functions within a company among shareholders, directors and managers seems to raise considerations quite different from the case of sole owners or co-owners of property. Ownership of the corporate resources is not vested in the shareholders. Their consent to the transfer or encumbering of the corporate resources is not required by law, and is not usually required under the constitutions of companies. Control of the resources is vested in the directors, not the shareholders. Important powers, such as the power to borrow against the resources, are vested in the directors, not the shareholders. The information relevant to assess the potentials of the corporate resources in the hands of the company is held by the management and directors. It is not usually available to shareholders or anyone else. We have plenty of evidence to the effect that it is not possible to assess the potential of a company outside the boardroom.

(3) The Efficient Market Hypotheses are sometimes strenuously asserted in support of the view that the share markets are constantly and accurately assessing corporate potentials. In a broad sense, so they do. But those markets value shares, and do so on the basis of published information. The 'strong form' hypothesis, which suggests that share markets 'impound' all relevant information, published and not published, has not, I believe, gained acceptance among researchers. It is, with respect, a piece of nonsense to anyone who has sat in a boardroom.

(4) Let me contrast a property owner's interest in his property with a shareholder's interest in the resources held by the company. An owner's interest in his property (and in the income produced from it) is

direct, vested, entire and immediate. A shareholder's interest in the resources held by the company (and in the income produced from them) is indirect, contingent, residual and remote. An owner has a direct entitlement to and power of disposition of the property and the income from it; a shareholder has no entitlement to or power of disposition of the corporate resources or income. An owner has a vested right to the income from his property; a shareholder has no right until the directors recommend, and a majority of members approves, a distribution: while the company subsists, his claim is contingent upon those decisions. An owner is entitled to the gross income from the property; a shareholder's interest is in a residue after the obligations incurred on behalf of the company by the directors have been satisfied. An owner is entitled to the income as and when it accrues; a shareholder is not so entitled and the directors may postpone a distribution as long as they think fit. Of course, the retained profits usually remain in the company, and, usually, are used to increase the company's earnings. Some profitable companies never make cash distributions, but make bonus issues of shares, which shareholders needing cash may sell. (A remarkable example is the Digital Equipment Corporation listed on the New York Stock Exchange.) Others make a cash issue when declaring a dividend. There is a lot of writing on the topic, but I think the essential point of comparison is that a dollar in hand now is less remote than a dollar held by someone else, which may be paid if he pleases at an indeterminate future date.

I am not criticising these differences, I am merely attempting to describe them in a way that will sustain your interest. Indeed, these differences, or at least some of them, probably account for the remarkable popularity of the company format. I agree with Professor Manne that we should not interfere with them without the most exhaustive and satisfying enquiry.

(5) When we take note of the fact that control of the corporate resources passes with the acquisition of less than all of the shares in the company, I think we must conclude that any similarity between allocation of property by consent of owners and allocation of corporate resources by takeover breaks down entirely. In this situation the buyer of some of the shares obtains control of the entire parcel of corporate resources held by the company, but pays only for the shares he acquires. The other shareholders remain as financiers of the corporate resources under the new controller on terms that he determines regarding distributions. There is the rule, of course, that distributions must be made pro rata to shareholdings, and this provides some safeguard against unfair discrimination between the holder of a controlling interest on the one hand and the remaining shareholders on the other. Experience has shown, however, that this is not a strong control, as a controlling

shareholder may benefit from his position of control without including the other shareholders.

(6) There is some debate about the level of a controlling interest. I think shareholdings fall into five tranches:

- **Minority holdings** less than, say, 10 per cent of the issued capital. These have little influence on the control of the company.
- **Strategic holdings** within the range of, say, 10 per cent to 15 per cent of the issued capital. These have some influence in the control of the company.
- **Substantial holdings** in the range of, say, 15 per cent to 40 per cent of the issued capital. These usually carry a strong influence in the company, and the holder is usually able to install at least one person of his choice on the board of directors. Under current accounting practice, a corporate holder is able to include an aliquot share of the net assets and profits of the company in its own accounts by a process known as equity accounting.
- **Majority holdings** of more than 50 per cent of the issued capital. These enable the holder to carry, without the support of any other shareholder (indeed against their opposition) an ordinary resolution at a meeting of the company. This gives power to replace the directors and to control distributions. Where the holder is itself a company, the law requires the consolidation of the accounts of the companies.
- **Dominant holdings** of more than 75 per cent of the issued capital. These enable the holder to carry, without the support of any other shareholder (indeed against their opposition) any ordinary or special resolution of the company, giving virtually complete control of the company and its constitution.

A controlling interest need not be a dominant or majority holding — it depends on the extent of dispersal of the other holdings. Thus, a 40 per cent holding has been held to be a controlling interest (*Brierley Investments Ltd.* v. *Commerce Commission and N.Z. News Ltd.*, High Court, Wellington, M152/85).

(7) Observation has convinced me that a person seeking control of a company is not so much concerned about the price he pays for any particular parcel of shares as he is concerned with the total or average cost to him of holdings within these tranches. For example, a shareholder who wishes to increase his holding from 49 to 51 per cent will pay very much more per share for the 2 per cent than he has paid on

average for his 49 per cent. On this ground, therefore, a sharp distinction can be seen between the bargaining process that goes on between sole owners and buyers of property on the one hand, and, on the other, the bargaining for a parcel of shares in a company.

(8) A further distinction emerges when we compare the process of financing an acquisition. A purchaser of property from a sole owner may, of course, finance his purchase by raising a loan on the security of the property acquired. A purchaser of control of a company has this and many more sophisticated methods at his disposal. I do not attempt to catalogue all of them, but I will mention some:

- The capital provided by the other shareholders remains in the company, and in effect finances the operations of the new controller. Again, I merely observe this fact with neutrality. Some experts have seen actual and potential injury in it, and if you wish to examine a controversy on the subject you should read the great academic debate that followed the decision of the US Court of Appeals (2nd Circuit) in the case of *Perlman* v. *Feldmann* 219 F.2d. 173.
- The new controller may finance his purchase by bridging finance, which he repays from a distribution he procures from the company after he has obtained control. Certainly, distributions from the accumulated profits of the company may be made for this purpose. That was established in New Zealand by *In re Wellington Publishing Company Limited* [1973] 1 N.Z.L.R. 133. Moreover, 'capital profits', even derived from revaluations of the company's assets, are also available for this purpose, as was established in the case of *Re New Zealand Flock and Textiles Limited* [1976] 1 N.Z.L.R. 192.
- The new controller may repay his loans or replenish his coffers by selling his assets to the company for cash on terms settled by him on both sides of the transaction. We have seen some notable examples of this technique.
- Where he controls two or more or more taxable entities, the new controller may use of a variety of methods to reduce the burden of taxation on either or both of them. Techniques, which some regard with admiration and delight, are seen and known by such labels as the 'refreshment of losses', the 'switching of debt and equity' (and vice versa), and the 'capitalisation of income'. A seminar could be devoted to this art. To the extent that it is successful, it may be observed that the general body of taxpayers is contributing to the payment for the transfer of resources. I express no view on the merits of that.

Comparing the Models

Perhaps I have said enough to demonstrate my reservations about the proposition that a takeover accomplishes a transfer of resources by a process similar to a transfer of property by a sole owner. If the sole owner model is accepted as the optimum method of allocating resources within an economy, then it should be profitable and instructive to examine the differences between resource allocation in accordance with that model, and resource allocation through takeovers.

I do not know of any empirical research expressly directed to that comparison. There are, however, some studies that, I think, give food for thought about it.

Value. It seems to be generally agreed among researchers that the shares in target companies that change hands in a takeover do so at a so-called 'premium' of about 30 per cent above the pre-takeover prices on the Stock Exchange. Some say that this is evidence that takeovers are 'value-creating' transactions enhancing the welfare of society as a whole. I think this evidence is equally consistent with the view that takeovers are 'value-recognising' transactions, and that the increase in prices merely shows a revaluation of the existing potentials of a target company. How do we distinguish a price movement that recognises pre-existing potentials in targets from a movement that signals increased wealth as an aggregate of targets and acquirers? I do not know. I suspect that it is not possible to adopt a general proposition, and that both views of the matter are exemplified in practice.

The empirical research seems to establish that prices of shares in offerer companies usually remain more or less unchanged at about the level they were before the takeover. This is evidence to ponder. It seems to me that the natural inference from it is that the judgment of the share market is that offerer companies do not obtain bargains by takeovers — they pay for what they receive. That judgment of the sharemarket may be correct or incorrect, but it seems to be the judgment. If that is a proper inference, it seems to me to support the view that takeovers are not 'value-creating' transactions, but are 'target-value-recognising' transactions.

Performance. Some research has been directed towards judging whether the performance of companies after a takeover is better than it was before. In New Zealand we have some work on this subject, notably by Professor Fogelberg alone, and in conjunction with Mr Garlick. The conclusions expressed by these studies are remarkably similar to the conclusions expressed in the recent Australian study by Professor McDougall and others under the auspices of the National Companies and Securities Commission.

As to the study headed by Professor McDougall, I will make only one observation. At page 182, it is said that 'the value created by a takeover was largely "captured" by [shareholders in target firms] through pre-takeover share price appreciation'. This statement assumes some of the matters I am questioning. It does not seem to me that the fact that share prices rise in takeovers proves that value is 'created' or that prices rise to the present value of the existing potentials of target companies. I am questioning both propositions. My good friend Henry Bosch, Chairman of the National Companies and Securities Commission in Australia, has said the study shows that target shareholders gain from takeovers. The study says so. In one sense that is indisputable — the prices of target company shares in takeovers usually exceed the previous prices by a substantial margin. But if in the process the target shareholders who sell transfer for that money a more valuable existing potential of the target company as an independent, or as part of a combination with someone else, do they gain? And more importantly, does society gain? I believe Adam Smith would not have assumed so.

Contested takeovers. My doubts are increased by the little research that has been done comparing prices in uncontested or 'pre-empted' takeovers with those in takeovers that are contested by target directors or rival bidders. A recent North American study of 28 management buyouts (each worth at least $100 million to the shareholders at the winning price) showed that, where there were three or more bidders, the median 'premium' over the stock exchange prices 30 days before the action began was about 76 per cent of those prices. This was compared with the median premium in all 28 cases (contested and uncontested) of 58 per cent. I believe the author regarded the so-called 'premium' as a revaluation of the existing potentials of the target company rather than as a special value to a particular purchaser. He said, 'the financial gains should not be confused with real gains'. I take him to mean that even these high premiums and the stock exchange prices together may not have equated the present value of the companies as independents having regard to their potentials. (L. Lowenstein, 1985, 'Management buyouts', 85 *Columbia Law Review* 730).

Corporate raiders. I am not aware of any research about the phenomenal success of companies that use the takeover process as middlemen, not for the purpose of obtaining resources for their own use, but for the purpose of transferring the resources to other uses. In New Zealand we have about 21 listed public companies that make a business of this process. They are beginning to consume each other. I do not suggest that they do not perform a valuable function for society wherever they direct their attention. I believe they do. I must say, however, that I have been impressed by the observations of Professor Tobin of Yale in his recent Hirsch Memorial Lecture, in which he confessed to an:

> uneasy Physiocratic suspicion, perhaps unbecoming in an academic, that we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity.

Is the genius of our managerial talent and financial skill (and we do have some) being devoted merely to transfers of value through the takeover process instead of producing real increases of wealth? I am inclined to think that in many cases it is.

Conclusion

One cannot move to a solution of a problem before one has identified the problem. I suspect that much of the highly emotionally charged controversy about takeovers arises from the failure to identify and attempt to resolve in a coldly analytical way the complex issues that the takeover phenomenon presents.

In opening only one issue before you, I will not presume to offer an answer (if, indeed, there is one answer). Let me restate that issue. Are takeovers as we see them in practice an acceptable method of allocating and re-allocating scarce resources within an economy? If we accept the model of allocation by voluntary consent of a sole owner as the optimum, then it seems to me that the differences between that process and the takeover process raise very large questions.

I will end there, because I will not presume to suggest a reform until I feel able to form a view of the appropriate answer to that issue, and to assess the weight of the answer among other issues. In my innocence as a lawyer, I thought economists could give me a convincing answer to the one issue. After reading the economic literature, and indulging in as much argument as my schedule over the last two years has allowed, I have still to find an answer. Perhaps some member of this distinguished program of speakers can give it to us.

Regulation and Corporate Control: The Australian Experience

Henry Bosch

Henry Bosch has been Chairman of the National Companies and Securities Commission since March 1985. He was educated at Sydney and Oxford Universities and the Centre d'Etudes Industrielles (now the International Management Institute) in Switzerland. After eight years with John Lysaght (Australia) Limited he became Managing Director of Nylex Corporation Limited at the end of 1980. He has served as President of the Plastics Institute and Chairman of the Chemical and Plastics Industry Council. In 1984 he chaired the government inquiry into Aviation Cost Recovery.

Regulation and Corporate Control: The Australian Experience

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I suppose everyone is familiar with Dr Johnson's remark, 'When a man knows he has to die in a fortnight it concentrates his mind wonderfully'. Something of the same pressure of concentration has been going on in the minds of those interested in the Australian economy in recent times. For while imminent death is not perceived, some very unpleasant consequences of past actions are widely anticipated. It is recognised that Australia is exporting too little and importing too much, and that this stems from industry failing to produce enough of what its markets want at a price its customers are prepared to pay. Many factors are thought to be relevent to this regrettable position: too little investment, too little research, too many wage increases, and so on. While we have many excellent companies, there are parts of our industrial sector where too many bad decisions are being made.

The takeover process — the number, size and form of takeovers — is relevant to this malaise. Takeovers are far from the only factor, perhaps not even the most important one, but their effect has not been insignificant and I propose to concentrate today on this aspect of them. I shall therefore raise this question: In what way and to what extent are takeovers affecting Australia's economic performance? I shall argue that on balance there are some adverse effects, and towards the end of my remarks I shall touch briefly on some changes in the law and regulations that might have a beneficial effect.

Let me first make two things clear.

(1) I have not shown this paper to my colleagues, and unless I specify otherwise I am speaking for myself.

(2) There are of course other important aspects of the takeover debate. In particular, the fairness with which the system operates and the effect on individual shareholders are matters of concern. These are not my principal concern today partly because the economic effects of takeovers are important and of greater current relevance.

Over the last year or so the public debate about takeovers has become much more intense. One of the measures I use to gauge it is the flow of letters and articles sent to me by various protagonists and other interested parties. Currently they are arriving at the rate of several each week. I read as may of them as I can and some of them are extremely valuable in helping to shape my thinking.

Among those I have received in the last few weeks is a paper from the Treasury called 'Some economic implications of takeovers', and another called 'Competition for corporate control' by Professors Dodd and Officer. These papers put forward some strong free enterprise arguments, which I have taken into account in preparing these remarks.

Those who argue in support of takeovers usually point out several important benefits that they can bring to the economy. Essentially these boil down to three main points: first, in a takeover a firm's existing management may be replaced by another that makes more productive use of the company's resources. As long as we use the word 'may', as long as we recognise that the new management may not be better than the old, the proposition is correct, even obvious. There have been and no doubt are management teams about that could be improved, and a mechanism that permits change is of benefit to the economy.

Second, takeovers can lead to the rationalisation of industry, to economies of scale, to synergistic benefits, and so on. Again, as long as we recognise that there is nothing inevitable about these benefits occurring, the proposition must be accepted. This is a powerful argument for welcoming and supporting the takeover process.

Third, the very existence of takeovers keeps all managements alert because they have to recognise that if they do not perform adequately they will be in danger of losing their jobs. It seems obvious that this threat is perceived by all or virtually all Australian managements and that their conduct is influenced by it. I shall argue that this influence is not wholly beneficial, but at least it can be agreed that it provides a significant stimulation without which the economy might well be weaker.

From these arguments two conclusions can be drawn: first, the takeover process is beneficial and valuable to the economy; and second, many, perhaps most takeovers provide net benefits to the economy. I do not think there would be any significant disagreements with the argument so far. It seems cogent and observation confirms its conclusions.

But how much further can we go? Can we say that all takeovers are beneficial or that the takeover process does no damage? Certainly not. I do not think that anyone takes such an extreme position and if they did it would not be difficult to refute it.

Can we say that the operation of the market for corporate control brings such significant net benefits to the economy that regulators should leave it entirely alone? I believe that that opinion or something like it is fairly common in Australia, perhaps in this room, and I would like to examine it in a little more detail.

Let us first take the proposition that when an entrepreneur offers a price for a company's shares that is higher than the then prevailing price on the stock market, he is thereby adding value to them. It is of course true that because he is prepared to pay more the shares have a higher value for him than for those who sell them to him. It follows that unless he has made a mistake he believes he can make a profit from them at the higher price, but it does not follow that the profit he expects will be derived from employing the assets represented by the shares in the more effective production of goods and services. There need be no additional production of goods and services at all.

Since real economic benefit can only come in the end in terms of goods and services, it does not follow that the fact that a purchaser values shares at a higher price will be reflected in an increased benefit to the economy.

Is this merely a nit-picking piece of logic? I do not think so. It is quite possible today to make very large profits by buying and selling companies and shares in companies without any consideration of what they produce or what contribution they make to the national economy. Peter Drucker described this phenomenon quite eloquently in a recent article called 'To end the raiding roulette game' when he said of hostile takeovers, 'The only rationale is to enrich someone who has nothing to do with the performance of the enterprise and who, quite admittedly has not the slightest interest in it'. Now if Drucker meant that to apply to all takeovers he was clearly exaggerating, but I believe it does apply in a significant and growing number of cases.

The mechanisms are quite simple. Let us take a couple of imaginary examples. Piranha Corporation, known for its aggressiveness, is trading on a price/earnings ratio (P/E) of 20. It attacks Porpoise Limited, which is making a useful but unexciting product for the export market and trading on a P/E of 10. Piranha uses its paper for its bid and offers the shareholders of Porpoise a handsome premium for their shares. The bid is successful and the automatic result is a substantial improvement in Piranha's earnings per share without any improvement whatever in either business.

As a result of its higher earnings per share Piranha recognises that another bid is a far quicker way to increase its profits than the boring and difficult business of rationalising the activities of Piranha and Porpoise, and so it looks out for another target.

This time it decides to use cash and selects the Dolphin Corporation, a large, productive organisation with a good cash flow. It does not matter whether Piranha knows anything about Dolphin's business — all that matters is that it can see from the published results that Dolphin has a strong, regular cash flow. A proposal is then put to the major bank, Gargantuan International, which was seriously embarrassed by its loans in South America a few years ago and desperately wants to place some of its enormous liquid funds in relatively secure countries like Australia in a situation where the servicing of the loan is well covered by cash flow. Gargantuan International is no more interested than Piranha in what Dolphin is doing, whether it is well managed, or whether the takeover will lead to a greater or more efficient production of goods and services.

The bid is successful, the Dolphin shareholders get their premium, the group's debt to equity ratio is increased, Piranha's chairman is hailed in the press as a great entrepreneur and goes on to select his next target.

Meanwhile the staffs of Porpoise and Dolphin are disrupted and demoralised, many of the best of them leave, and few if any of the rest have any respect for Piranha. Investment, research and productivity decline.

Does this happen? Of course it does. A very experienced and internationally recognised investment banker told me the other day that it was no longer possible for a company to grow quickly by investing in productive facilities. The only way to rapid growth and success, he explained, was to start on the takeover trail. Of course he was selling his services and justifying his own activity, but I have no doubt that he has brought huge benefits to some of his clients, far beyond the possibilities of such boring, old-fashioned activities as manufacturing and mining.

He has created riches, but where are the goods and services to back up the money profits created?

Now those of you accept the hypothesis of market efficiency will be having difficulty in accepting all this. You will have in your minds some concept such as 'stock market prices are the present value of expected future dividends'. You will remember the persuasive pro-market arguments put forward in defence of takeovers, and you may be wondering how to reconcile them. I find those market-based arguments quite persuasive too. They remind me of the microeconomics that I learnt at university.

Perhaps it will be interesting to take that comparison a little further. The theory of demand curves, supply curves and price elasticity curves is logical and persuasive. It makes a valuable contribution to our understanding of firms and economies, but it is far from a complete explanation. I remember polishing up my newly acquired economic theory when I first came into direct contact with pricing policy some 30 years ago. I was then employed in the headquarters of Alcan in Montreal, and when I found that my superiors were not at all interested in price elasticity curves I formed uncharitable views about Canadians and the aluminium industry. Over the next 30 years I worked in five major companies, in four industries and on three continents, and I had to deal with the pricing of a very wide range of products. In all that time I never saw anyone making any real practical use of a price elasticity curve or for that matter a demand curve.

The concepts are generally understood and people quite often refer to them, but when the detailed work starts they play little or no part. The reason of course is that the theory is incomplete. It is not sufficiently detailed and in a rapidly changing competitive market place things never stand still long enough for the theory to catch up.

Takeover theory is very similar. Those elegant and well-phrased arguments are persuasive as far as they go. As long as the words 'may', 'can' and 'permit' are liberally scattered through them, I can agree with them. But they are not a complete account and their practical use is limited.

To return to the stock market, if it was an efficient market surely prices would move reasonably in line with the present value of real dividends. But it is impossible to believe that there is any such correlation; rather, prices fluctuate violently as a result of speculation. Fads and fashions play a large part.

There is nothing new in all this. For centuries speculative assets have at times been overvalued because they are fashionable and have attracted undue attention. Once an activity becomes fashionable its price begins to rise and people make money by investing in it. Others see the success and join the party. Prices continue to rise till they reach some barrier. Then the bubble bursts and the price drops precipitously since there is no further price increase to sustain the high demand.

At the present time in Australia we see just such a speculative fad in the shares of a small number of takeover entrepreneurs. A lot of shareholders have made money from it and no doubt there is more to be made. However the price/earnings ratios at which the shares I am thinking of are being traded are extremely high — far higher than would be justified by the fundamentals. It is only a matter of time before we have a sharp collapse.

There have been plenty of similar situations in the past. The history of the 1920s is full of them. But the one that made the greatest impression on me was the story of Slater Walker. You may remember that in the 1960s and early 1970s Jim Slater's name was almost a synonym for enterpreneurial dynamism. Slater Walker was lauded by British prime ministers and symbolised the so-called 'white heat of the technological revolution'. Between 1967 and 1970 Slater Walker took over 17 companies and a dozen private firms. In 1966 its profits were £370 000, in 1969 they were £10 443 000. The stock market value of the company's equity capital rose from about £4 million at the end of 1966 to some £135 million at the end of 1969. The value of one share, allowing for free issues, increased by 1300 per cent.

By 1975 the whole edifice had collapsed and the Bank of England had provided a special stand-by facility to bail it out. Charles Raw, in his detailed and perceptive analysis, sums up the story:

> Slater Walker had erected a mammoth paper chain of companies in the UK, Australia, South Africa, Canada, Singapore and Hong Kong each with its own stock market quotation; and this was matched by a string of investment vehicles, its dealing companies, unit trusts and life insurance companies. Shares were then churned around this complex with the effect that the value of the investments ... lost contact with any growth in the underlying businesses but were determined only by the malleable forces that rule share prices and the eagerness of investors to join any promotion bearing the Slater Walker imprimatur.

Now let me make it clear that I am not suggesting that we have any Slater Walkers in Australia today — I believe our laws and regulations are capable of providing sufficient investor protection to prevent that. But it is worthwhile pointing out that the Slater Walker phenomenon occurred in a free market economy in which some very sophisticated legislators and administrators thought they had set up an effective system. The Slater Walker story clearly shows that enormous increases in share prices, profits and price/earnings ratios can be generated with the assistance of takeovers and without any underlying improvement in productivity or the generation of real wealth.

One swallow, as they say, does not make a summer, but that is not the only swallow. Slater Walker may well be an extreme case, but it should cause us to look at the price/earnings ratios on our stock exchanges and to ask about the strength of the underlying companies and the quality of their reported profits.

I began this section of my remarks by questioning the proposition that when an entrepreneur offers a price for a company's shares that is higher than the prevailing price on the stock market, he is thereby adding value to them. In its simplest form that proposition is always true, but it does not follow that the extra dollars available for the shares will be backed by the generation of more goods and services. It may be and often is the case that the takeover results in better management, industry rationalisation, symmetry, and so on, but it need not be so. I have tried to demonstrate that in our economy today it is quite possible and quite rational to pay a premium for ownership or control of a company without any intention of managing it differently, simply in order to make a capital profit. It is also possible to buy a company with the intention of creating more real wealth and more dividends and then to fail to do so.

How often do these things happen? Are takeovers generating additional real wealth in Australia? The evidence is limited and it was for that reason that the NCSC in conjuction with the Australian Institute of Management asked Professor McDougall and Mr Round to do a study for us. We wanted something done quickly and we did not have much money, so we chose a well-tried methodology that could be applied to Australian data without elaborate and lengthy development and that would enable us to make comparisions with the experience in other countries. We chose the Mueller methodology because it fitted those criteria.

The McDougall/Round study provides the best information yet available and makes a real contribution to our knowledge of the economic consequences of takeovers. As expected, it provides a ready comparison with the situation in seven other countries.

Many different methodologies have been used to measure economic effects of takeovers in other countries, particularly the USA and the UK. The most thorough seem to be the input-output analyses on individual firms. We did not seriously contemplate sponsoring such a study because of the time and cost involved, but if anyone else will volunteer we would like to see if we could help.

The second type of methodology is based on accounting data, as was the McDougall/Round study. There are of course many problems with using accounting data, not least of which is the fact that accounting practices vary considerably between companies. It does not follow that the results of such studies are not valuable. It seems improbable that any method will provide a complete and final answer. There will always be room for debate and fresh perspectives. I hope there will be more studies of this type, and if the NCSC can be of help in revealing more of the truth we would like to know.

We can confidently expect a robust debate between those who have chosen one method and those who have chosen another. Such a debate is to be welcomed. But I hope it will be a little more constructive than some of the criticisms of the McDougall/Round study as reported in the press. Some comments that I have seen reported (if the reports be true) seem more appropriate to a bout of political infighting than to a serious debate.

The third type of methodology is based on share market prices. I have heard it said that these studies are the most numerous, but as you will have gathered from my earlier comments I find it hard to give much weight to them. The connection between stock market prices and the creation of real wealth seems difficult to make. It is certainly nice for those who have made profits on the stock market to know the score, and there are other correlations that can be made, but we should not lose sight of the production and profitable sale of goods and services; that is the real touchstone.

What conclusion can we now draw about the economic effects of those takeovers that have been completed? Recognising that our data are incomplete, it still seems worthwhile to try to assess the impact of this phenomenon that is engaging so much effort and attention in our economy. We know that some takeovers are directed to industrial rationalisation: they seek synergy, they succeed. Substantial economic benefits flow from them in terms of productive economies, better management and so on. Other takeovers appear to be made with little or no regard for such considerations, and it seems unlikely that they would produce much real economic benefit. We can also expect, as with all other human endeavours, that there will be a proportion of failures.

What is the net effect? The best evidence we have is in the McDougall/Round report, which shows that in the case of the 88 takeovers studied the average result was rather unimpressive. It could still be argued that Australia was better off as a result of those takeovers taking place, but the contrary position would also be arguable.

May I now turn from discussing the effects of takeovers that have taken place to consider the effects of the current wave of takeovers on our industry as a whole. At the beginning of this talk I mentioned that one of the generally recognised benefits of takeovers is that managements who might be prone to complacency are stimulated by fear of a bid. There is no doubt that all or virtually all managements are well aware of the present high incidence of takeovers and that it is affecting their behaviour.

There can be little doubt that any managements prone to complacency would now be feeling insecure — a far lower level of takeover activity would be sufficient for that — but is the effect on their behaviour beneficial? Against the criterion of increased real wealth by the production of marketable goods and services, are they doing better or worse as a result?

I was speaking to the Managing Director of one of our top 100 companies the other day and he told me a story that bears on this point. Not far from here is a large factory on a prime site. As one looks at it now one is amazed that such a site could have been used for a factory. But now its useful days are over and it seems appropriate to pull it down and use the site for something else. Preliminary contacts have been made with estate agents and the results are rather disappointing. If the site were sold now it would yield a small return to shareholders but nothing like the full potential. That potential depends on understanding the way Sydney is developing and the way its zoning and other regulations will apply. It might be enhanced not only by clearing away the existing factory but by re-developing the site perhaps in partnership with others. All this would be likely to take two to three years and considerable expenditure — a drain that reduces profits and increases the company's vulnerability to take over. What should the company do?

The managing director has no doubt that in the longer term the price would be greatly increased by at least clearing the site and doing a detailed study of the options, combined with a careful marketing program. But when I last spoke to him he was thinking that perhaps a quick sale would be the prudent course.

Consider again. Imagine that you are the managing director of a $300 million company. You are earning 12 per cent after tax on funds employed, your cash flow is strong and you are not under a takeover threat. Things are going along quite nicely. Now your manager of research and development tells you of a great research breakthrough. He believes you will be able to make computerised widget cutters and wants to invest $20 million in a development program and pilot plant, with a larger investment before full production and of course no guarantee of certainty. You know that if you go ahead it will be at least three years before you break even, and that during that time the program will be a serious drain on profits. Your shareholders are mainly institutions competing to show the best results in this quarter. You are fairly sure that at least some of them would sell your shares to a raider at the drop of a hat if they thought they could make a capital gain that would put them a couple of places up in the league table. For them the idea of additional profits and exports three years down the road is simply jam tomorrow. Your marketing director tells you that automated widget cutters will have a tremendous market in Europe and that Australia needs exports. Your finance director tells you that you cannot afford to let your return on funds slip. What will you do?

That is a simplified example of course. But when we look at Australia's regrettable record of industrial research and development and investment, can we deny its relevance? Certainly a lot of managing directors have been deciding not to invest. No doubt there have been many reasons, but I believe that the threat of takeovers is relevant in at least some cases.

Both of the studies to which I referred earlier consider that sort of situation and point out that in the long term a policy of not investing and not doing research would be counterproductive. It is argued that the maximisation of short-term earnings would not be a good defence against takeovers in the longer term. It is not specifically argued but it seems to be implied that because it is not rational it is not being done, or at least ought not to be done.

For anyone who takes that position, let me relate an anecdote about Sir Anthony Eden, Bt, the father of the former British prime minister. Towards the end of his life, when an old, crusty and irritable man, he rose one morning on a day appointed for a family picnic. To his great annoyance it was raining. As he descended the stairs for breakfast he came upon the family barometer hanging on the wall. It showed fair and rising. He tapped it — no movement. He banged it — still fair and rising. So he tore it off the wall and hurled it through a closed window shouting after it, 'Get out there and see for yourself!'.

Let me tell you one more story about a managing director, this time the leader of one of our largest companies, which is under a current takeover threat. He commented to me the other day that he had not done a stroke of productive work for four months.

Frankly I am totally unimpressed by theoretical arguments that our management ought not to be influenced by the threat of takeovers. We expect them to be stimulated. Can we seriously expect them to welcome a bid, or to fail to let it influence their decisions?

So far I have argued that the takeovers that are occurring do not seem to be bringing as much economic benefit as we might hope, and that the takeover wave is having an adverse side effect at least in some cases. The economy gains some benefits from takeovers but it also suffers some damage. May I now pass on to consider whether this is an appropriate matter for legislators and regulators to consider.

I was putting this to one of my public sector colleagues a few weeks ago and he expressed suprise. He felt that if a matter was left to the market it would be sorted out; commercial decisions would be made and eventually Adam Smith's invisible hand would guide things to a satisfactory conclusion.

It is not always so. The publishers of Taiwan and Indonesia who copy books, records and tapes without payment of royalties are competing freely. In a completely free market they should be applauded, but they are condemned because they undermine the valuable system of copyright. What about the system of patents? Patent law imposes serious penalties on those who compete by copying an invention without permission. But in a completely free market patent law would be abolished as an infringement of freedom. On a slightly different tack, there are regulations governing the mesh of fishing nets to ensure that baby fish get away to become bigger next year. I have heard those regulations attacked as a gross infringement of freedom, but without them fish stocks would be seriously diminished and the future of the fishing industry threatened. The same sort of point applies to rules governing replanting of trees after timber logging. All these examples are cases in which it is accepted that the market cannot be allowed to run completely free. In these cases restraint strengthens the market. Restraints are resented from time to time, but without them the economy would be weaker.

It is also worth noting the experience of Australia in the last century. In colonial days state governments deliberately fostered economic growth by assisting immigrants and by borrowing capital to build the new economic infrastructures. Railways, waterways, water and sewerage, electricity, gas, telephone and many minor services were government matters in Australia, while private enterprise was establishing them in the USA and Britain. In this country at any rate the textbook style of private enterprise economy has simply never existed. Would it be too subversive to point out that following a century in which Australia had the highest rate of government intervention in the world it also had the highest standard of living?

It does not follow from this that additional regulation is necessarily a good thing. Certainly if it is done it has to be done with great care. Certainly there are powerful arguments against prohibiting takeovers or selecting good ones from bad ones, but there are some things that we might do that could possibly help the situation. Certainly I think they are worth discussing and I hope that you will consider them and perhaps make some constructive suggestions. I'd like to outline six.

The first that comes to mind is the recent proposal by the Australian Associated Stock Exchanges that we should permit companies to buy back their own shares under restricted circumstances. I expect that most of you read the fairly extensive press coverage on that proposal last week and I will not repeat it. Let me say only that the AASE is not the only one to put the idea forward. My own view is that the prohibition has outlived its usefulness and that permitting share repurchase would be a worthwhile piece of deregulation though it would make takeovers a bit more difficult.

In much the same category comes the possibility of companies issuing non-voting shares. The UK experience is that removing this prohibition had very little effect, and I suspect that it would have little effect here. But the Canadians find it a useful tool and I can see no adequate reason for continuing the prohibition.

The third possibility concerns the use of shareholder plebiscites. The partial takeover bill now before the senate will (if passed) permit plebiscites to be used in cases of partial bids where shareholders so decide. If they prove to be popular and workable some extension of their use might be appropriate. One possibility might be their use by offerer companies before bids are launched. It seems a trifle anomalous that target shareholders, who nearly always benefit from bids, should be consulted while offerer shareholders, who benefit much less frequently, should not.

A fourth area of possible attention is disclosure. The concealment of intentions and the warehousing of shares has become a fine art involving nominee companies, options and trust documents. Loopholes in the law are being developed with skill by polished and experienced practitioners. It would be difficult to prevent all this but some improvement might be made by lowering the substantial shareholding disclosure threshold from 10 per cent to 5 per cent and by generally tightening up enforcement.

At the same time we need to reform the regulations governing section 261 notices, which are being seriously abused. I doubt whether it would be wise to abolish them because to do so would be to transfer a responsibility from companies to the NCSC — a move in the wrong direction. But some form of limitation on their use, possibly a charge to cover costs, might be appropriate.

The final example I shall give is the possibility of reducing the potential for court action. The great increase in the number of court cases in 1986 and the consequent delay and cost give rise to a serious concern. No detailed proposals have yet been worked out but some change in this area seems desirable.

These examples are not meant to be a comprehensive list of possibilities. Many proposals that have been widely canvassed have been left out and others have not yet been sufficiently developed. There certainly is no shortage of ideas.

The six possibilities I have outlined do however give you some idea of the current state of the debate — at least as seen from my desk. You will note that there is no proposal for radical reform of the code, no thought of prohibiting takeovers or of selecting good ones from bad ones. There is no thought of a radical shift towards the regulatory systems of the USA, the UK or Canada. We continue to watch developments in those countries closely. As changing market developments require modifications of our code their experience can be a valuable guide, but there is no good reason for considering their basic codes superior to our own.

I shall now try to draw these threads together. In terms of economic benefits there is a good basic case for takeovers, but it is frequently overstated. There is cause for concern about many of the takeovers taking place and about the overall effect they are having on our industry. We do not fully understand the economic effect of this activity and there is a need for a good deal more research.

There is no persuasive case for regulations to ban takeovers or to select the good ones from the bad. Our regulatory system is working fairly well, but in the face of a rapidly changing market place there is a need for further adjustment.

Panel Comments

Auckland

John Fernyhough

Richard Manning

Sydney

Henry Manne

Robert Baxt

Commentary

John Fernyhough

The paper by Dr Jarrell and his colleagues is refreshing because it traces with lucidity the US experience over the last few years and reminds us of the immense debates and enormous research that have gone into this subject. It reminds us too that in the cycle of ideas and in the translation from ideas to practice New Zealand has for a long time now lagged behind the other major English-speaking common law jurisdictions; it would be strange if it was otherwise.

The Jarrell paper gives us the opportunity to look ahead to see the evolution of ideas, the introduction, maturation and testing of concepts in a time frame that is ahead of our own. There is no way we in New Zealand can match the resources brought to bear on this topic in the United States. The problem has been exhaustively probed by the academics, promoted by the gladiators, pushed up and down to the Supreme Court of the land, addressed by the highest legislative bodies in the nation — yet in the end the conclusion is that takeovers are better left alone.

Against this remarkable body of research and experience it would be an extraordinary arrogance on our part in New Zealand to think that we know better, but in a land where Jack is as good as his master I am afraid we will try our hand.

And hence, the efforts of the Securities Commission over the last five years. During this period the Commission has laboured mightily, with the chairman at its head, foraging constantly through one series of papers after another, through one public inquiry after another, through one private inquiry after another, looking for a guiding principle to provide a foundation on which to build an edifice of new regulation.

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These efforts represent the Commission's search for the Holy Grail and the Patterson paper presented here today proves, I'm afraid, that the Commission is no nearer its destination that it was when it set out five years ago.

The 17th-century French philosopher Descartes figured that all human knowledge could be derived from his famous dictum *Cogito ergo sum*, I think therefore I am. From that basic postulate, elaborate and seductive reasoning reached out to prove the whole sum of human knowledge, including detailed theories on the circulation of the blood. I am reminded of it by the Patterson approach. He starts with the simple principle that 'The voluntary consent of the owner is necessary for an effective transfer of his property', and from there develops an elaborate theory of property transfer, a perceived list of misgivings about takeovers and a scarcely veiled conclusion that unregulated takeovers are not an acceptable method of allocating and re-allocating scarce resources within an economy.

A sustained attempt is made to show that the takeover process is unlike the allocation of a single resource by a sole owner using voluntary consent. This may well be true, but whoever argued that the takeover process was like that?

In all the literature I do not know of such an argument. The takeover process is quite unlike bargaining for the sale or purchase of an individual corporeal asset. It is a process that involves, in the first instance, buying the interests of shareholders, and in the second, acquiring control of the company. The acquisition of a share is the acquisition of a chose in action, a bundle of rights and expectations, an incorporeal piece of property. It represents no right or entitlement to any part of the business or to any asset in the business, and I would have thought that all the features of voluntary negotiations over transfer of property applied quite well to the acquisition of a share in a takeover bid.

Patterson's concern is that control passes with acquisition of less than all the shares. The reasoning seems to be that if a private owner had control he would part with it only at a fair price. In the takeover context an acquirer pays only part of the price a private owner would have wanted. The acquirer therefore gets control on the cheap. It is therefore different from private ownership and the sale of private assets because control can be obtained on the cheap. Therefore the takeover process may not be an economically sound method of allocating resources.

A number of points could be made about this argument. I will confine myself to two. First, the argument is an economic one and it is disturbing that the Commission should be seeking to make decisions on important structural legislation on economic grounds when it is not qualified in that field. The Commission members do not include an economist among them, nor is an economist to be found among the alternate members, nor so far as I know among its present staff. This perhaps accounts for the fact that in the paper no data are produced to show that less than 'normal' prices are paid for control in a takeover setting. Equally, there are no data to suggest that even if a price less than "normal" was paid, that the resulting resource allocation is bad.

Second, the argument predicates that the prior owners of a company get less for control than they should. The point is put this way in the paper:

> But if in the process the target shareholders who sell transfer for that money a more valuable existing potential of the target company as an independent, or as a part of a combination with someone else, do they gain? And more importantly, does society gain? I believe Adam Smith would not have assumed so.

This requires some discussion of the value of control, and in that connection I would like to introduce and read to you portions of a note I wrote in 1983.

I was a member of the Securities Commission from its inception in 1979 until I resigned in April of 1985. The proposals on takeovers published by the Commission in 1983 represented the Commission's views at that time on an appropriate new regulatory regime. I dissented from them and requested at the time the paper was produced that an appendix be attached setting out the questions that troubled me. The chairman refused to attach my appendix to the report and also refused to publish it through the Commission. It was very difficult in a private capacity to publish the paper without appearing disloyal. As I am no longer a member of the Commission I think the paper can properly be circulated because the questions that troubled me in 1983 continue to trouble me today. I now read relevant portions of that note written in 1983.

EXTRACTS FROM NOTE PREPARED FOR INCLUSION IN SECURITIES COMMISSION PROPOSALS PUBLISHED IN 1983

It is common ground that the liberty of the subject ought not be abridged or in any way impeded unless it can be shown positively that unrestricted freedom leads to harm and damage which, when balanced against the benefits of such freedom, is unacceptable and requires legislative intervention.

At present we have in substance an unregulated takeover market; the Friedman ideal, if you like. It was not intended to be so because the

1963 amendment to the Companies Act clearly aimed to limit freedom of action in this area, but in substance and in fact the market has been unregulated largely by reason of the courts' interpretation of the Act as restricted to written offers and the opportunity created by the stock exchange for buyers to acquire shares pursuant to oral contracts.

How then has this freedom been abused and what harm has been caused that justifies legislative intervention? Some of the evils alleged in the present unregulated market are set out below.

Equality

There is no equality of treatment of shareholders; shareholders receive different prices for their shares during the course of acquisition of control. I wonder whether equality is an appropriate concept in relation to price in the market place. The stock market is an active market and on any one day there are different inputs and different appreciations, from the standpoint of both buyers and sellers, which go to make up the market price for the day. The weight of those varies on a daily basis and for this reason it is not normally suggested that there is anything unequal in buyer A receiving price X in one week and buyer B receiving price Y the next week, nor is it considered unequal within a fully regulated takeover regime when seller A sells on the day before a takeover is announced at price Y and seller B sells the day after the takeover is announced at price Z. That inequality is just considered the luck of the draw and not in breach of any moral precept. Equally, the notion that equality requires all holders of a particular class of security to be extended an offer would not normally apply in a market for commodities. If buyer A is in the market for pumpkins and elects to buy them from farmer X, it is not considered a breach of the principles of equality if he fails to make a similar offer to farmers Y and Z.

Disadvantaged Minorities and Partial Bids

The argument is that if partial bids are permitted in an unregulated manner a minority shareholder will be disadvantaged because the value of his security will reduce if the majority shareholders use their control position for some ulterior purpose unrelated to the benefit of the company. I have two questions. First, what evidence is there that partial bids have indeed led to situations where those holding control have improperly acted to the disadvantage of the remaining shareholders? Second, might it not be a better approach to look at the remedies for minority shareholders such as section 209 of the Companies Act rather than to write a takeover law in response to what is essentially a minority shareholder protection problem? On the first question, I am not aware of any evidence in relation to partial bids in New Zealand that would suggest that minority shareholders have been disadvantaged by a passing of control.

Failure to Pay Premium for Control

Some argue that the market for control is not efficient or competitive because in an unrestricted environment a buyer can acquire control without paying an adequate premium for it. To put it another way the argument is that the premium for control belongs to the existing shareholders prior to control commencing to pass, and that a failure to pay an adequate premium would (a) defraud the vendors of something that is rightfully theirs, and (b) create a less efficient allocation of economic resources within the community.

As to (a) I suggest that the concept of a market for control connotes and necessarily entails that the vendors in that market have control. If they do not then they do not have anything to sell and they cannot be said to be defrauded if they are not paid for it. I suggest that the vendors in a typical public company situation do not have control, and that therefore they have nothing to sell. Each of them has a minority parcel of shares, the value of which depends upon the income that will ultimately be derived by holding those shares. It normally has nothing to do with the assets of the company. It is an intangible chose in action, a right to an income stream, which the market capitalises after it takes into account the security of that income stream and the likelihood of an increase or reduction in relation to the market average. I suggest that control in an unregulated market is what the buyer creates by putting together large parcels, not what the vendor sells. Control before the buyer commences his purchases does not exist, and to say that the purchaser should pay for it is the equivalent of saying that he should pay for something he himself has created. There is, of course, a premium for control once it has been created, but the benefit of that premium I would have thought should more properly be attributed to the person who has it, and the value of control, or premium if you like, belongs to those who possess it.

Allocation of Resources

So far as efficient allocation of economic resources is concerned the argument is that a system of competitive bidding for control will lead to an allocation of resources of the company to the best and most efficient use. If one bidder is prepared to pay more for them, then presumably he can put them to a more profitable use than the bidder who is prepared to pay only a lower figure. Should this argument carry more or less weight than the argument that a free and unrestricted market will lead to more frequent changes of control and, therefore, in a greater number of instances to a more efficient use of resources than a more restricted market would permit, where the frequency of acquisitions might be substantially diminished?

Defences Prejudiced

An unregulated market means that the opportunity for defence by a board of directors is foreclosed. This was the justification for the 1963 amendment to the Companies Act. I wonder whether or not this ground is well founded. I question why a company on which a market raid is effected cannot defend itself by issuing an immediate 'Don't sell' notice, to be followed by appropriate information. If shareholders choose to ignore such a notice, that is their prerogative. The law ought not to protect them against themselves or to prevent them from making a decision to sell, if they consciously elect to do so in the knowledge that they do not have at that time the information the directors wish to impart to them. Is not the best defence for a company against a gradual passing of control by a bidder purchasing over a long period in the stock exchange, the publication of adequate information concerning the company's affairs? A properly informed market will price the share so that it will be out of the purchaser's reach. If it is not then the purchaser must have plans to use the assets more profitably than the directors or market have judged to be attainable. Should directors who are worried about losing control through a gradual change in their share register be concerned if a buyer is prepared to pay more for shares when they are fully priced in accordance with the market assessment of the directors' expectations?

Even if rules and restrictions in the area of takeovers can be justified on any of the above grounds, there is a need to evaluate the harm caused by the unrestricted market against the benefits that such a market creates. I suggest that there are at least three benefits that need to be taken into account.

Efficiency in Allocation of Resources

There is evidence that many inefficient companies have been acquired as a result of takeovers and their assets redeployed to the ultimate advantage of the community as a whole. To the extent that any rules might restrict or reduce the number of such acquisitions, there must be a real economic cost. The specialists who have entered the market in recent years have, arguably, performed a valuable scavenging function in cleaning up inefficient operations. We ought not to discourage that.

Reduced Accountability

In theory directors are accountable to shareholders, but that is and has been for many years a fiction. Shareholders in public companies are not interested in directors' performance except as it affects either the price of their shares or their dividend cheque. If they do not like either, they vote with their feet. They go down to their broker and they sell the shares. So the directors themselves are never personally accountable. They tend to be a self-perpetuating body. If the directors are ultimately inefficient to the point where their share price exposes them to the designs and ambitions of those who think they can do better with the assets, then the directors will lose their jobs. Perhaps the most dramatic form of accountability for directors and perhaps one of the few means of making directors accountable is the takeover. At that stage the board is simply voted out. That is an implicit recognition that the bidder who comes in and is prepared to pay a higher price for the shares is able to do better with the assets. From the community's point of view it is vitally important that the bidder be given this chance. The pre-eminent need from the community's standpoint is that its assets and resources be used efficiently. In this sense the directors are trustees or custodians entitled to retain control of the assets only if they are more efficient than the alternatives. Unregulated takeovers may be one of the most effective ways of making directors perform in the public company context.

Takeover Rules Can Enable Directors to Improperly Retain Control

There are examples of directors taking steps gravely to the disadvantage of the company in order to beat off a takeover bid, and their ability to do this is greatly enhanced if they have time on their side. A formal set of rules that gives directors an opportunity to provide information also gives them an opportunity to assemble their forces to try and fight off the bid. There are numerous examples of directors pulling rabbits out of the hat when given such an opportunity, sometimes with quite disastrous results for the shareholders when the bid has been defeated. Manoeuvres to retain control are sometimes cloaked in language relating to the protection of shareholders' rights.

These are some of the matters that concern me in relation to any new takeover regime that might be introduced.

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In conclusion may I suggest that the values enshrined by John Stuart Mill 150 years ago still shine brilliantly today. The liberty of the subject ought not to be abridged unless there is a good, proper and sufficient reason for it. In the context of takeover legislation those who would propose to regulate must discharge an onus. They must show that there is a present evil that requires legislative intervention. In the commentaries and analyses so far published I have not been able to perceive what that evil is.

It is testimony to the intellectual honesty both of the chairman and of the Securities Commission itself that over a period of five years they have examined numerous bases for a new takeover regime but so far have rejected each one. It is not surprising that the process is time consuming; it is equally not surprising that in the papers presented to us today the search for the elusive, fundamental evil that would justify intervention, the search for the Holy Grail, has failed yet again.

Commentary

Richard Manning

Discussants are not required to give praise. Their function is to detect and correct error. For that reason I will concentrate first on the paper by Mr Patterson, and will turn only later to the contribution of Dr Jarrell and his co-authors.

Mr Patterson makes it clear that the New Zealand law relating to takeovers has yet to be written. The views of the New Zealand Securities Commission, of which he is chairman, will be very influential, if not decisive, in drafting that law. This forum therefore provides me with a rare, indeed unique opportunity: if I can persuade Mr Patterson to my way of thinking, then I will make an input to a branch of law with profound implications for New Zealand's economic performance.

The central question posed by Mr Patterson is 'Are takeovers as we see them in practice an acceptable method of allocating and re-allocating scarce resources within an economy?' I will show that the answer to this question is 'yes', and that this answer is implied by various statements that he evidently believes.

To begin, it is helpful to review Mr Patterson's position. He agrees 'that the best method of allocating scarce resources within an economy is by competition in an open market'. Following this statement he develops an eleven-point justification in its support. Economists will recognise in this development a rather laborious presentation of the 'gains-from-trade' theorem. This theorem asserts that voluntary exchanges improve the well-being of the parties involved, and that in equilibrium no one can do better by being involved in a different set of exchanges (for one classic statement of this theorem see Debreu,

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1959:ch.6). Economists are far from inarticulate in expressing their preference for the competitive market as a means of allocating scarce resources, despite Mr Patterson's claim to the contrary.

The conclusions of the gains-from-trade theorem are predicated on the assumption that individuals are the best judges of their own well-being. To the legal mind of Mr Patterson, this conclusion rests on 'an ancient legal rule. It is a general principle of law, to which there are only a very few exceptions, that the voluntary consent of the owner is necessary for an effective transfer of his property'. But it is clear that this principle is not fundamental. It seems to be derived from the belief that desirable consequences flow from respecting individuals' views. Many philosophical and psychological objections can be raised against the assumption that individuals are the best judges of their own welfare, but for everyday transactions engaged in by adults these objections can be dismissed. They also ought to be dismissed over a wider range of activity, in my view, since the alternative assumption implies paternalism and elitism; and it justifies the interference of do-gooders and busybodies into other people's lives.

After expounding his version of the gains-from-trade theorem, Mr Patterson applies it to the allocation of resources owned by companies. He points out that takeovers, in particular, involve shareholders in involuntary transactions, since 'A shareholder's interest in the resources held by a company (and in the income produced by them) is indirect, contingent, residual and remote'. On this basis he expresses his 'reservations about the proposition that a takeover accomplishes a transfer of resources by a process similar to a transfer of property by a sole owner'. In short, he is suggesting that open competition in the market for corporate control may result in outcomes that are not in the interest of some shareholders, since exchanges may be involuntary.

This suggestion has the merit of novelty, but it is wrong. Several well-known, fallacious arguments for the regulation of takeovers are examined by Dr Jarrell and his co-authors. These fallacies, and Mr Patterson's new one, rely on an alleged 'market failure'. When viewed from the proper perspective the error becomes obvious.

At a purely formal level it is possible to dismiss Mr Patterson's suggestion as unproved. While voluntary exchanges are sufficient for open competition to be beneficial, no one knows if they are necessary. Of course, most of the fun would go out of economics if it was known what conditions are necessary for the validity of Adam Smith's insight into the workings of a market economy. Fortunately for the employment of economic theorists, and unfortunately for the argument of Mr Patterson, these necessary conditions are not known. It might well be that open competition is beneficial even with a measure of involuntary exchange.

There is, however, a more compelling counterargument, which has the virtue of bringing out several important features of the market economy. Mr Patterson takes as given the existence of shareholders, companies, and the resources of companies. He inquires about the effects of takeovers on these resources. His analysis is static; it ignores the birth, growth and demise of companies. These dynamic effects are essential in the application of the gains-from-trade theorem to takeovers. When considered in a dynamic setting, it is clear that shareholders are not forced into involuntary exchanges in takeovers. Nothing compels individuals to become shareholders. It is a voluntary act to invest in a company, and an individual who does so expects to be better off as a result.

The individual shareholder's expectation of the gain from investing in a company is formed with the knowledge that the rules of association of that company restrict his freedom in various ways. But he volunteers to lose these freedoms. It may be argued that no one should be allowed to give up his or her freedom of action. Certain kinds of transactions are prohibited on this ground. For instance, it is illegal to enter into indentured labour contracts. That is, we cannot sell ourselves into slavery. Whatever are the merits of this particular prohibition, it does not illustrate an acceptable general principle. Almost all decisions entail some loss of freedom of action. Each class of decisions that results in a loss of freedom must be judged by its consequences.

The consequences of forming companies are beneficial, and Mr Patterson appears to recognise this when commenting on the differences between owning shares and owning other property: 'these differences, or at least some of them, probably account for the remarkable popularity of the company format'. The invention of limited liability companies, with their attendant restrictions on shareholders, is correctly regarded as one of the most powerful engines driving economic growth in the last couple of centuries. Investment and economic growth are enhanced when laws facilitate the development of companies.

The greatest possible flexibility needs to be allowed in the formation and operation of companies. This flexibility permits forms of association that suit the peculiarities of the business to be carried on and cater to the whims of investors. From the dynamic perspective, voluntary agreements can be made on these matters, and open competition is the best guarantee of an outcome in which the participants gain.

Any limitations on the formation and operation of companies (except those that outlaw fraud and the like) must reduce the opportunity of gains from trade. This is true of the regulation of takeovers in particular. The most serious effect of a reduction in the gains from trade in this part of the economy is that investment is discouraged.

To summarise: The gains-from-trade theorem, which Mr Patterson accepts, when applied in a dynamic setting to the formation and operation of companies, implies that takeovers are beneficial and should not be regulated.

Finally, a small criticism of an otherwise excellent paper by Dr Jarrell et al. (and, for all I know about the literature, this criticism might be quite generally applicable). They stress that the value of both companies is increased in a takeover, and express the concern among economists that regulations on takeovers (specifically the Williams Act) 'may excessively discourage productive investment in takeover activity'. However, they do not extend this concern to the effect of takeover regulations in discouraging investment in general. In the long run, it seems to me that this is the major reason why takeovers should not be hampered.

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Commentary

Henry Manne

I have probably been an interested observer of the takeover situation for longer than anyone in this room. I say that with some confidence because, as far as I know, I was the first academic to pick up pen (that was in the days before PCs, and before most universities even furnished typewriters) to write about the subject, and it has fascinated me ever since. In fact I know of no topic that gathers everyone's interest quite the way this one does. It has been a rich source of new kinds of approaches by academics, economic, legal and political; it has certainly been a major subject of interest for regulators and politicians; and of course the business community has kept a very sensitive eye on what goes on in this field. Nonetheless, given the community of interest that we seem to observe, it is amazing how little communication often exists between these various groups.

By way of commenting on these papers I would like to do something a bit unusual. I would like to exercise the prerogative of not talking on the assigned topic at all. That is not quite true, but as a way of getting perhaps a more helpful insight into the difficulties of communication that I think are quite apparent in the presentations today, I would like first to look at two extreme situations involving

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takeovers and then to come back to what we might call the middle ground, which we seem to be developing today.

First let me take the extreme free market point of view: absolutely no regulation of takeovers. We would probably have to go even further and join with the proposition first stated around 1980 by then Professor, now Judge Easterbrook and Professor Fischel in the *Harvard Law Review* on the legally proper role for managers, that is directors and top officers, confronted with a hostile bid for control. Easterbrook and Fischel said that when confronted with a tender offer managers should be completely passive; that is, they should be absolutely immobilised: no white knights, no defences, no personal buyouts, no reassignment of shares, nothing. Now, as you can see, this goes even further than the pre-Williams Act in the United States. There is literally nothing that managers can do to avoid a threatened takeover.

Under this extreme passivity rule of Easterbrook and Fischel we would probably have a few adjustments in the American courts' decision on the so-called "business judgment rule'. To a large extent that rule has been used by American courts to allow managers to develop defensive tactics; as long as there is any semblance of an honest business judgment in the defensive tactics, the courts will not interfere. However, the holding could easily have gone the other way. One condition necessary for the business judgment rule to apply is that the managers have no conflict of interest. The courts could have said, as Easterbrook and Fischel would have had it, that any time there is competition for a manager's position that manager faces a conflict of interest and therefore cannot give a completely neutral business opinion in the interest of the shareholders.

What are the arguments against this scenario? There are a variety. First, many argue that takeovers generally are not good for shareholders because they cost shareholders too much. In fact, there is no stock market evidence to support this argument, and there is no evidence that stock market prices do not reflect the very best information available.

Next we could argue that this proposition is not good because the shareholders would be denied the benefits of an auction market, and the evidence is clear that bid prices go up with competition. But that argument misses a crucial point. Certainly every rational individual would want more rather than less for his shares, but is the *ex post* competitive bid the correct measure? Clearly an intelligent choice must be made *ex ante*, or, as the philosopher John Rawls said, 'from behind a veil of ignorance'. That is, since we do not know today whether we will hold target shares tomorrow — or ever — we should prefer a system that in aggregate maximizes the value of all shares over a period of time. Ideally, what we would like is for all shareholders to receive the economic benefit of the information produced by takeovers. But this information has to be produced first, which means that there must be initial property rights in takeover information. But the only way that property rights in information about takeovers can be protected is by denying the subsequent possiblity of an auction. On balance it is fairly easy to demonstrate that, *ex ante*, all participants in the market will be better off with that rule.

This extreme no-defence proposition also presents a high level of risk to corporate managers, perhaps higher than many are willing to accept at their current levels of income. The market then will simply have to adjust for the higher risk by paying managers a higher salary. There is an even more effective way of dealing with that problem: the so-called 'golden parachute'. This in effect is an *ex ante* agreement between shareholders and managers to neutralise any hostility that the managers might have towards a takeover by guaranteeing the managers certain benefits, usually money, if for any reason their jobs were terminated. The same thing can be accomplished either way, with higher salaries or with golden parachutes.

Now let's look at the other extreme — not as extreme as you might think — where no takeovers are allowed. To say that there is a law against all takeovers is in effect to deny the very existence of the diffused ownership corporation as we know it. In that system all corporations except those with control closely held would be run like non-profit organisations — universities and government agencies, to take the two worst cases. The legal version of this would be a rule saying that there cannot be a takeover without the approval of the incumbent board of directors, or as a variant of that, that any corporation may elect to have in its charter a provision that requires approval of the board of directors for a takeover to proceed.

This is not such a strange animal as it may seem. After all, mergers, at least in American law, and I presume here as well, are negotiated arrangements in which the approval of the board of directors has to be obtained. There are a vastly larger number of negotiated mergers than there are hostile takeovers. I don't know the numbers in Australia, but in the United States we are now running about eight to ten times as many negotiated mergers as hostile takeovers.

Suppose we allowed companies to have a general rule requiring board approval for a takeover; does that mean there would be no takeovers? Obviously not, though the number would be far less than today. There is one further legal qualification necessary to allow us to consider this extreme. This qualification would be that there would be nothing wrong with *ex post* negotiations between an acquiring company and the managers of the target company, in effect for the sale of their offices. Then of course, the managers can be paid to allow the takeover to proceed. The result of this would, of course, be a transfer of wealth from shareholders to managers. A large part of the premium that is presently exacted by shareholders in the case of a tender offer would undoubtedly flow to the managers under this solution.

How disastrous would this extreme position be? At first it sounds gruesome. We simply could not tolerate that kind of transfer, particularly to bad managers who made the takeover premium higher by making the value of the shares even lower. But I don't think that is what would really happen. I think the market would develop an equilibrium price to be paid to these managers *ex ante*. A manager going into a position where he or she will have a property right in the office, simply will not get the same salary as another individual who does not have that right. I grant this is a highly theoretical approach, but I think it is particularly helpful because, like my first proposition, it forces us to see how the market will respond even to extreme situations.

I have presented two extreme versions, but the middle ground is the mess we currently have, regulation, disclosure, delay and uncertainty. Who benefits from this? Clearly the regulators benefit, either because they are interested in regulating as a profession or because they are able to allocate wealth to preferred political targets. There is another group that benefits from the present system, one that I predict will cause the sort of scandal in Australia that we have in the United States right now. Those of you who follow the United States financial press know that the great story of the moment is insider trading by people who have access to information about tender offers but who are not themselves directly involved in either the target company or the offering company. This happens because the delay and the regulations and the disclosure requirements have prevented the people who produce the valuable takeover information from controlling the flow of that information. It is just as if someone were dropping thousand-dollar bills on Wall Street and saying to all those pedestrians down there 'don't pick those up, they are really not yours'. That is exactly what we have done with takeovers. We have scattered Wall Street with valuable information and now the SEC tells us not to touch it. That is absurd. There are billions of dollars at stake, and the SEC will never find more than a tiny fraction of the individuals involved. This problem is a direct result of the regulation of takeovers. Before the Williams Act it was not a problem. The people who produced the information could move very quickly and protect the full value of their information, thus giving them a greater incentive to act in the way that benefited shareholders. I don't think there is any question that regulation, including litigation, disclosure requirements, and so forth, has increased the cost of takeovers considerably to the net detriment of the shareholders.

Finally, again, as under my second 'extreme' case above, but even more so here, the wrong managers win. There is no device under this middle scheme that allows contracting in or contracting out. You can't have a golden parachute; you can't negotiate for the sale of your office;

you can't do anything. We have effectively prevented the market from developing a solution to either kind of extreme problem, and we have ended up with the worst possible world.

Commentary

Robert Baxt

What I would like to do today is to comment on some of the matters that perhaps have not been referred to directly in the discussion but that I believe are essential to the question of takeovers and the Australian attitude towards them. I am also delighted to hear that Mr Bosch believes that we have not yet reached the stage where we need to tinker with the legislation too dramatically.

I want to say something about that a little later, but first I want to emphasise a point that was made by Henry Manne and by Gregg Jarrell and by Peter Dodd, and I think by Mr Bosch himself, and that is that before we rush in to pass any more legislation — and as Peter Dodd suggested the present legislation has grown from two pages to well over 100 pages — we must be absolutely certain what needs to be done and what legislation is needed to do it. Let me just give you a couple of examples of the kind of mess this country can get itself into by regulation. Whenever politicians decide we have a problem, if a company has gone down the drain or something has happened to someone in their electorates or whatever it might be, and particularly in cases where empirical research is not being done effectively, their immediate reaction is to pass an act of parliament to deal with the particular issue.

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My first example is the 1983 Green Paper introduced by Senator Gareth Evans to change the Trade Practices Act. Now the Trade Practices Act is very, very relevant to takeovers. One provision in that Act deals with mergers, and when he introduced his Green Paper Senator Evans said that according to the evidence he had, the current regulation on mergers under the Trade Practices Act was creating terrible problems for Australia: not enough competition, companies being taken over by monopolies, too much concentration. We needed to reintroduce the 1974 guidelines on mergers. When he was asked to give the evidence to support that proposition, the evidence simply did not appear. The same thing happened in relation to monopolisation. A couple of people in the electorates of one or two of the leading politicians in the Labor Party could not get supplies of a particular product; therefore they were the victims of monopolistic behaviour; therefore we must change section 46 of the Trade Practices Act to tighten up the regulations on monopolies.

When legislation is introduced based on that kind of evidence, without proper research being done, without the opportunity for the community to respond to the views that the politicians are putting forward as being dangers we have to guard against, then we do have real problems, not least of which is the mountain of paper that hits our desks in all sorts of areas. I am an academic and I probably have more time than many of you here, but I don't have time to go through all this legislation to read and understand it, let alone to perceive the implications of it. What I am pleading here today, and I hope Mr Bosch and the Ministerial Council take note of it, is that we do not want any more regulation. We do not want more sections of acts being introduced simply because of some emotional reaction to takeover activity in relation to one or two companies, or simply because we do have problems that may be able to be handled by looking at other areas of the law. I believe, and I think this will come out in the paper currently being written by Bob Officer, Peter Dodd and myself, that some of the problems in this area relate not to takeovers and the need to regulate the market more, but to some of the other basic rules of company law and directors' duties.

Henry Manne has very interestingly raised the question of the American business judgment rule. We have a similar rule in this country. We need to look at that, at how effective it is, at how it is used by the regulators, by the courts, and so on. Maybe it needs to be tinkered with, but we certainly don't need pages and pages of additional regulation to deal with certain issues that may reflect some of the difficulties in that particular law.

Another example of lack of empirical research leading to legislation. Peter Dodd referred briefly to the legislation on partial takeovers. A discussion paper was introduced by the Companies and Securities Law Review Committee (CSLRC) with an appendix by Peter Dodd containing his research on partial takeovers. There was no evidence to suggest that partial takeovers were creating damage or legal problems. Despite that fact, and despite the fact that there was very significant opposition to the legislation, the legislation has been introduced and I believe it has now been passed by the senate. The story around town, if you can believe those stories, is that there is a very real chance that the Labor Party at its national conference will propose the total prohibition of partial takeovers. Again, that would be nothing but the knee-jerk reaction that we see so much of in this country because the politicians themselves cannot find the resources and the patience to look at these issues in a more constructive way.

I welcome the development of more research in the area of takeovers. Henry Manne referred to the fact that in the United States this has been going on for a considerable time. It is only a recent phenomenon in this country and certainly something to be applauded.

Now let me deal with more specific problems in the takeover area in the Australian context. I do not agree with Henry Bosch's view that we do not need review of the takeover legislation. The first problem we have, and the problem will never go away unless we as a nation are prepared to face up to it, is the ridiculous scheme whereby the states cooperatively oversee the operation of the securities market. Securities markets are national and international markets. I believe that around 30 per cent of trading in the securities markets is international. Our scheme, where the National Companies and Securities Commission is answerable to the Ministerial Council and each of the states plus the Northern Territory has a say in what's to be done and what's not to be done, must be costing the business community a fortune. I cannot understand why the business community has not reacted more positively to suggestions that have been made from time to time that if we are going to have regulation in this area it should be national regulation. It seems to me that if we are going to have regulation in the trade practices area it must be a federal scheme.

Some would argue that we need some competition in the company law area between states. Henry Manne and Gregg Jarrell can give us particulars about the competition between states in the United States for incorporation of companies. Delaware is of course the most popular state for incorporation because, as I understand it, its regulatory scheme is less stringent than in some of the other states. The Northern Territory was outside the Australian cooperative scheme for a long time and it may well be that that could have created a situation where competition existed. This still does not change the fact that if we are going to have to have overall regulation of the securities markets, then we must have a national approach.

The second problem with the scheme of regulation in place at the moment is the lack of what I call a dual enforcement scheme. The

NCSC is the investigator, the prosecutor and the judge all in the one go. Tremendous tensions are created when a body such as that has to investigate a particular set of share transactions, hold a hearing and then find itself actually litigating in court on the particular matter. I would like to see the NCSC given a clearer role in this regard and relieved of the onerous task of having to adjudicate as well as investigate and perhaps prosecute.

But at the same time, and I am sure Mr Bosch would agree with this, if we are to have the NCSC as an effective body in this area of takeover regulation, and I assume in all of these remarks that we are going to continue to have some form of regulation, then we must give it the resources to do its job. I have a great deal of sympathy for the fact that Mr Bosch, Mr Greenwood, and Mr Williams have been sitting on a crucial BHP decision. They are responsible for a whole lot of other areas of company securities law, and just like the managing director in Mr Bosch's story who for the last four months has not been able to do very much effective work, I wonder how much effective work the commissioners have been able to do in some of these other areas, except in their spare time. It must be very, very difficult.

Another problem with the Australian law and the way it has developed and been interpreted is the fact that we seem to have this view that we must set out our law in very precise language that is clearly understandable to every lawyer. As soon as we try to put the language in more general terms, the lawyers say oh no, this is going to be unclear, business won't understand it, let's change it. May I give you another story dating back to the Trade Practices Act? When Senator Murphy, as he then was, introduced the Trade Practices Bill in 1973, it was a very short piece of proposed legislation. It contained very general language about what kinds of activities should or should not be permitted. There was an immediate reaction to this from many sections of the business community, I believe fired on by the legal profession, suggesting this was not on, they wanted more precise language, they wanted it all spelt out in fine detail. As a result over the years we have seen the Trade Practices Act grow from about 40 pages to well over 100 pages. When the NCSC legislation was first introduced we saw the judges who were responsible for interpreting it run far away from giving that legislation a spirit of intention approach — an approach that the American, Canadian and New Zealand courts have very little difficulty in adopting. I don't need to remind you of the famous comment made by a judge in the Queensland Supreme Court who had a case brought to him under the securities and takeover legislation and said it was the first time and he hoped the last time he would have to have to interpret legislation of this kind. Mr Justice Needham in one of the very first cases refused to be a bold spirit or even a timid soul in interpreting the legislation; he simply would not look at policy. Contrast that to the recent judgment in the North Broken Hill case involving Industrial Equity. That judgment is full of references to the spirit and the philosophy of the legislation.

I don't believe though that the present courts are the appropriate body to interpret this legislation. Maureen Brunt and I argued in relation to trade practices, and we would make the same argument in relation to this area, that because the courts are unwilling despite the directions they have received to give the legislation the kind of interpretation that I believe it merits, the courts are not the appropriate body to handle the basic issues of the philosophy and interpretation of a piece of legislation. Clearly legal rights and other issues that relate to directors' duties and so on will need to go to the regular courts, but I would like to see a change in the approach here.

There are a number of propositions that are fundamental to our takeover code, or at least they are suggested as fundamental criteria for our takeover code. This comes back again to the point about research and giving the community the chance to evaluate the relevance of the propositions that are going to be enshrined in legislation. In 1961 a two-page piece of legislation on takeovers was very simply drafted. An early interpretation by Mr Justice Gowans in the Colotone case suggested in 1965 that if we gave this legislation the kind of commercial interpretation that people would expect there would be few problems, or at least that is the thrust of some of his remarks. Over a period of time, the lawyers seemed to playing around with the legislation, trying to find ways and means of protecting the interests of their clients, and as a result there was some breakdown in the way the legislation operated.

A special committee was appointed by the Attorney-General to look at takeovers, and it was given one month, over Christmas, to consider the issue. After one month of marathon sitting the committee came down with four propositions that it suggested were the criteria that should be essential to our takeover code. Those are the criteria contained in section 59 and they are still the criteria that are the basis of the code, together with additional comments made by Mr Wal Fife when he introduced the cooperative scheme of legislation in the late 1970s. The four criteria relate to the issues that we have been discussing today: identity, information, etc. The one that has caused the most difficulty is the question of equality of opportunity wherever practicable. I believe that particular issue needs very careful re-examination in the context of all the discussion and debate that has gone on in relation to partial takeovers. It seems to me that now is the time when those criteria, which were brought forward after one month of study and no discussion period allowed, should be seriously reviewed. I certainly welcome the opportunity for informed economists, lawyers and others who are interested in this particular area to have a go at reviewing the criteria and ensuring that if we have to have regulation it should be a more systematic and well-thought-through piece of legislation.

One final comment in relation to disclosure of information. Disclosure of information can be a delicate and tricky thing, and I wonder just how much information the average shareholder out there really needs in the context of takeovers and securities. I wonder whether or not we might be going overboard, and whether the United States is an example that perhaps we should not follow in that regard.

In summary, the Australian community has been forced to bear an enormous cost over the last 16 years because of the way takeover regulation has evolved. We are getting more and more legislation and we do not have time to read it. I do not know how Mr Bosch and his colleagues have time to go through and understand fully all of the legislation that keeps coming out. I do not know how other regulators have the time to deal with it. Certainly the business community and their advisers don't have the time to read and understand it and still operate their businesses efficiently. It seems to me that now is a very opportune time in the takeover debate to ask parliament to stop dead in its tracks. No more regulation, no more changes in the law unless there are some very, very serious reasons to do it. And let's make sure that the problems are really serious and that we have a chance to do some proper research to ensure that any change is thought through and is to the benefit of this country.

Discussion
Auckland

Colin Patterson: After listening to Dr Jarrell, I would like to contrast the New Zealand legal regime with the US legal regime. There seemed to me to be at least eight points of difference.

(1) The United States has a beneficial interest disclosure law that requires anyone who holds more than 5 per cent of the equity securities in a public company to report that fact publicly, and to report his subsequent dealings. New Zealand does not have such a law.
(2) The US has a takeover law resting on the notions of, as Dr Jarrell put it, 'disclosure and delay'. New Zealand does not have a law like that, except where the takeover offer is made in writing. Some practitioners in New Zealand take good care to avoid putting anything in writing.
(3) Under US law, a company can purchase its own shares. Under NZ law such transactions are prohibited. When US companies see the prices of their shares decline, they do not hesitate to go into the market themselves and buy them. There is also the a practice known over there as 'greenmail', which is unknown in NZ.
(4) The US has established a remarkable system of corporate reporting, which includes a requirement that significant events affecting the value of securities issued by a company must be reported within a short time after they occur. The NZ system of financial reporting, on the other hand, usually ensures that significant events are concealed for about six months.
(5) In the US there are stringent laws creating civil and criminal liability for insider trading. These help get price sensitive information to the market in a timely way. NZ has no statute law on the subject. The few court cases in which the doctrines of equity have been invoked have been monumental in scale and cost.
(6) The US has established procedures for class actions, which are frequently invoked in the interests of minority shareholders in takeover situations. These seem to be fuelled by a vigilant legal profession, which participates in the spoils. In one notable case in Delaware, that of *Van Gorkom*, the triumphant attorneys for the class were awarded $5.5 million as costs for their labours in

recovering a fund of some $23 million. In NZ, class actions are not allowed, and contingent fees are regarded as unethical.

(7) US courts have placed liabilities on company directors that seem horrendous to New Zealanders. In the *Van Gorkom* case, the directors advised target shareholders to accept a bid of US $55 per share, at a time when the stock market price was about $37 per share. The directors were held to have been grossly negligent because they had not sought a higher bid elsewhere. They were held personally liable for the difference between $55 a share and what the court described as 'the fair value of the target company'. After five years of litigation, they agreed to pay the target company shareholders another $1.85 per share — another $23 million. Such a case could not even get on its legs in New Zealand.

(8) The SEC itself is a vigorous and effective enforcement agency, especially in regard to takeover law. Stanley Sporkins' 'nose for fraud and unparalled sense of inventiveness and creativity' has been known in New Zealand — and only with difficulty has he been persuaded that his writ does not run there. New Zealand has no government agency involved in that kind of enforcement process.

So, looking broadly at the US takeover scene from a distance, I am not at all surprised to see resistance to proposals for even more legal interventions and restraints. What does surprise me is that the so-called policy of 'deregulation' has not brought a move towards relaxation and removal of some of the US laws. But as Dr Jarrell hinted, perhaps this is coming.

The differences between the two legal regimes are important in assessing the weight of opinion. For example, when Dr Jarrell, in his paper, concluded that the economy benefits from an unfetterd market for corporate control, I have to ask whether he regards the present US legal regime as 'unfettered'? In his oral comment this morning, Dr Jarrell seemed to think that perhaps it was. To me, the US regime is the most stringent legal intervention in takeover activity that could be found anywhere in the English-speaking world. If it were attempted to introduce the US legal regime into New Zealand, the howls of protest would be audible in Washington.

There is another significance in the points of distinction between the two regimes. It might be that the US legal regime procures the economic result that some value that should be fairly regarded as belonging to bidders' shareholders is passed to target shareholders — the distributional effect that Dr Jarrell mentioned. I share Dr Jarrell's concern about that possibility, just as much as I am concerned about the assertion that in New Zealand, under an unregulated regime, some value fairly belonging to target shareholders might move to bidders and bidders' shareholders. I believe that what is wanted is a regime that secures bargained transactions for each set of shareholders. In my paper I sought a guiding principle for a reform of the law in that direction.

Question: Mr Patterson would probably be suprised to hear me advancing this argument as in practice I tend to be an advocate of unregulated competition. But I must say that I feel more than a little sympathy for the position he is espousing. My understanding of the classic Adam Smith economist's argument is that any form of regulation must tend to inhibit society or diminish its total wealth. Now I would be very interested to hear whether, in fact, that is what is being said here today. As Mr Patterson pointed out, Dr Jarrell and others are talking about highly regulated economies and I certainly did not take them to be saying that all regulation should be abolished, which appeared to me to be what Dr Fernyhough indeed was saying. We need make only a passing examination of a number of other areas of economic activity to demonstrate that there must be a balance between total regulation and no regulation. For example, at the end of the 19th century money lending was totally abolished from the economy in England. The result was an economic disaster, and it was reintroduced. My point is that there are social objectives to be achieved as well as economic ones, and in the company field there are very, very strong social objectives. It seems to me that the position of a minority shareholder in a company is, in fact, totally different from the position of a person who owns an asset in its entirety. Much of company law is designed to balance and protect against this.

I would like Dr Jarrell to tell us where he sees the balance to be. Does he advocate total freedom? or does he think the balance lies, for example, where New Zealand is at present? or perhaps somewhere between New Zealand and the United States? In other words, it is not practical to argue on a purely theoretical basis that competition is good and therefore any restrictions are bad.

Gregg Jarrell: I hope all the questions are not quite so hard. First of all my arguments were based very, very little on theory. We need very little theory to understand takeovers, or to understand the very simple problem facing New Zealand today. Does New Zealand take the first step down the road towards regulating takeovers, or does it maintain the environment that it now has?

Second, I would say economists do not dislike regulation, indeed we often benefit handsomely by it. I would not for a minute advocate that we abandon antitrust regulations — they are one of the economist's best friends. The SEC does a fairly good job of regulating fraud and enforcing certain types of contracts. The corporate laws of the individual states are also important.

My statement is that the United States has paid a heavy price for its regulation of tender offers. It has indeed obtained a certain measure of equity that it would not have obtained without the regulation. But the price was high and difficult to measure. It is truly frightening the way regulations have discouraged innovative and productive investment. I think New Zealand can learn from this. I think New Zealand will be better off if it maintains the environment that it now has.

Let me just point out one other thing. Many economists are actually worried about rules that would force auctions in corporate control transactions. That looks like a bunch of economists walking away from open competition, but what we are saying is that when the state forces open competition on something it has to be careful. The point is easy to see. For example, the state does not force open competition in the area of innovation. The whole system of patents abandons open competition and provides a monopoly to the inventor for 17 years. Why do we provide a monopoly for people who invent something? Because of the tremendous benefit to society over the long term in maintaining the incentives for people to engage in this kind of activity. So we swallow hard and we allow them to have monopolies when they come up with new ideas that are valuable. All advanced countries do this because we all judge it to be better in the long run.

So it is not that easy. You cannot just say, let's see, I am an economist, I am supposed to be in favour of competition, therefore I am against all regulation. It is sometimes very difficult and that is why you have to turn to the evidence. Unlike the United States when we were looking at these questions 15 years ago, New Zealand has the benefit of empirical results from other countries. With proper care to make sure that you take into account the differences between countries and cultures, I think the answer is, don't take that step towards regulation in the corporate control market.

Comment: May I just give a legal perspective on that question? I do not think the debate is between a regulated or deregulated economy. The current law in New Zealand does not impose any restrictions other than those of the 1963 Companies Amendment Act, which is largely ineffective. That is the current legal position in New Zealand and it has been for 15 years or longer. The question is, should that be changed by bringing in some new rules?

Those who believe there is a need for those rules must establish that there is some evil occurring out there that would justify that rule. We all acknowledge that rules are required from time to time to repel some evil. But what is it? and where is the evidence? It has been suggested that minority shareholders may need some protection. Again my question is, what is the evidence? The evidence as far as I know, and I am not speaking authoritatively because I have not got it all in front of me, suggests that minority shareholders in the last 15 years in New Zealand have done very well. If there is in fact evidence of some evil that I am not aware of, why do we not just strengthen section 209 of the Companies Act, which is designed to provide protection for minorities? Why would we need a new takeover law?

So I do not think the debate is about regulation as such. The question is, given the current law, what is the evil that requires it to be changed? If there is an evil, which is the most convenient and least regulatory way to stop it?

Comment: I think the debate that has been generated around this issue has created a great gulf between lawyers and economists and always will until economists recognise that what the general public sees as their ruthless objectivity is not attractive unless it is packaged properly. You're not recognising that lawyers with their talk of fairness and equality find a more ready market than economists who are talking about efficiency. I think perhaps the debate between Mr Patterson and virtually all of the other official speakers is not recognising the question of whether or not a share is an interesting assest or an interesting bundle of rights relating to an asset. Perhaps it is a red herring.

Jarrell: You are right, an economist is the type of person who, when you start talking about the rise in store thefts, gets worried about the dead weight social waste that goes along with anti-burgulary devices. Economists do not worry about the wealth or the distribution. They say the store lost wealth, but someone else in society gained precisely the same amount, therefore we can ignore that and go on to the efficiency considerations. That is the way we think and talk, and we are horribly bad marketers.

I would like to add one comment about the protection of minority shareholders, particularly target shareholders. My question is: what did the target shareholder produce for society? To what end are we fashioning rules that will maximise or increase the total exchange from takeovers and the fraction that goes to target shareholders? The target shareholder is not the inventor, the target shareholder is passive, he has bought shares in the firm and is holding them. The bidder is an inventor or an investor by this theory. So it just seems completely wrong to a lot of economists that we spend so much time and effort trying to ensure that 90 or 95 per cent of the total gains go to the target shareholders. We try to protect minorities with lots of rules, and believe me in every firm I own stock in I am a minority and I am very concerned about protection. But these rules have very important ramifications for the long-term incentives to invest in this kind of activity. The evidence is that this is not just a theoretical concern hatched from an economist's equation. It is rare to come across regulations that have had a more dramatic effect on the distribution of wealth in the market place.

Discussion
Sydney

John Green: I would like to bring up some matters of principle that have practical repercussions. Mr Bosch asked earlier if regulators should be involved in the debate on takeovers. In my opinion they should, but the NCSC should not. It is none of the NCSC's business to question whether there are too many takeovers. Its function as far as takeover policy is concerned is limited to ensuring that takeovers, however many there are, are run fairly and within a framework that fosters market confidence and efficiency. In my view the NCSC should get its nose out of this debate. Of course Mr Bosch is entitled to his personal views and I think they are a welcome contribution to the debate. But he should speak in his personal capacity and not for the NCSC.

The NCSC complains that it is poorly resourced and I agree that it is. I firmly believe that we should increase the resources of the NCSC to ensure that the functions we allow it to continue to have, because that is part of the debate I suppose, are exercised properly and quickly. But if it is the function of any regulatory body to look at the question of whether there are too many takeovers, it is not the function of the NCSC. Perhaps it is Treasury's job, and perhaps it should be the Trade Practices Commission so far as competition policy only is concerned. But I believe quite strongly, Mr Bosch, that it is not the NCSC's role in this matter. Do you have any comments on that?

Henry Bosch: My comment is fairly simple: you are quite wrong. The formal agreement that set up the cooperative scheme says that we do have a policy role, and I can assure you that the ministry looks to us to provide substantial policy input. Perhaps what you have said is an ideal situation but it is not compatible with our law and politics at the moment.

Green: If I can respond briefly to that, I am aware of what the cooperative agreement says and I considered this question before I made my comment. I believe the NCSC does have an important policy role, but it is a policy role in making the market run fairly, not in determining how many players there are in the market.

Bosch: Well, we differ fairly widely in the interpretation we place on the formal agreement. I can only say that as I understand what the various ministers concerned are saying to me, they want me to be doing the things that I am doing and are very supportive of me.

Perhaps I can widen my remarks to talk a bit about one or two points that Bob Baxt raised. He introduced the very much wider question of the workings of the cooperative scheme. I have a lot of sympathy with some of the things he has suggested, but I would say to him, before you advocate a change you have to work out what sort of final position you are going to have. In a federation it is not at all simple to make something a matter for federal government alone. The Americans have not succeeded; even though they have a very powerful SEC, the states still have important legal rights and activities. The Canadians, who are perhaps a little more like us, have not managed to make it a federal matter at all; there it is entirely a provincial matter. In fact I find that a number of Americans and Canadians when they have looked at us consider that we have some advantage.

I also think, looking at the practical alternatives to the present cooperative scheme, that it is extremely unlikely that the states would be prepared to give up their role and their responsibilities. At the very least they have a massive revenue raising potential which they would be very reluctant to give up. There have been various proposals put forward since I have been in my present position and I don't think they are really practicable.

As far as the comment about reducing our role as investigators and judges is concerned, I think that would be a wonderful improvement. It is also a more practical suggestion and I hope it could come about very quickly. I think it is important that groups like this one here today take a role in thinking about the practical changes.

Frankly, I think it is asking for pie in the sky to hope that there will be no more legislation in this country in the next couple of years. The trade union movement is quite determined that there will be and the biennial conference of the Labor Party that I referred to earlier will be very important.

This audience is predominantly a free enterprise audience. I will simply say this to you: it is no use hiding your head in the sand. You have got to come out and make practical proposals for change within the realms of the possible. I know that Bob Baxt is doing this because I have seen some of the work he is producing, and I know he is going to have an impact on the next ministerial council and I welcome that very much indeed. I just wish there were more people from this side of the political spectrum putting forward their practical ideas because there are going to be changes. It is essential that people of this view think about the issues and put forward their suggestions. I welcome this sort of discussion hope something positive will come of it.

Question: I would like to raise an issue with Dr Jarrell that has been ignored in the discussion so far. In the entire discussion this morning no one has addressed the question of who is funding the growth of a particular business. For instance, two years ago in Australia BHP posted its worst economic slump in ten years, and therefore there was a drop in the share price to $7 from $10 or whatever it was then. The very next day, headlines again in the financial press, in the British markets BHP price breaks through the $10 barrier. Now the only reason that occurred was that BHP knew and the market knew that the government was basically coming to the party with a $2.3 billion interest-free loan.

Research funding is another example. Many American corporations have generated huge profits because they had virtually guaranteed underwriting from the government for long-term research and develoment. This naturally ties into your point that investors do not sell their shares when a company embarks on long-term research and development, because much of the time they are funded by government-guaranteed money.

Jarrell: First of all I assure you that in our research, when we were trying to get a feel for which firms were committed to the long term and which firms were committed to the short term, the funding was only in a very minor way public money. Research and development as measured in that study included capital expenditures by firms for long-term research and development, long-term plant and equipment.

But your question raises a much more contentious issue. When raiders finance takeover aquisitions by loans, the interest is deductible. That gives a lot of people unease because they think that perhaps there are too many takeovers because the financing is subsidised by the government (taxpayer). A couple of points immediately occur to someone who considers this argument for a moment.

First, interest is deductible regardless of what the financing is used for. The government doesn't say if this is used for an aquisition you can deduct it and if it is not you can't. Interest deductibility is a general bias in favour of debt financing. These sorts of laws usually come about because of forceful, aggressive and effective lobbyists, in this case bankers. But if it is undesirable for society to have this bias towards the use of debt, then government ought to address it through the tax code. There is a good deal of discussion about that in the United States, and there are a lot of good arguments being made to equalise the tax treatment of the use of equity financing and the use of debt financing. But to suggest that there are too many takeovers because of the interest deductibility of debt is to miss the point. The fact that interest is deductible cannot possibly explain why debt financing would be used for takeovers versus other investments.

Second, interest on debt has been deductible for a long time in the United States and the boom in takeover activity is relatively recent. So there again I don't think that helps to explain it.

I think that what all of this the comes down to is the question, what is the source of value in corporate takeovers? We hear about raiders and pirates who borrow huge sums of money on the cheap because the interest is deductible. They take these huge sums of money and they offer large premiums for the stock of a company. The shareholders would be foolish not to sell out; they can hardly be expected to hang in there for the long term when faced with those sums of money. The raider then aquires control, breaks up the target and sells the assets to different people across the land. Where once was a proud, productive member of the business community, now there is only a hole in the ground.

The first time I heard that story I was genuinely moved. I thought this is terrible, something must be done about this, we have to put a stop to it. I don't care what those professors told me in Chicago and I don't care what this computer says, something has to be done about this social problem. It can be a very emotional issue.

Then I started to think about it and I thought, instead of telling the story about a company, I will tell it about my house. Somebody comes up to me in my neighbourhood, a nice proud residential neighbourhood, and offers me $150 000 for my house, which is worth $100 000 on the market. Take it or leave it. They finance this with a loan from a bank for almost the entire amount, and they deduct that interest from their taxes. I am foolish not to take the premium and move, so I sell, giving them total control over the house with no regard to my neighbours and community and employees. I leave happily and go buy something else. The new owners come in and strip the house down. They throw the doors off, the doorknobs off, they pull out the windows, and they sell the pieces to various people across the land, leaving where there used to be a proud residential member of the community a hole in the ground.

Now obviously we need no laws against that kind of problem because that kind of problem doesn't exist. Why doesn't it exist? I dare someone to pay me 50 per cent more that the current market value for my house and employ that scheme once, let alone a dozen times as some of these raiders have probably done, and continue to get financing from the bank. The difference between the two stories is simple. Corporate raiders are able to sell the assets to people for greater sums of money than the capital market is currently valuing them as part of the encumbered management enterprise. That is the only reason they are able to do it, and the only reason they are able to continue to obtain financing.

Regulation and Corporate Control: The British Experience

The Rt Hon. Christopher Chataway, PC

The Rt Hon. Christopher Chataway, PC is Vice-Chairman of Orion Royal Bank Limited and a former Minister in the Government of the United Kingdom. An Olympic athlete who held the 5000m record in 1954, Mr Chataway was a television commentator prior to his election to parliament in 1959. As Minister in the Department of Trade and Industry from 1972-74 Mr Chataway saw mergers and acquisitions policy from the viewpoint of government. In the last twelve years he has been principally concerned with Orion's M&A department which specialises in international affairs. He holds directorships in a number of financial, broadcasting and corporate organisations.

Regulation and Corporate Control: The British Experience

Christopher Chataway

Takeover activity seems, like cricket, to be a sport with strong Anglo-Saxon roots. In most parts of Europe hostile bids are rare and in Germany and Japan they are almost unknown. Yet in many countries of the English-speaking world, the hostile takeover has seemed recently to dominate the business scene. Newspapers in the United States, Britain, Australia and Canada have detailed an extraordinary succession of bids — many of unprecedented size. From far and wide bankers, lawyers, advertising and public relations men have flocked in their droves to join in these battles. Stock markets have often seemed to be driven principally by the takeover fever, as prices respond to the latest bid or rumour of a bid. The air has been thick with the cries of businessmen, whether aggressors or defenders, accusing each other of every type of incompetence.

It is not surprising that all this has prompted a good many doubts. Will the megamergers lead to improved performance? In Britain one or two academic studies have suggested that on almost any criterion most merged companies do worse together than they previously did separately. But nobody, of course, can prove that it was not the realisation of impending decline that induced one or both of them to want to get together in the first place, and that without the merger, the descent would have been even more rapid.

Are we producing a land fit only for arbitragers? While our competitors purposefully build their industries, are we allowing ours to be shuffled around like chips in a casino? Many business leaders are complaining of the time and effort that management has to devote in the current environment to preparing for assaults and warding them off at the expense of getting on with the real job. But then, of course, one would hardly expect all managers to be always enthusiastic about a process that may harshly expose their shortcomings — and not all are equipped with those lovely golden parachutes.

It is difficult, looking at the British scene, to believe that the system could function effectively without takeovers — some of them unfriendly. Most successful British companies are built in part upon shrewd acquisitions. A very few, like Marks and Spencer, have relied wholly upon organic growth, fostering in the process a unique organisational pride that would hardly tolerate the idea of bringing anyone forcibly into the fold. But the great majority of British front-runners are what they are today partly because they have proved themselves to have an eye for underperforming, undervalued assets and to have the management ability to turn them around.

It is all very well to say that Germany and Japan have achieved their commercial successes without the spur to efficiency that is supposedly provided by the predator. But in looking at the history, the national characteristics and the organisation that have produced their successes, nobody could surely argue that the absence of hostile takeovers was a major contributor. There are goads to efficiency in both these countries that do not exist elsewhere. And when it comes to the UK and one recalls the sleepy British companies that have been acquired and rejuvenated by James Hanson, for example — or the sleepy British companies that have turned themselves around for fear of James Hanson — it is hard to believe that we should be more productive without the bid battles.

So I am in favour of bids and deals and of mergers and acquisitions — and I know you will banish from your minds the unworthy thought that I am in any way influenced in arriving at this careful conclusion by the likelihood that I would be out of a job without them.

But what of the rules? How to avoid abuse and excesses? I would like to look briefly at the mechanisms we use in Britain for trying to ensure that bids are fairly conducted, and then at some of the broader issues involved in competition policy.

The British system of self-regulation is in stark contrast to the US federal system for regulating takeovers. The American system was described by Sullivan and Cromwell, the leading attorneys, as 'Based on disclosure, administered and enforced through detailed rules which must be followed to their letter because of the potential drastic consequences of a violation such as: the imposition of substantial damages ... and in an extreme case imprisonment or fines'.

By way of contrast, Principle 1 of the City Take Over Code states 'It is impracticable to devise rules in such detail as to cover all the various circumstances which arise in takeover or merger transactions. Accordingly, persons engaged in such transactions should be aware that the spirit as well as the precise wording of these General Principles and of the ensuing Rules must be observed. Moreover it must be accepted that the General Principles and the spirit of the Code will apply in areas or circumstances not explicitly covered by any Rule'.

The Take Over Panel and the City Code, dating from the later 1960s, have functioned well. The rules, which have become more detailed, have been subject to continuous amendment. The rules and the rulings have been almost universally observed — and without draconian penalties. The principal sanction — hardly ever used — is the withdrawal of the use of the UK securities markets and other facilities of the City of London. Public or private censure is the usual method by which the panel exercises its influence.

The emphasis of the City Code is:

First, that all shareholders are treated alike both with regard to the terms on which shares are acquired or offered to be acquired and with regard to the information they have available to make a decision. Thus such evils as 'greenmail' and the 'poison pill' are impossible. Neither the attacker nor the defender may favour certain shareholders at the expense of others.

Second, effective control of a company cannot be obtained without a general offer being made to all shareholders. There is the 30 per cent rule, where a general offer has to be made at this level of ownership. There are rules restricting the ability of a shareholder to take a holding above 30 per cent prior to making a general offer and restrictions on the speed at which a shareholder can take a stake up to the 30 per cent level.

In all this most observers would agree that the Panel has been highly successful — far more successful in my view than any statutory system could be. I hope that self-regulation will survive. There is no doubt that it is threatened, however, by the financial revolution that is at present sweeping through the City of London. So long as a handful of British merchant banks were responsible for both sides of virtually all contested transactions, the club atmosphere ensured the authority of the panel. With increased competition, not only are there doubts about whether the newcomers from Wall Street are going to be prepared to enter into the spirit of this particular ballgame, but there are even some doubts about the home players. At least one leading UK merchant bank is thought to have recently been making a practice of seeking to impress its clients by trying to run rings around the Panel.

The sheer size of recent deals as well as increasing competition has raised the stakes for merchant banks. This has resulted in more occasions where the view of the panel's executive is not accepted and there is an appeal to the full panel or even recourse to the courts.

I now turn to the role of government and its agencies and to the control of monopolies. In Britain the Office of Fair Trading (OFT) scrutinises every proposed acquisition involving gross assets of £30 million or more, or market shares of 25 per cent or more, though the OFT does not usually bother with market segments with a turnover of less than £15 million. Of 259 such bids in 1984 and 181 in 1985, only five in each year were referred by the Secretary of State for Trade and

Industry on the advice of the Director General of Fair Trading to the Monopolies and Mergers Commission (MMC). This Commission takes about six months to come to a conclusion. A reference to it, therefore, is sometimes enough to kill the deal, since the bidder may not want to wait that long. Or at the end of six months the market may have changed. The Secretary of State can allow a deal that the MMC has recommended against, but cannot ban a deal to which the MMC has given the all clear.

The system does not, on the whole, work badly in achieving the limited objective of preventing undue market dominance. A weakness, in my view, is that the legislation requires the MMC to consider not only the question of enforcing and preserving competition but also the 'public interest'. The Commission is not equipped to take such decisions, and if any deals are to be killed for other than monopoly reasons — regional employment, national security and so forth — then the government ought overtly to take the responsibility for doing so.

There have been some silly references. One notable example, the result of some skilful lobbying, was the decision two or three years ago to refer an American bid for Sotheby's, the art auctioneers — on what grounds, other than that some of the well-connected directors did not like it, was never made clear. In the end some other Americans bought it without a reference. The Secretary of State's recent decision to refer the Elders bid for Allied Lyons on the grounds of its financing seems to me also to be mistaken, but I will return to that.

With the increasingly sophisticated methods available to industry to define market segments, one wonders whether the leanly staffed Office of Fair Trading has sufficient resources at its disposal. It may seem that Company A's acquisition of Company B would give it 20 per cent of the widget market, but if two-tone marzipan-covered widgets are in reality a discrete market segment and A plus B will finish up with 90 per cent of it and the regulators did not realise, then the consumer would probably suffer. As Karl Marx realised, capitalists will consistently try to get as close to monopoly as they are allowed, and if Marx is to continue to be proved wrong in so many other ways, it is important that regulators have sufficient skills and resources as well as powers.

In combating monopoly the British system has worked quite well. As competition in many industries becomes more global, the decisions get harder. Should GEC be allowed to acquire Plessey and a dominance in telecommunications switching in the UK on the grounds that although neither has any significant exports at present, telecommunications administrations are becoming less nationalistic in their purchasing policies and in a future world market only giants will survive? Quite a difficult decision and one that the MMC is wrestling with at present. Such issues could be considered in a more coherent framework if the pace of European economic integration were more certain. We are still a long way, though, from a common market in which free competition throughout the EEC would render obsolete any concern with national monopolies.

Despite the competition policy of successive British governments and more latterly of the European Commission, the process of concentration has continued. In 1953 the 100 largest manufacturers accounted for 27 per cent of industrial output. In 1972 that had risen to 41 per cent, and the trend has since gone further in the service sector as well as manufacturing. In 1981 the top 50 companies accounted for 45 per cent of the capital employed by the top 1000 companies in Britain. Three years later that figure had grown to 61.3 per cent. It is not, as I have indicated, that the MMC has been lax in combatting monopolistic acquisitions. The concentration of ownership is due quite largely to the spread of conglomerates. The more successful large companies, precluded from further domestic expansion in their main lines of business, have diversified. One of the surest ways for a well-regarded company to increase earnings per share is to use its highly rated paper for acquisitions. If monopoly policy does not allow an acquisition in its own business, market pressures soon push the company towards some other purchase. The company gets bigger. An even higher proportion of the country's commercial and industrial activity is accounted for by the leading firms.

It is entertaining to note the language generally used in this process. 'Conglomerate' is not really a polite word anymore. Geneen of ITT did not mind it in the 1960s, but since the collapse of that particular empire and some others like it, companies have on the whole sought to portray their activities as closely connected. Chairmen's speeches tend to make approving references to the cobbler sticking to his last and to emphasise that 'Your company will continue to stay with what it knows best'. What it knows best is, however, often described in disarmingly general terms — 'Services to Industry', 'Mass Merchandising' and 'Medium Technology'. When BTR, a highly successful British engineering company, bid a few years ago for Thomas Tilling, a well-diversified company whose activities stretched from publishing through silk stockings to insurance, BTR argued in the ensuing battle that these activities were contiguous with its own. Although a somewhat unlikely claim, it was nice to have a new word imported into bid battles where the language — derisory, inadequate, and so on — tends to be a little repetitive. Anyway BTR won and so far has made a great success of managing these entirely unrelated — I am sorry, contiguous — businesses.

The serious point is that in Britain, as I suspect in other economies where there are few impediments to growth by acquisition so long as it is not monopolistic, the trend towards a concentration of ownership in the hands of the larger companies is disturbing. The answer in my view lies not in more regulation and a greater interference in the market place but in making demergers easier. The present British government has made a start with changes in the 1981 budget, which reduced some of the tax impediments. For a British company to achieve a tax effective means of demerging its activities is still, however, unnecessarily difficult.

There is also some prejudice against what is called 'asset stripping'. If a bidder wishes to break up a company into its constituent parts and can demonstrate that they should be worth more separately than they are together, then he ought, in my view, to be encouraged to do so. The Elders bid for Allied Lyons was referred to the Monopolies Commission because the very high gearing was thought to make it likely that in the event of success Elders would sell off parts of the empire. So what? There can surely be no overriding argument that groups of hotel companies, food companies, drinks companies once joined in corporate matrimony should never be put asunder. Indeed the presumption ought surely to be the other way. Gifted entrepreneurs put together widely spread empires and are able to add to them by demonstrating to the market an ability to succeed over a broad range of enterprises. Once that genius has gone, the odds are that the parts will do better separately than together.

The growth of management buyouts, still gathering force in Britain, is a healthy trend. The number of disposals by major companies has also grown in the last decade as it has become more common for managements regularly to analyse their portfolios. But if the process of concentration is to be halted, we could probably do with a few more so-called asset strippers.

I referred at the outset to the anxiety aroused by the recent wave of takeovers. I have attempted briefly to describe some of the strengths and weaknesses of the British regulatory system and I think there are more strengths than weaknesses. In conclusion I would simply emphasise my belief that the greatest responsibility lies with shareholders and particularly with institutional shareholders. Of course there are thoroughly bad bids and proposed bids undertaken for all the wrong reasons — empire building, personal egos and all the rest. But I have very little confidence in the ability of governments to distinguish between a bid that will increase the value of an enterprise and one that won't. I would always be reluctant therefore to extend the powers of governments to intervene other than on straight monopoly grounds.

The major responsibility for judging the merits of a takeover rests and ought to rest with institutional shareholders, such as pension funds, insurance companies, and investment trusts. Their performance as fund managers is judged in the medium to long term. So they have far more incentive than politicians to get it right. They have also got — or certainly ought to have — many more of the skills required. So, important as governments and regulatory agencies and rules and codes may be, let us continue to put the weight of the responsibility for decision making squarely upon the shoulders of the shareholder.

Some Evidence on the Determinants and Effects of Corporate Takeovers in Australia

Fred M. McDougall

Fred M. McDougall is Professor and Head of the Discipline of Accounting and Finance at the Flinders University of South Australia. He has taught at the Universities of Melbourne, Adelaide, Glasgow and Southampton, at Macquarie University and at Concordia University, Montreal. For over 15 years he has combined teaching, research and consulting work and has published widely in Australia and overseas. His specialty is corporate finance and he has acted as a consulatant to a wide range of Australian organisations. In 1985 Professor McDougall and David Round were commissioned by the National Companies and Securities Commission and the Australian Institute of Management (Victorian Division) to study the determinants and effects of corporate mergers in Australia.

Some Evidence on the Determinants and Effects of Corporate Takeovers in Australia

Fred M. McDougall

Introduction

In August 1985, David Round and I were commissioned by the National Companies and Securities Commission (NCSC) and the Australian Institute of Management–Victoria (AIM) to undertake a study into the determinants and effects of corporate takeovers in Australia. The study was published in April 1986 (McDougall and Round, 1986). The present paper represents a summary of the methodology employed and the findings and conclusions of that study, and provides some comments on the implications of the study for the topic of this conference — takeovers and corporate control.

When Mr Henry Bosch was appointed Chairman of the NCSC he arrived at a time when considerable public debate was occurring about corporate takeovers. This debate was fuelled by a number of issues including a rise in the number of takeover attempts being made; an increase in the scale of takeover attempts (with some well-known large public companies receiving bids); controversy over the use of partial bids; the activities of a number of so-called corporate raiders; and the economic impact of takeovers. Inevitably, given the vested interests involved, the debate soon became concerned with the regulation, or otherwise, of corporate takeovers. The NCSC and the Standing Committee of Attorney-Generals on Companies and Securities were under pressure to respond. In the process, the available Australian research on takeovers was considered and found to be wanting as a basis for policy formulation and review. The NCSC decided to commission its own study into the effects of takeovers. It had no funds for this sort of activity, however, and welcomed a proposal from the AIM–Victoria that they jointly sponsor a study. The AIM–Victoria had sponsored special research projects for several years, and had been considering takeovers as the subject of its next project.

Once the decision was made to sponsor a study, two problems arose. Who should undertake the study, and what direction should the study take? After considering a number of individuals, David Round and I were chosen for the research team. The research methodology had to be an accepted one that could be applied relatively quickly given the state of the debate on takeovers. The NCSC consulted with various individuals and organizations as to the appropriate methodology, and finally selected the approach used by Professor Dennis Mueller and co-researchers in an international study of takeovers sponsored by the International Institute of Management of the Science Centre, Berlin (Mueller, 1980).

The NCSC study was commissioned in order to obtain an assessment of the determinants and effects of takeover activity in Australia over the period 1970–1981. It was not expected to provide the complete story on the topic — years of investigation would be needed for this. A methodology was adopted that had been successfully applied to the analysis of takeovers in a number of overseas countries, and that would permit Australian results to be placed in an international perspective.

Methodology and Sample Selection

Mueller's methodology is based on a rather complex analysis of the major corporate performance characteristics in the pre- and post-takeover periods. These performance characteristics are largely based on accounting data, and incorporate measures of profitability, risk, leverage and growth. The method also includes some analysis of share price changes. Performance is evaluated by comparing the **pre-takeover** performance of the acquiring and target firms, and by comparing the **post-takeover** performance of the enlarged entity with the pre-takeover performance of the acquiring firms and with the pre-takeover performance of a composite of the acquiring and target firms. The methodology also requires the selection of a group of control firms thet have not been involved in takeovers but that otherwise could be expected to perform in a similar way to the merging firms. These matching firms must not have been involved in takeovers over the comparison period of six to ten years (to give at least three years before and after a takeover), and must be of a similar size and in the same industry as the acquiring and target firms.

In selecting takeovers for analysis, it was necessary that certain criteria be satisfied. The takeovers must have occurred in the industrial, services and transport sectors of the economy; involved **full** takeover offers; involved listed companies; have been successful to a substantial degree; and have at least three years before and after the takeover free of the effects of any other takeover for both the acquiring and target firms. This latter requirement was considered necessary to judge the effects of a takeover on corporate performance.

Our initial selection process indentified 235 takeovers in the period 1970–81 that satisfied the first three parts of our criteria. Application of the full criteria reduced the number to 88 takeovers. It did, however, result in the exclusion of some takeovers made by a number of companies very active in the takeover area (including several so-called corporate raiders). Our final sample consisted largely of acquiring firms that appeared to be expanding by a balance of internal and external means, and that were concerned with a continuation of the major activities of the target companies.

Our sample contained a reasonable distribution of takeovers across industries, with certain industries being particularly prominent, including the media; food, drink and tobacco; steel and engineering; builders' suppliers; and electrical and durables. We found about 44 per cent pure conglomerate takeovers; 22 per cent product or market extension takeovers; and 3 per cent vertical takeovers. Much of our analysis recognised these differences in takeover type from an economic viewpoint.

Having identified our sample we proceeded to test a series of hypotheses concerning the determinants and effects of takeovers.

Summary of Findings

Acquiring firms were on average much bigger than their targets, and generally enjoyed higher before-tax profitability in the pre-takeover period. It was especially noticeable that in this period the acquirers experienced much lower levels of profit variability, both before tax and after tax. Generally, acquirers' pre-takeover growth rates were not overwhelmingly superior to those of the target firms, and only in the case of horizontal takeovers and larger than average takeovers did the acquiring firms experience significantly higher leverage levels.

A comparison of the post-takeover performance of the acquiring firms with performance of the matching non-merging firms showed that the acquirers grew at a relatively faster rate, even though this rate, strangely enough, was lower than that achieved on average by the acquirers in the pre-takeover period, except for acquirers in large takeovers. It was noticeable that leverage levels became relatively higher in the post-takeover period, perhaps due to the financing of the acquisitions. The post-takeover profit performance of the acquiring firms was not impressive, generally speaking, and it appeared that the acquisitions left the acquiring firms with a higher risk profile than in the pre-takeover period, especially when risk was measured by the intertemporal variability in earnings after tax.

There was scant evidence to be found in support of the hypothesis that the search for economies of scale was a major reason for takeovers. Acquiring firms were, on average, considerably larger than the target firms, especially in the case of horizontal takeovers, where scale economies would normally have been expected to be an important motive behind takeovers.

Similarly, there was little support for another commonly advanced motive for takeovers, namely the desire to reduce risk. Risk can be measured by the variability of profits. The evidence suggested that, compared to non-merging firms, firms involved in takeovers did not experience significantly higher pre-takeover profit variability, and that if pre-takeover profit variability was in fact higher for merging firms, its source was probably in the target firms' operations rather than in those of the acquiring firm. Thus, the desire to reduce profit variability could not have been a major determinant of takeover activity. Alternatively, risk can be measured by changes in leverage levels. Several tests confirmed once again that takeovers did not appear to have been undertaken primarily for the purpose of risk reduction. There was no systematic pattern in the empirical results that indicated that acquiring firms sought out target firms with different leverage levels, or with lower intertemporal variability in leverage than non-acquired firms.

We evaluated the effects of takeovers in terms of five variables: profitability, profit variability, growth, leverage, and returns to shareholders. In all cases, there was no strong evidence to suggest that takeovers in general led to an improved performance by the acquiring firms, or to higher relative returns for shareholders in the acquiring firms.

There was no major post-takeover improvement in the profitability of the acquiring firms, either absolutely or in comparison with the matching firms, except perhaps for acquirers involved in large takeovers. These gains for large acquirers appeared not to be real gains, however, but rather after-tax improvements resulting from favourable tax treatment or the use of greater levels of debt finance.

Likewise, no evidence was found to support the proposition that takeovers reduce the variability of profits of acquiring firms. Indeed, we found that the post-takeover profit variability of the acquiring firms generally increased significantly when compared to their pre-takeover experience, and also when compared to that of the combined matched non-acquiring and target firms in the pre-takeover period. This pattern was rather more strongly evident in horizontal takeovers, and for acquirers in smaller than average takeovers. Similarly, the acquiring firms experienced relatively greater post-takeover variability, compared with pre-takeover variability, than did the matching non-merging firms, especially with respect to after-tax earnings. Again this effect was most noticeable for acquirers in horizontal takeovers and in smaller than average takeovers.

Relative to their matching non-acquiring and target firms, acquiring firms experienced an average post-takeover rate of growth in assets that surpassed the pre-takeover experience of the merging firms, although this superiority was not statistically significant. Non-acquiring firms seemed to be able to grow at just as fast a rate through internal growth (which could be more desirable in terms of capital creation) as could acquiring firms through a combination of external and internal growth. The takeover route to growth is not the only route available to firms with growth goals.

There was very strong evidence that the merging firms increased their post-takeover leverage, both compared to their matching non-merging firms and compared to the acquiring firms' pre-takeover leverage levels. This increased leverage appeared not to be just a transitory short-run effect after the takeover, as it seemed to persist throughout the post-takeover period under investigation. It can be concluded that the greater use of leverage by the merged firms relative to the non-merging firms was the most likely cause of both their superior after-tax profitability performance and their increased variability in after-tax earnings.

The findings on returns to shareholders strongly indicated that it was the shareholders in the target firms who gained most from takeovers. The returns to shareholders in the acquiring firms were not significantly different from the returns to shareholders in the non-merging firms over both the pre- and post-takeover periods.

A comparison of the findings of this study with those of the international study undertaken by Mueller et al. indicated that acquiring firms in Australia displayed superior performance characteristics in the pre-takeover period, compared with their international counterparts. It was noticeable, however, that acquiring firms in Australia suffered more from the takeover experience than did acquirers overseas, despite their superior pre-takeover performances, a situation that may have been due to the different institutional and behavioural factors at work in Australia.

Major Conclusions of the Study

(1) A strategy of corporate acquisition resulted in a deterioration in the performance of the merging firms, both compared to their pre-takeover experience, and compared with the experience of the matching non-merging firms, measured in accounting terms. Further, the actual returns received by shareholders in the acquiring firms were little different from those earned by shareholders in the non-merging firms — slightly better in the pre-takeover period and worse in the post-takeover period.

(2) Shareholders in the target firms benefited most from corporate takeovers. The value created by a takeover was largely 'captured' by these shareholders through pre-takeover share price appreciation and the payment of a premium over the target firm's current share price by the acquiring firm.

(3) The acquiring firms in Australia had superior performance characteristics to their overseas counterparts in the pre-takeover period, but emerged from the takeover experience in a poorer state than did the acquiring firms overseas. This situation may be due to the different institutions and behavioural factors at work in Australia (for example, the highly regulated labour and financial markets, continual union problems, the lower levels of training and sophistication of Australian managers, high market concentration levels, the fragmented nature of our manufacturing industries, the across-the-board tariff cut in 1973, and persistent pressures from imports, to name but a few of the major differences).

(4) We were unable to confirm as being present in Australia any of the major motives usually advanced to justify takeovers, such as improved profitability, risk reduction, economies of scale, and so on. Takeovers, on balance, appear to have been caused by so-called managerial motives, or by a desire to develop or enhance market power.

Evaluation of Findings

Our findings, strictly speaking, relate only to the takeovers included in our sample; our results are expressed in terms of averages for the whole sample or subgroups of the sample. In this perspective, our results overall are not particularly supportive of a corporate strategy of takeovers. Clearly, however, there were both good and poor takeovers. We did not consider the reasons why some takeovers result in an improvement in corporate performance and others fail in this regard. We note the comments of the chief executive of one prominent corporate acquirer: 'There is no great skill in takeovers. The real skill is in getting good earnings out of them'. Clearly, some useful research can be done in this area.

Our findings led us to two major observations. **First,** these conclusions suggest that the emphasis of existing takeover regulation on the protection of the shareholders in target firms may be misplaced. Some attention should be paid to the shareholders of acquiring firms who, in some situations, appear to have been powerless observers of the actions of corporate managers, and yet who will suffer the consequences of a poor decision. Top management should have to justify the gains expected to flow from a takeover in the light of the investment necessary, and perhaps should be required to seek shareholder approval for major takeovers. We recommend that the management of an acquiring firm provide detailed justification of its takeover bid, so that shareholders, the market and the public in general can adequately judge the merits of the bid. There is a need for some procedure or mechanism to filter out ill-conceived takeover bids. Perhaps, as suggested by the Victorian Attorney-General, Mr Jim Kennan, following the March 1986 meeting of the Ministerial Council on Companies and Securities, takeover documents should include more information on the social and economic impact of the takeover in order to assess the effect of the takeover on the public interest.

Second, we recognise that our study uses one of a number of possible methodological approaches to the topic. The corporate takeover is far too complex a topic to have the questions raised about it in the public debate answered by one, or indeed several, research studies. A concerted research effort must be undertaken to provide a basis for informed public debate and any subsequent change to the regulatory environment. The effect of takeovers on issues such as productive capacity, competition, external balances, business investment, research and development, and employment have not been explored by us or, to my knowledge, by anyone else in Australia. What we advocate, therefore, is that the existing cautious 'hands-on' policy towards corporate takeovers be maintained until these issues have been adequately explored.

In the months since the study was released, it has been interesting to note the initial reaction. Except for one or two instances, the findings of the study have been reasonably reported — as well as one can expect the financial press to report a 200-page study in 100 words or so. Also, the study was released on the same day as the eventful BHP–Elders press conference, which naturally was of more interest to the press than a research study. One or two reporters found it difficult to understand why we had not answered all the questions arising with takeover activity. They also presumed that because the study was partly sponsored by the NCSC it must advocate more regulation. A few sentences, taken out of context, were found to support this position. This provided one reporter with the opportunity to advocate a completely deregulated market for corporate control. Clearly, the effects of such a policy were considered less important than the principle. Hopefully, the study will be given due consideration by others without strong vested interests in deregulation or otherwise of takeovers.

The Market for Corporate Control

In our study, we pointed out that we accept the need for the corporate takeover, or the threat of a takeover, as a means of removing assets from the control of poorly performing managers, or of stimulating managerial performance.

Let me now suggest several points relevant to the subject of this conference, acting perhaps in the role of a devil's advocate. **First,** in focusing on the market for corporate control and its regulation, are we placing the cart before the horse? Surely the fundamental question to be investigated is the relationship between the efficiency of this market and economic growth. Has the considerable activity in this market contributed significantly to the economic growth of Australia in the last 15 to 20 years? To my knowledge, no evidence is available to answer this question. It is interesting to note that the countries often quoted as examples for Australia to emulate, particularly in regard to manufacturing — Japan, Sweden, Switzerland, West Germany and some of the Asian countries — do not have a developed market for corporate control for various reasons.

Second, there is little doubt that takeovers, or the threat of takeovers, have significantly improved efficiency in a number of industries in this country. Rationalisation, the displacement of poorly performing management and the achievement of scale economies where possible, have resulted in the emergence of some efficient operations in an international context. But we appear only now to be realising the cost of this process. Many activities have been abandoned, others considerably pruned, and monopolistic situations allowed to emerge in certain areas. In the process, our reliance on imported manufactured goods has increased. Obviously, other factors besides takeovers have contributed to this situation. But in policy formulation we must view the market for corporate control as part of a larger setting. We need to move towards a national policy for the manufacturing sector of our economy, and consider the role that takeovers can play within this policy.

Third, if takeovers are a means of transferring corporate control, then they would appear to be a costly way of achieving this objective. Perhaps we should work on improving the attitude in this country towards the replacement of poor performing top management and directors through normal internal processes. In this respect, we should examine the role of institutional investors who are in many instances the largest shareholders in our public companies. They could take a more responsible long-term view of their position and attempt to institute internal changes in companies, rather than letting them deteriorate to the stage where a 'takeover situation' is created, aided by their known 'willingness to sell'.

Finally, is an active market for corporate control a healthy feature of our business environment? Surely, it is a question of relativity. There are both good and bad aspects to the market for corporate control. The high level of activity in this market in the last two years may have generated some adverse effects. In this respect, it is interesting to note the recent comments of Mr John Gough, Managing Director of Pacific Dunlop, reported in the *Australian Financial Review*:

> Mr Gough said the devaluation of the dollar had advantages for manufacturing, but companies needed as much as five years of stability to respond. 'The J curve in my judgment can only move with a drop off in imports. It will take some time before manufacturing industry takes advantage of it and increases exports.' Mr Gough said that one of the real problems was that public companies were forced to think in the short term for fear of takeover. In the environment where takeovers have gone too far, innovation becomes a costly liability, he said. 'I think the takeover laws have to be changed if you are going to have security for companies developing in the long term. I don't think takeovers should be stopped, but a lot of the speculation that has taken over share trading should be removed for the good of our society.' (*Australian Financial Review*, 20 May 1986, p.34)

We need to get some balance into the market for corporate control; that is, balance consistent with overall economic policy.

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Takeovers: The Australian Evidence

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In 1985 Professors Dodd and Officer and Steven Bishop were commissioned by the Centre for Independent Studies to undertake a major empirical study of the effects of takeovers in Australia. The present paper represents the preliminary results of that study; the final results have been published by the CIS as *Australian Takeovers: The Evidence 1972–1985* (1987).

Takeovers: The Australian Evidence

Peter Dodd

R.R. Officer

Introduction

Two fundamental questions arise in the context of takeovers:

(1) What conditions give rise to takeovers, and (2) Who benefits and/or who loses from takeovers? The level of interest in takeovers depends on the level of takeover activity as the press, other financial commentators and politicians question the value of takeovers and seek answers to the questions posed above and related issues. In an earlier study (Dodd and Officer, 1986) we have addressed many of these issues at an analytical level; in the current research we seek to resolve some of the empirical questions. This paper presents a preliminary summary of those empirical results. The complete report of the research appears in Bishop, Dodd and Officer (1987).

The Pattern of Takeover Activity

It is frequently asserted that economic theory has an inadequate or no explanation for takeovers at an aggregate level. This is wrong as a generalisation, but a significant number of issues relating to takeovers are yet to be resolved. In theory, a merger of two enterprises (or a takeover) will occur when there exists some synergy between the enterprises, i.e. the value of the combination is greater than the value of the individual parts making up the takeover or merger. As a consequence we should be able to observe that the value of the ultimate enterprise is greater than the sum of the values of the enterprises going into the combination. We will be addressing this issue shortly. It still does not explain why there should be patterns or waves of takeover activity.

'Waves' of takeover activity have been noted for many years in the economics literature; moreover, these waves appear to transcend national boundaries. For example, the first episode of intense merger activity in the United States was observed early in the 20th century, the second in the 1920s, another wave was noted in the late 1960s and more recently we have seen another wave of growth in takeovers in the 1980s. The latest wave appeared to start early in the 1980s, then slacken off slightly, but it has proceeded with renewed intensity in the mid-1980s. A similar pattern can be observed in Australia although the analysis contained in this paper commences only in 1972.

In theory, the motivation underlying a takeover is to increase company profitability, but this still does not explain why there should be cyclical movements in takeovers. Tobin (1969) advanced a theory that when the market value of a firm's assets is greater than the replacement cost of those assets, the firm will be induced to invest in more of those assets since the value of the new capital investment would exceed its replacement cost. Tobin's measure has become known as the q-ratio (q = market capitalisation of all the firm's assets/the replacement cost of those assets in the physical market). A related implication of Tobin's theory is that firms with q-values greater than the q-values of firms with similar assets would be inclined to take them over, i.e. $q^B > q^T$ where B is the bidding firm and T the target firm. No Australian evidence on q-values is available as yet, but in a recent US study Hasbrouck (1985) reports that target companies are characterised by low q-values. This theory is consistent with synergy as the driving mechanism for takeovers, but it does not explain why these differential valuations should go in waves.

The relationship between the number of successful takeovers and the deflated Statex Actuaries Accumulation Index is depicted in Figure 1 for the period 1974–1984. Clearly, there is a close relationship between the buoyancy of the stock market and the number of successful takeovers; this evidence is also consistent with that found overseas and reported in Melicher et al. (1983).

A number of possible explanations can be given for the relationship between the state of the share market and the number of takeovers, but as yet we have not had time to explore them in sufficient detail to give a satisfactory conclusion. The explanation we prefer, on analytical grounds, is that periods of stock market boom are periods of optimism for investment, and firms can increase their investment by either internal or external (takeovers) means. This theory requires that the opportunities for synergy between two companies increase during periods of stock market buoyancy and decrease when the stock market falls. This is quite plausible in that the expanded demand for real goods in the economy that created the stock market boom also creates various economies of scale, which could lead to synergy between firms. Our theory would require investment decisions to be pro-cyclical, i.e. a

Figure 1
Total Number of Takeover Bids and Deflated Statex Actuaries Accumulation Index

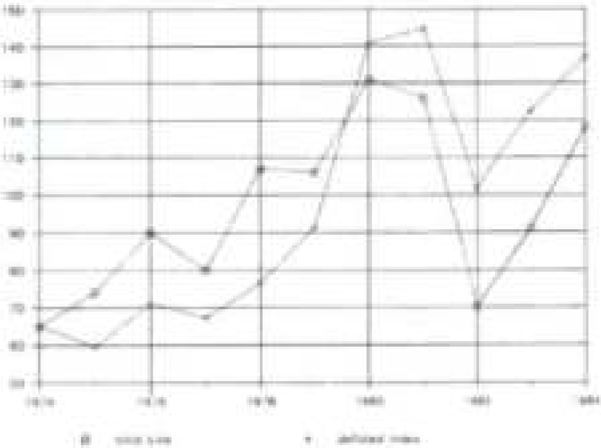
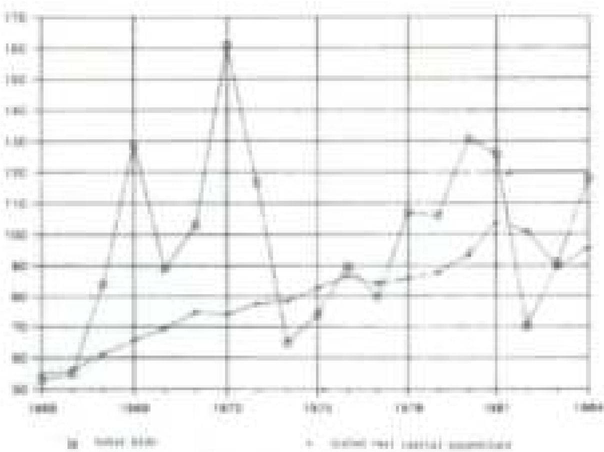


Figure 2
Total Number of Takeover Bids and Scaled Real Gross Capital Expenditure



positive correlation between the stock market index and internal and external investment decisions of firms (and also Tobin's *q*). Again, preliminary support for the theory is evident in Figure 2, which graphs the relationship between successful takeovers and real capital expenditure.

Who Benefits, Who Loses?

If one were to judge takeovers on the basis of the press comments surrounding them, particularly adverse comments, and the many calls for the regulation of takeovers, particularly the requirement for disclosure of financial and other information by bidding companies, one would be led to the conclusion that it is the target company's shareholders who are likely to lose as a result of a takeover. However, the evidence is overwhelmingly in the opposite direction: if there is one group who benefits from takeovers, it is the shareholders of target companies. To our knowledge there has not been a single study examining the effects of takeovers that has documented evidence that, as a generality, the shareholders of target companies do not benefit from takeovers. This includes studies from around the world, using a variety of experimental techniques to examine the effect of takeovers.

However, the evidence with respect to the wealth effects on the shareholders of bidding companies as a result of takeovers is not as clear. For example, Jensen and Ruback (1983), in a survey of the evidence from the US, conclude that 'the target company's shareholders benefit, and that bidding firm shareholders do not lose'. One of the reasons for the apparent uncertainty with respect to the benefits that bidding company's shareholders receive is that bidding companies are usually much larger than target companies. This means that if the benefits of a takeover were to be shared equally between the bidding company's shareholders and the target company's shareholders, the target company's shareholders would receive a higher return on their investment in the company than the bidding company's shareholders. We would expect, under these circumstances, the greater dilution of the benefits to the shareholders of bidding companies to make it more difficult to detect benefit of the takeover to this group of shareholders.

In this study we will restrict our examination of the effects of takeovers to the shareholders of acquiring and target companies. Other groups that may be affected by takeovers, such as the consumers of the products of the companies involved in the takeover (who may be adversely affected by a reduction in competition), management, and employees, will not be examined, although we have explored the possible effects on such groups in another paper (Dodd and Officer, 1986). However, we should note in passing that there is no consistent or unambiguous evidence suggesting that any of these groups are adversely affected by takeovers.

Measuring the Effect of Takeovers on Shareholders

There are two basic ways in which the effect on shareholders of takeovers could be examined. One way is to examine the accounting records of companies before and after the takeover to see whether reported earnings, assets and other variables respond positively to the effect of the takeover. The other way is to examine the shareholder's dividends and capital gains that can be attributed to the takeover.

There are a number of severe problems in using accounting numbers to examine the effect of takeovers.

(1) The effect of a takeover may take some years to be fully reflected in accounting earnings, so that the accounting returns would need to be examined for an extended period after the takeover. Moreover, because the effect of a takeover is likely to be felt at different intervals of time after the takeover for different firms, any aggregation of the effects is likely to be diluted, making it more difficult to analyse.

(2) Accounting practices vary enormously between companies. Even companies in the same industry, operating under the same accounting standards, can adopt accounting methods that lead to significant differences in reported earnings. Aggregating the effect of a variety of accounting practices on companies under takeover will lead to ambiguity and possible bias.

(3) Any bias in reported accounting numbers, particularly earnings, is not necessarily self-correcting as is any bias in capital market rates of return. There is no obvious arbitrage strategy that can be adopted by shareholders and other investors if it is perceived that reported accounting earnings are consistently biased relative to 'true' earnings. Shareholders cannot trade accounting numbers. Any bias that is detected would be immediately impounded or corrected in sharemarket prices, so that while the capital market rates of return are unbiased, accounting numbers could be significantly biased. This does not imply that accounting numbers are useless, or that they are not the main source of information for sharemarket investors. It is the relative changes in a company's reported earnings that are important to investors when they assess whether a company's shares are over- or undervalued, not the absolute level of accounting income.

(4) Acquiring companies that pay a premium in a takeover relative to the target company's net tangible assets report that premium

as 'goodwill' in the asset account. Under existing accounting standards, such goodwill must be written off through the Profit and Loss Account within 20 years. Moreover, the company will usually write up the value of other assets. The consequence is likely to be a reduction in the reported earnings of the company after the takeover. The ratio of accounting earnings divided by net tangible assets after a takeover is likely to be a biased measure of the 'true' rate of return. In general, accounting figures are not satisfactory measures of rates of return.

The preferred method of measuring the effect of takeovers on shareholders is through capital market rates of return after adjusting for capital changes such as stock splits, bonus issues, and rights issues, and adding back any cash distribution such as dividends to capital changes. This methodology is also not without its problems. Share prices reflect the expectations of future cash flows. Future benefits are capitalised into the current share price. This implies that current shareholders are able to obtain the benefit of capital appreciation in their shares. However, it is always possible that the expected benefits of a takeover will not be realised. In these circumstances the share price would overvalue the benefit of a takeover. The converse is also true: the benefit of a takeover may be underestimated in the share price. In short, we cannot be sure that the change in share price that capitalises the expectations of the effect of a takeover will accurately reflect the true effects of takeover on the fortunes of a company and its shareholders.

Nonetheless, while the share returns of a specific company undergoing a specific takeover may be wrong, we would not expect any consistent bias in returns across all companies. In other words, the share market prices and the capital market rates of return estimated from these will be unbiased estimates of the future benefits arising as a result of takeovers. Should any bias develop, then there is an opportunity for investors to capitalise on that bias by adopting profitable trading strategies. The effect of such trading strategies would eliminate the bias. Therefore, while it is possible to criticise the market's expectation of the effect of a takeover on the performance of a company in a specific instance, such criticism is not legitimate in aggregate or over extended periods of time. The statistical law of large numbers ensures that measurement errors that are independent and therefore not a result of any consistent bias will cancel each other out in an aggregate sample of firms involved in takeovers. The use of capital market rates to assess takeovers has none of the disadvantages that were listed above for accounting numbers.

A Suitable Control

In any scientific study it is necessary to establish a suitable control against which the symptoms or effects under study can be assessed. We are concerned with isolating the effect of a takeover on the performance of companies from all the other effects on company performance. One method of approaching this problem is to adopt a control firm so that every firm that has undergone a takeover, either as target or acquirer, would have assigned to it a similar firm that has not undergone a takeover.

The problem with this approach is finding a firm that is similar. The fact that one firm is involved in a takeover and the other is not is likely to indicate substantial prior differences between the firms apart from the mere fact of the takeover. For example, firms that have a cash surplus or borrowing potential but are limited in the amount of internal investment (e.g. plant expansion) that they can undertake are likely to expand their operations by external investments, i.e. takeovers. The converse is true for firms with internal growth potential. The two firms may be equally good investments, so that their returns may be identical. A comparison between the two firms would suggest that the takeover did not benefit the firm that grew by external investment; however, such an inference would be wrong because the firm that grew by takeover did not have the opportunity to grow by internal investment.

In general, we would not expect external investment, that is investment by takeovers, to be a superior strategy to internal investment, that is growth by investment in plant and equipment. It depends on the circumstances facing companies. If takeovers were a superior investment strategy we would expect more and more companies to enter the takeover game until the rewards were diminished and the returns were consistent with alternative forms of investment. The converse is also true. Therefore a matching firm control is hazardous because of the difficulty in finding the correct matching firm, viz. the firm that could have and should have grown by takeover but did not, but was identical to the firm involved in the takeover in all other respects.

An alternative approach to the matching firm control is to form separate portfolios of bidding firms and target firms, and then compare the performance of these portfolios with the portfolio that incorporates the market for all equities (shares). The notion behind this control is that all the other factors that affect share prices, such as the state of the economy, government policy, etc. will be captured in the market portfolio. Therefore the only distinguishing feature between the market portfolio and the portfolio of acquiring or target companies will be takeover activity.

There are a number of useful alternative models that adopt the market portfolio as the basic control. These are variously known as the

Capital Asset Pricing Model, the unconstrained Market Model, the constrained or zero-one Market Model, and various multifactor models that incorporate the market as the main factor. The models have various attributes and disadvantages. It would be digressive to discuss the advantages and disadvantages of each. It suffices to comment that we adopted the zero-one Market Model on the grounds of its simplicity. This makes the interpretation of the results more straightforward than if other, more sophisticated models had been used.

The unconstrained market model is described as:

$$r_{pt} = \alpha_p + \beta_p r_{mt} + u_{pt} \tag{1}$$

where

- r_{pt} is the portfolio return over time period t;
- α_p is a constant or intercept term;
- β_p is a slope coefficient that measures the sensitivity of the portfolio return to the market return;
- r_{mt} is the market return over time period t; and
- u_{pt} is the portfolio's residual return, i.e. that part of its return that is unexplained by the market. By definition, the unconditional u_{pt} of all firms making up the market portfolio has an expected value of zero.

The zero-one Market Model constrains the intercept term to zero and assigns the value of one for the beta coefficient.

The effect of a takeover on the portfolio is measured by the residual or abnormal return u_{pt}, which represents the part of the return that is unexplained by the market. Since our portfolio differs from the market only in that it was involved in a takeover, u_{pt} represents the effect of the takeover on the portfolio's return. The u_{pt}s are calculated over a period of time around the takeover to measure the cumulative abnormal return or the full effect of the takeover as it is capitalised into share price returns.

If all the information about a takeover were capitalised into the share price at one point in time for all firms, relative to the public announcement date of a takeover, then we would need to observe only one value for u_{pt}. However, the share market's expectations of the effect of the takeover are modified as news of the takeover becomes impounded into price around the period of the takeover. Because this information becomes impounded into share prices at different times for different firms, it is necessary to accumulate the abnormal return over the period during which news relating to takeovers is released. We will have more to say about this in our discussion of the results.

Data

The sample of takeovers covers the period from January 1972 through December 1985, and is derived originally from the Sydney Stock Exchange's publications *Current Offers* and *Takeover Offers*. The sample includes only offers for ordinary shares and excludes schemes of arrangement and other non-takeover transactions. The relevant details of the offers were collected from the files of the Sydney Stock Exchange, from the financial press, and from surveys of individual companies involved. These details include:

- the date of the initial public announcement of the offer;
- the price offered;
- the percentage of issued shares sought in the offer;
- the percentage of issued shares held by the bidder prior to the offer;
- the closing date of the offer; and
- the outcome of the offer in terms of the percentage of shares held after the close of the offer as well as the date at which that outcome was publicly available.

For some offers it was not possible to collect a complete set of data required from the above sources. Offers that fell into this category were used only when there was sufficient data available for a particular class of firm involved in a takeover.

The sample includes offers for target firms listed on the Sydney Stock Exchange as well as offers by bidders listed on the Exchange for unlisted target firms. Therefore, some transactions are included where either the bidder or the target firm was not listed. To be included in the analysis, sample firms had to have available stock price data on the files of the Centre for Research and Finance at the Australian Graduate School of Management.

Each takeover offer was classified as to its outcome using the following rule: If the offer was not withdrawn and the bidder held over 50 per cent of the target company's issued shares after the bid (and did not hold over 50 per cent prior to the bid), the offer was defined as **Successful**. If the offer was not withdrawn and the bidder held less than 50 per cent after the offer, the offer was defined as **Unsuccessful**. We recognise that this definition is subject to misclassification, especially when a bidder is able to achieve an effective operating control of the target with less than 50 per cent of the issued shares. However, for the purposes of the analysis it is impractical to inspect each transaction on a case by case basis.

The sample that met the above data requirements and is used in the analysis is shown in Table 1.

Table 1
Sample Breakdown

Targets	Successful	506
	Unsuccessful	117
	Withdrawn	136
	Outcome unknown	214
	TOTAL	973
Bidders	Successful	419
	Unsuccessful	82
	Withdrawn	114
	Outcome unknown	139
	TOTAL	754

The average relative market capitalisation (measured in $000) six months before the announcement of takeover is shown in Table 2.

Table 2
Capitalisation of Sample

	Mean	**Median**
Targets	28 359	5 291
Bidders	108 168	29 341
Target as a % of Bidder	26.2	18

The difference in average capitalisations suggests that the bidding companies are of the order of four to five times larger than the target companies. Also, it is worth noting that the extreme differences between the mean and median reflect the very strong positive skewness in the distributions of the size of both the target and bidding companies.

Results

The results are shown first as graphs of cumulative abnormal returns (CARs), i.e. cumulative abnormal residuals of the zero-one Market Model described as u_{pt} in equation (1) above. These graphs start accumulating the abnormal returns 36 months before the announcement of a takeover. The announcement month is shown as zero, so that three years before the takeover would be designated as –36 months; similarly +4 indicates four months after the announcement date.

The announcement date is when it is assumed that the takeover is announced publicly. In many cases the imminent announcement of a takeover is anticipated by the market so that the market tends to react before the formal announcement. Further, the probability that the takeover will be consummated is usually less than 1 at the announcement date. This means that it is not surprising to see the cumulative average residuals rise after the announcement date as the probability that the takeover will be consummated comes closer to certainty. Where the CARs flatten out in the graph it is an indication that there is no longer a positive accumulation of abnormal returns; the abnormal returns are approaching zero, which is expected for the market as a whole. Note also that the graph is an average of the market reaction to takeovers. For individual takeovers the market reaction is not as smooth as is depicted in the graph. The graph does, however, depict the typical or average market reaction.

The results are also presented in tables describing in more detail the characteristics of the cumulative abnormal returns at particular times. In effect, these tables describe the distributional properties of the CARs for the time interval indicated. Because of uncertainty about the properties of the distributions of these CARs, the distributions are described by the mean, median, first quartile, third quartile, number of positive abnormal returns, and number of negative abnormal returns. Because of the problems associated with the distribution of abnormal returns we have not attempted to derive any formal significance tests of the returns. We believe that the information provided allows the reader to clearly assess whether or not the takeover has benefited a particular shareholder group whose abnormal returns are described by the tables.

All bidding companies. Figure 3 shows the abnormal returns to all the bidding companies in the sample from three years before the formal announcement of the takeover offer through two years after the announcement. The graph shows that starting from three years before the takeover, the average abnormal returns for all the bidding companies accumulate to peak at approximately one month after the formal announcement. The CAR is about 25 per cent over the 38 months, i.e. 36 months before the takeover and approximately two months after the formal announcement. The graph indicates that approximately two months after the formal announcement there are no abnormal returns, on average, to the bidding companies.

Because it is unlikely that a takeover would be anticipated a full three years before its announcement, the almost monotonic increase in the CARs over the three-year period suggests that bidding companies are typically companies who have been doing well. This, to some extent, confounds the actual effect of the takeover on a bidding company.

Figure 3
Cumulative Abnormal Returns
All Bidding Firms

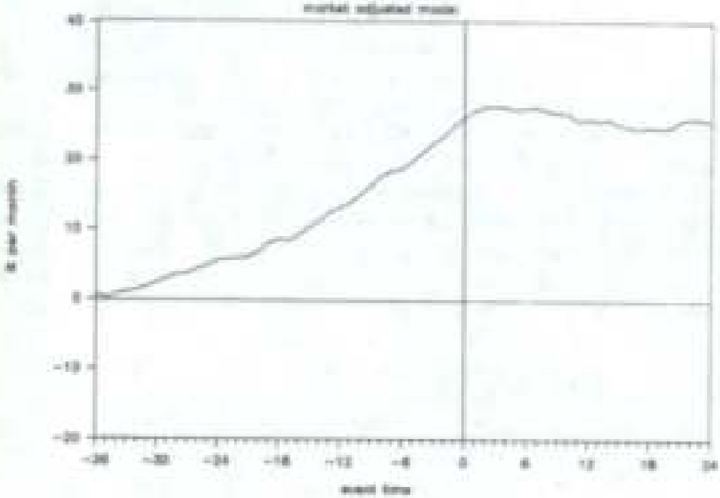


Table 3
The Returns to Shareholders of All Bidding Firms
(CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through 0	+1 through +2	−3 through +3
Mean	12.6	12.1	1.4	6.0
Median	12.4	10.8	0.7	5.2
25th percentile	−15.2	−7.9	−6.2	−10.0
75th percentile	45.9	33.1	8.7	21.5
No. +ive CARs	468	468	397	465
No. −ive CARs	295	295	353	315

However, as we might expect, once companies have made a bid and therefore have clearly identified themselves as being companies with abnormal returns, allowing the effect of the bid to be impounded into share prices (which we assume has occurred by two months after the announcement of the takeover), the companies no longer earn abnormal returns. If the abnormal returns were to continue after this date there would be a clear strategy open to investors to invest in companies that make bids for other companies to earn abnormal returns. The fact that the abnormal returns do not continue after the completion of the takeover offer indicates that such a strategy would not yield abnormal returns, and therefore the market can be judged as being efficient with respect to the information surrounding a takeover offer.

Table 3 describes the cumulative abnormal returns over specific time period for all bidding companies. The first column in the table records the cumulative abnormal return from three years before the announcement through one year before the announcement. This column indicates that on average bidding companies over this two-year period had cumulative abnormal returns of around 12 per cent. The bottom 25 per cent of the bidding companies had less than –15 per cent abnormal return, and the top 25 per cent had greater than 45 per cent abnormal return. Further, there were about 60 per cent more companies with positive CARs over this period than with negative CARs. Overall, it would be reasonable to conclude that from three years to one year before the announcement of a takeover, bidding firms experienced, on average, positive abnormal returns.

A similar interpretation can be made for the second and third columns of Table 3 where the CARs are examined for the twelve months before the announcement up to and including the announcement month, and from the announcement month through two months after the announcement. The final column looks at the abnormal returns three months before the announcement month through three months after. This seven-month period probably captures most of the information surrounding a takeover that is relevant to a bidding company. The results indicate that, on average, bidding firms benefit from a takeover, although not all bidding firms experience positive abnormal returns over this period — 40 per cent of the sample experienced negative abnormal returns.

Successful bidding companies. Figure 4 depicts the cumulative abnormal return behaviour of companies that successfully took over the target company. The sample is a subset of the previous all bidding company sample. The pattern of CARs is very similar to the all bidding sample and the same points made with respect to that sample are relevant.

Table 4 describes the CARs over specific time intervals for successful bidding companies. The results are broadly similar to those

Figure 4
Cumulative Abnormal Returns
Successful Bidding Firms

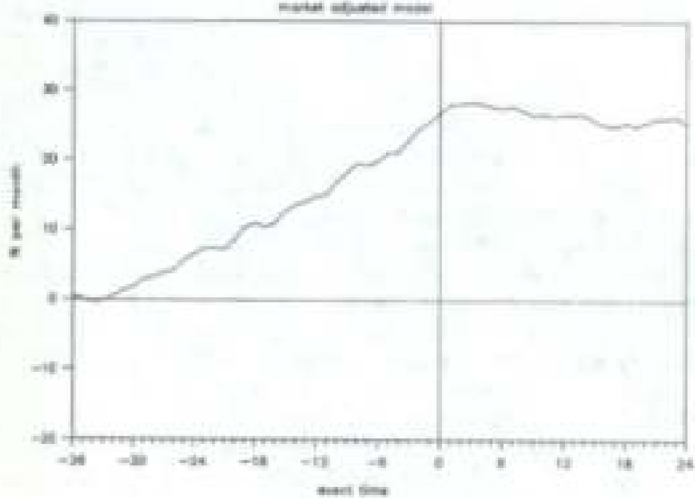


Table 4
The Returns to Shareholders of Successful Bidding Firms (CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through 0	+1 through +2	−3 through +3
Mean	11.8	12.1	1.6	7.9
Median	9.9	10.5	1.3	7.5
25th percentile	−18.5	−7.9	−5.6	−8.4
75th percentile	45.2	32.4	7.7	22.6
No. +ive CARs	208	238	202	236
No. −ive CARs	154	132	161	133

for all bidding firms and the conclusions remain much the same: in general, successful bidding companies earn abnormal returns and these returns can be associated with the takeover.

Unsuccessful bidding companies. Unsuccessful bidding companies are companies that made a bid but were unable to acquire 50 per cent of the target company's issued shares. We could expect that a significant proportion of these companies would become locked into the target company's share register but without control. In such circumstances we would expect the market to review adversely the performance of these firms, which should result in abnormal losses and a consequential downturn in the CARs.

Figure 5 depicts the CARs of unsuccessful bidding companies. In contrast to the above expectations, the CARs continue to increase after the announcement month for about six months and then appear to plateau. The graph suggests that the market continues to revalue unsuccessful bidding firms upwards. Moreover, the abnormal return is considerably greater than that experienced for successful bidding firms.

One explanation of this apparently anomalous result is that the unsuccessful bidding firms are bought out of their holding at a higher price than their offer price; in effect, the firms represent successful 'greenmailers'. A number of companies like Industrial Equity Ltd have a successful history of making takeover offers and then being bought out of their holdings at a considerable profit. The persistent increasing post-offer abnormal returns in the graph are again due to the averaging effect across bidders, where abnormal returns from greenmail occur at different points in time relative to the initial takeover announcement.

Table 5 shows the CARs for unsuccessful bidding companies over specific time intervals. It is clear from these results, particularly the first column, that unsuccessful bidding firms are firms that have significant positive abnormal returns well before the takeover offer. These positive returns could reflect the fact that many of these firms, and in fact bidders in general, make a succession of takeover offers, and that the market has capitalised the expectation that they will continue to make offers and be bought out at considerable profit to themselves. Also, it should be noted that the number of firms in this category (about 80) is much smaller than that in other categories. The Table also indicates a significant increase in abnormal returns after the announcement date. These results are consistent with a proportion of these unsuccessful bidders being successful greenmailers.

Bidding companies that withdrew their bids. Figure 6 depicts a pattern of abnormal returns for companies that made a bid but then withdrew it. The results indicate that the abnormal returns leading up to the offer are considerably lower than for other categories within the sample of bidding firms; moreover, abnormal returns begin to appear only a little over twelve months before the announcement of the offer.

Figure 5
Cumulative Abnormal Returns
Unsuccessful Bidding Firms

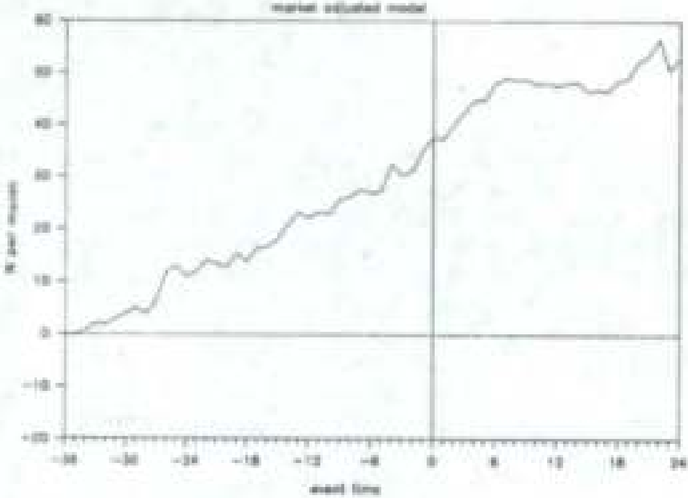


Table 5
The Returns to Shareholders of Unsuccessful Bidding Firms (CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through 0	+1 through +2	−3 through +3
Mean	21.8	14.8	2.5	10.0
Median	20.1	15.1	−0.7	6.5
25th percentile	−3.9	−4.4	−8.7	−4.5
75th percentile	52.9	30.2	13.1	23.0
No. +ive CARs	64	59	37	58
No. −ive CARs	25	30	44	30

Figure 6
Cumulative Abnormal Returns
Bidding Firms that Withdrew Their Bids

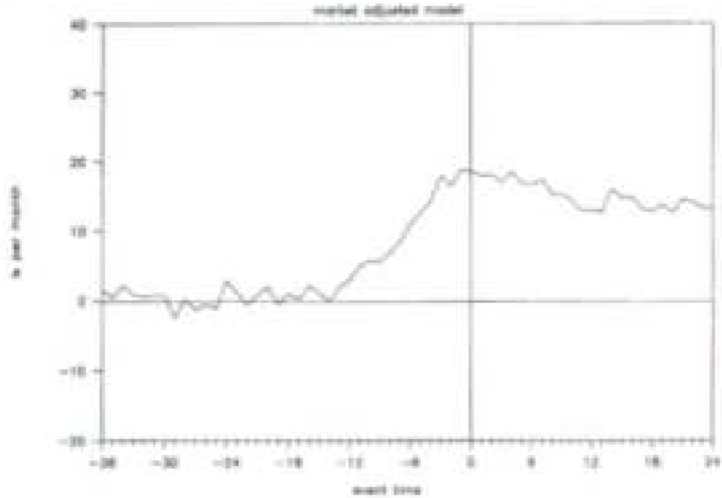


Table 6
The Returns to Shareholders of Bidding Firms that Withdrew Their Bids
(CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through 0	+1 through +2	−3 through +3
Mean	8.7	16.1	−1.5	1.8
Median	18.5	20.1	0.0	3.3
25th percentile	−10.4	−6.3	−9.8	−19.2
75th percentile	45.6	40.4	5.9	16.1
No. +ive CARs	84	90	60	74
No. −ive CARs	43	39	64	56

Further, there is some suggestion that the market revises its estimate of the value of such companies in that the CARs tend to drop in the period after the offer.

The results in Table 6 confirm the results depicted by Figure 6.

All target companies. Figure 7 depicts the behaviour of CARs for all target companies in the sample (approximately 980 companies). The results indicate that most of the large positive abnormal returns occur in the six-month period prior to the announcement of the offer. The abnormal returns show a premium of about 35 per cent, but there is some suggestion of a revised estimate after the announcement of the takeover in that the CARs tend to fall. The reason for this will be explained when the behaviour of withdrawn bids is examined.

Table 7 confirms the general impressions derived from Figure 7. Nearly all the abnormal returns to the portfolio of target companies is achieved over the seven-month period from three months before the target has received its offer to three months after. The results unambiguously indicate high returns to target company shareholders: on average the shareholders receive about 22 per cent positive abnormal return over this period.

Successful target companies. Successful target companies are those in which the offerer company gains a shareholding greater than 50 per cent during the offer. The pattern of the CARs for successful target companies (Figure 8) broadly reflects the pattern of returns for the total sample of target companies as described in Figure 7. Table 8 confirms the results: target companies that are subject to a successful bid for more than 50 per cent of their issued equity capital earn significant abnormal returns for their shareholders.

Unsuccessful target companies. Companies that were targeted for takeover but in which the bidding company obtained less than 50 per cent of the issued equity capital, show abnormal returns not dissimilar to those of successful target companies. From Figure 9 it appears that the target companies where the offerer was unsuccessful in gaining control do not suffer in terms of the valuation placed on them by the share market. Table 9 confirms these results.

The evidence is that target companies subject to unsuccessful takeover offers do not suffer adverse market reaction relative to successful offers. This may suggest that the synergy between the target and the offerer company is not the prime reason for the revaluation of the target company. A likely explanation is that the market expects these target companies to be subject to successful offers at a later date.

Withdrawn bids: Target companies. Figure 10 depicts the pattern of CARs of target companies that had the bid for their shares withdrawn by the offerer companies. The graph indicates that this sample of companies was performing abnormally well before the offerer

Figure 7
Cumulative Abnormal Returns
All Target Firms

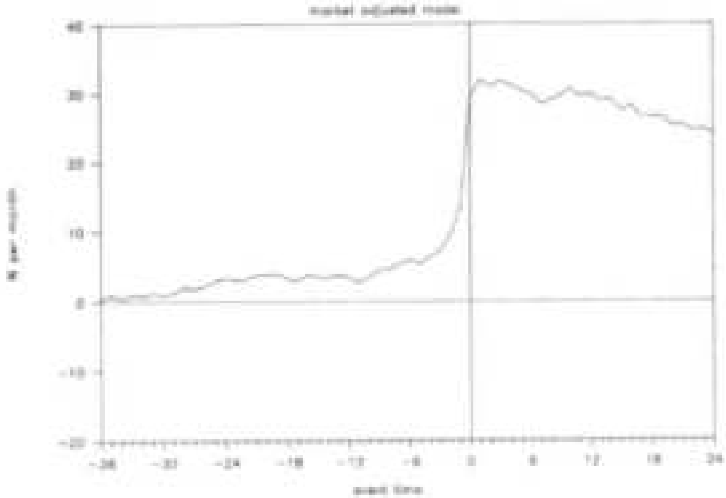


Table 7
The Returns to Shareholders of All Target Firms
(CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through −7	−6 through +1	−3 through +3
Mean	2.0	1.7	22.2	21.0
Median	3.9	0.1	20.8	16.7
25th percentile	−26.3	−12.4	0.9	0.3
75th percentile	33.5	13.5	43.2	39.6
No. +ive CARs	436	388	626	638
No. −ive CARs	384	382	207	207

Figure 8
Cumulative Abnormal Returns
Successful Target Firms

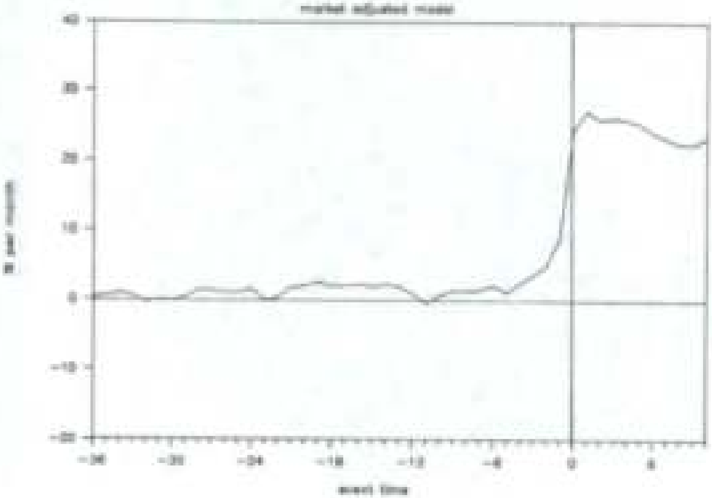


Table 8
The Returns to Shareholders of Successful Target Firms (CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through −7	−6 through +1	−3 through +3
Mean	−0.4	0.4	21.9	20.1
Median	2.4	−0.3	21.3	16.5
25th percentile	−27.2	−12.7	2.2	0.5
75th percentile	32.4	12.2	43.1	39.3
No. +ive CARs	240	216	362	360
No. −ive CARs	220	221	108	113

Figure 9

Cumulative Abnormal Returns Unsuccessful Target Firms

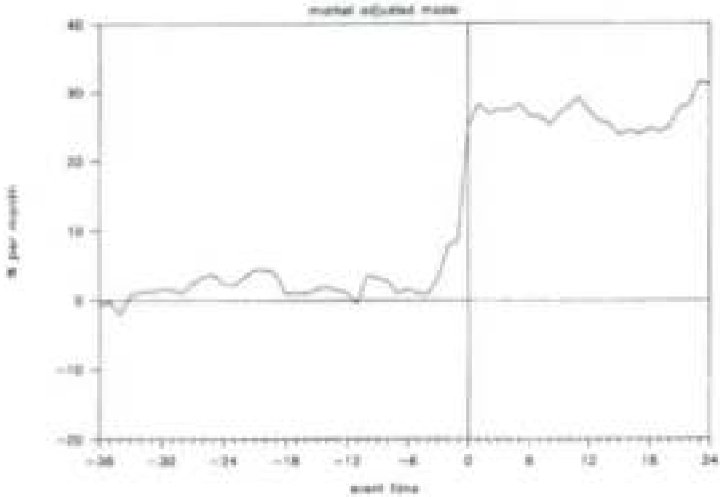


Table 9

The Returns to Shareholders of Unsuccessful Target Firms (CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through −7	−6 through +1	−3 through +3
Mean	−0.3	−0.1	22.6	21.8
Median	0.4	0.8	19.4	17.7
25th percentile	−29.7	−15.9	−2.3	0.4
75th percentile	26.5	10.9	42.8	35.2
No. +ive CARs	39	35	59	67
No. −ive CARs	37	34	22	15

Figure 10
Cumulative Abnormal Returns
Target Firms Whose Bid Was Withdrawn

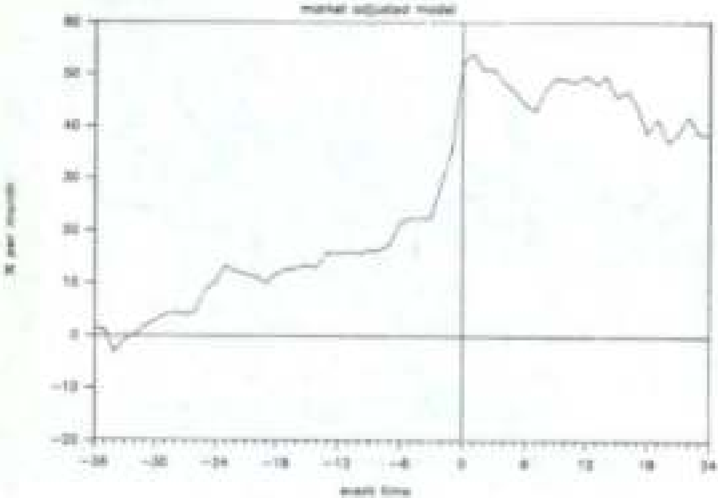


Table 10
The Returns to Shareholders of Target Firms Whose Bid Was Withdrawn
(CARs Over Specific Time Intervals)

	Period of the Cumulative Abnormal Return Relative to the Takeover Announcement Month (Month 0)			
	−36 through −11	−11 through −7	−6 through +1	−3 through +3
Mean	12.0	1.2	30.5	23.3
Median	12.9	0.7	30.5	18.0
25th percentile	−19.4	−12.3	4.4	3.6
75th percentile	44.1	13.0	50.4	44.0
No. +ive CARs	58	50	82	81
No. −ive CARs	42	43	20	23

made the bid, or more accurately before the capital market anticipated a bid from the offerer company. The results are confirmed by Table 10.

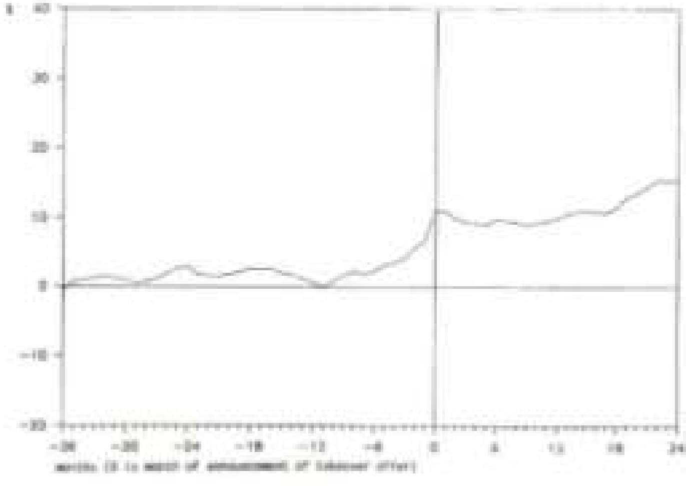
There is also evidence of a downward revision in the market's value of such target companies: CARs decline slightly in the months following a withdrawn bid. The decline is not significant but it does suggest some downward revision in the market's value of the company, possibly reflecting a change in the expectation that such companies are going to be subject to another bid.

Conclusion

The overriding conclusion of this study is that takeovers, on average, are value-creating investments. The results show that shareholders of bidding and target companies earn positive abnormal returns at the time of a takeover.

Perhaps the most succinct representation of the evidence is presented in Figure 11. As noted earlier, bidding firms on average are much larger than targets. To account for this size discrepancy and to ensure that the results are not overstated by that discrepancy, the abnormal returns to all bidders and all targets are weighted by their relative market capitalisation and then aggregated. This result is presented in Figure 11. In effect this is the performance of a value-weighted portfolio of all sample firms

Figure 11
Cumulative Abnormal Returns
Value Weighted Portfolio of All Sample Firms
Engaged in Takeover Activity



engaged in takeover activity. Such a portfolio earns large positive abnormal returns from takeover offers and this result is evidence of the benefits accruing to shareholders from takeover offers.

The evidence on takeovers in Australia is clear: as the economic theory presented in Dodd and Officer (1986) predicts, takeovers are value-creating investments. On the basis of this evidence, regulatory proposals to restrict takeovers must be severely questioned. Such proposals cannot be sensibly premised on arguments that takeovers waste resources. Indeed, inhibiting takeovers is tantamount to restricting transactions that increase the economy's wealth.

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Assessing Competition in the Market for Corporate Control: Australian Evidence

Philip Brown and Andrew Horin

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Assessing Competition in the Market for Corporate Control: Australian Evidence

Philip Brown and Andrew Horin

Introduction

The degree of competition in the market for corporate acquisition has been examined from many perspectives. Some have inferred competition by observing the 'abnormal' share price changes of firms that bid successfully, or by observing how the gains are shared between the shareholders of the target and bidding firms, or by observing the time series of the market value of target firms.

This paper provides further evidence on the degree of competition in the Australian takeover market, by replicating Ruback's (1983) experiment. Competition is inferred if it is found that it would not pay the unsuccessful offerer to lift his offer to the successful offerer's price. Our results indicate that the Australian market for corporate acquisitions is competitive, in this sense.

Motivation for the Study

There are at least three reasons for being interested in the competitiveness of the corporate acquisitions market.

(a) A competitive market for corporate control provides a means by which corporate assets can be allocated to their most highly valued uses. Providing market participants with the opportunity to combine resources so as to form more efficient and profitable entities enhances economic welfare.

One criticism of takeovers is that they concentrate market power, enabling the merged firms to increase product prices or reduce output, thereby harming consumers. Stillman (1983) and Eckbo (1983) found that the gains generated by takeovers arose not from the creation of market power, but rather from improvements in productive efficiency and other synergy gains.

(b) A competitive market for corporate control is a useful external control mechanism that restrains management from departing from its shareholder commitments.

(c) Ruback (1983) suggests that a competitive acquisitions market eliminates the need for regulation of the market, because the price of the target firm would be bid up to its 'fair value'. In Australia, takeovers are regulated by the Companies (Acquisition of Shares) Act. In general terms, the purpose of the legislation is to provide target shareholders with more information about the bidder as well as to give them more time to decide whether or not to tender their shares. United States evidence supports the view that imposing security regulations reduces the profitability of takeovers for bidding firms (see Jarrell and Bradley, 1980; Asquith, Bruner and Mullins, 1983; Schipper and Thompson, 1983a, 1983b).

Ruback's Interpretation of Competition in the Takeover Market

Ruback (1983) is the most recently published attempt to evaluate competition in the US market for corporate control. According to Ruback, an examination of the returns to bidding and target firms is not a direct test of competition. Instead, he proposes an alternative method that focuses primarily on the returns to unsuccessful bidding firms. The rationale for using this approach is that in a competitive market, a rational offerer will not raise his bid above the price where the corporate acquisition has a zero net present value. A further implication of a competitive market is that the successful bid price exhausts all potential gains to unsuccessful bidders. The market could not be called competitive if unsuccessful bidders did not pursue positive net present value bids.

For a sample of 48 unsuccessful bids, Ruback (1983) estimates that the average potential loss from the bidder's **matching** the successful offer price is $91 million, which is significantly less than zero (t = –4.34). The potential gain for the unsuccessful bidder is calculated as the effect of the bid's announcement on the market capitalisation of the bidder, less the amount needed to raise his bid to the successful bid price (see the next section).

Further analysis reveals that for 41 of the 48 bids, a negative net present value acquisition would have been realised if the unsuccessful offerer had matched the higher competitive bid.[1]

Research Method

Although visible competition, in the form of competing bids for a given target company, is not a necessary condition for competition in the takeover market, Ruback's test requires an analysis of these competing bids. We must estimate the net present value (NPV) of the acquisition for the unsuccessful bidder at the successful offer price (Ps). If we use Ruback's notation, the potential gain to the unsuccessful bidder, Gu, from revising his offer to Ps is given by

$$Gu(Ps) = Gu(Pu) - (Ps - Pu) \tag{1}$$

Equation (1) states that the potential gain to unsuccessful firm u from making a bid at the successful offer price Ps is the NPV of the takeover to the unsuccessful firm at its final offer price $Gu(Pu)$, less the additional cash outflow that would be needed to raise the final unsuccessful offer to the successful bid price.

The gain to the unsuccessful offerer at the unsuccessful offer price $Gu(Pu)$ can be measured in the following way. If the announcement of the offer is not anticipated by the market and the market is convinced that the offer will be successful, then $Gu(Pu)$ is the abnormal change in the equity value of firm u that is associated with the bid. Thus the NPV of the offer can be measured as

$$Gu(Pu) = E_{t-1}\, AR_t \tag{2}$$

where E_{t-1} is the equity value of firm u one week before the announcement of the bid and AR_t is the abnormal return associated with the announcement.

Initially we calculate U_{it} (the section below on sensitivity analysis reports results from the Capital Asset Pricing Model [CAPM] of Sharpe, 1964 and Lintner, 1965), the abnormal return on share i in week

[1]For the remaining seven offers, the abnormal changes in the unsuccessful bidder's equity value exceed the difference between the successful and unsuccessful offer prices. This is evidence unambiguously inconsistent with a competitive takeover market. Ruback measures the average potential gain of meeting the higher bid at \$23 million, a value which is insignificantly different from zero. He points out that the abnormal change in equity value underestimates the potential gain from an acquisition if the prior probability of consummating the offer is less than one.

t, by subtracting Rm_t, an estimate of the market rate of return in week t, from R_{it}, the return on share i in week t:

$$(3) \qquad U_{it} = R_{it} - Rm_t$$

Since 'the market' is unobservable, a surrogate index must be used. We use the Statex Actuaries Accumulation Index for 1973–1985; and prior to 1973, Walter's index, which is an equally weighted average of all rates of return included in Walter's (1984) data file, subject to the following two exclusions: (a) for offeree companies, data for the 26 weeks prior to a takeover announcement are excluded; and (b) for offerer companies, data for the three years prior to a takeover announcement are excluded.

Walter (1984) reports an average of 193 rates of return in each weekly index value. He finds that prior to the public announcement of their bids, offerer companies typically experience systematic price increases. Walter interprets this share price behaviour as evidence that the market anticipates the announcement of a takeover offer. Although no time estimate is provided, an examination of the abnormal returns of both successful and unsuccessful offerers suggests that this adjustment begins at least one week before the announcement of the bid. US evidence provided by Bradley (1980) suggests that leakages could have occurred over the five days before the official announcements.

To capture the full announcement effect, the leakage factor must be incorporated into the analysis. This is done by summing the abnormal returns for the week before and the week of the announcement, to estimate the cumulative abnormal return $(CAR_{t-1,t})$. (In the case of a revised bid, the offerer's CAR is calculated beginning with the second Friday before the week of its first bid and ending with the Friday of the week of the revised bid.) The equity value is measured at the start of this period. Thus

$$(4) \qquad Gu(Pu) = E_{t-2}CAR_{t-1,t}$$

An additional problem associated with measuring the gain to the unsuccessful offerer is the assumption that the market, at the time of the announcement, expects that the takeover offer ultimately will be successful. However, it is unlikely that the market always assigns a value of one to the probability of success, particularly for bids that over time are rejected by target shareholders.

The abnormal change in equity value (equation [4]) therefore measures only the **expected** gain to the bidder. Define πx as the probability that a given takeover will be successful. Then the change in equity value is given by

$$E_{t-2}CAR_{t-1,t} = \pi s Gu(Pu) \tag{5}$$

From (1) and (5) we have

$$Gu(Ps) = [(E_{t-2}CAR_{t-1,t})/\pi s\,] - (Ps - Pu) \tag{6}$$

Thus the gain to the unsuccessful offerer at the successful bid price $Gu(Ps)$ must be non-positive, for the evidence to be consistent with the competitive market hypothesis. Other things being equal, a positive value is inconsistent with competition.

Inspection of equation (6) indicates that three different results are possible.

(a) The abnormal equity change $(E_{t-2}\,CAR_{t-1,t})$ is positive and greater than the difference between the successful and unsuccessful offer prices. This evidence would be unambiguously inconsistent with a competitive market for all values of πs.

(b) The abnormal equity change is negative. This evidence would be unambiguously consistent with a competitive market for all values of πs.

(c) The abnormal equity change is positive but less than the difference between the successful and unsuccessful bid prices. In this this case the value of πs is critical. For example if πs is 'close to' one, then given the above condition, the evidence would support the hypothesis of a competitive market; whereas a sufficiently small πs would be evidence inconsistent with the hypothesis. The critical value of πs can be ascertained from equation (6) for each takeover.

Unfortunately, when it comes to result (c), there is no accepted method by which we can assess the prior probability of success for a given takeover offer. However Walter (1984:79) reports an unconditional relative frequency of success of 67 per cent. We use this estimate as the critical value of πs. If the πs computed from equation (6) is less than 0.67, then the unsuccessful bid is deemed consistent with a competitive market; whereas a value of πs greater than 0.67 is deemed evidence inconsistent with a competitive market.

To clarify the methods used in this paper, the Appendix details three takeovers that fall into each of the above situations.

Data and Sampling Plan

The first set of data we use to test the competitiveness of the Australian corporate acquisitions market is from the Walter (1984) takeover offer samples. Walter in turn identified his bids from Walker (1973), a schedule of delisted firms prepared by the Sydney Stock Exchange and from tables published in the *Australian Financial Review*. We checked the offer details for the bids we used, and found no discrepancies between Walter's data and the *AFR*. The bids cover the period 1966–72. Our additional requirements are:

(a) At least two bidders competed for each target company. This is not a necessary condition for a competitive takeover market to prevail. For successful acquisitions that involve a single bidder, if the bid price exhausts all possible abnormal gains that could have accrued to other potential bidders, then the hypothesis of a competitive market for corporate control is not rejected.
(b) The values of the successful and unsuccessful bids are known.
(c) The announcement dates of the initial and any revised bid are known.
(d) The successful bidder gained a majority holding of the target company's ordinary shares. Although in a number of takeovers the bidders made offers for the targets' preference shares, this component of the transaction was ignored, since the voting rights attached to preference shares are generally limited to circumstances where dividends are in arrears, or there is a proposal to reduce capital or to wind up the company (see s.5(1) and s.244 of the Companies Act 1981).
(e) The unsuccessful bidder was listed on an Australian stock exchange at the time of the bid.

During the period 1966–72, 97 unsuccessful bids were made for partial or complete control of the target firms and 34 of them are included in our final sample. Table 1(a) outlines the reasons for the 63 exclusions. No clear winner can be identified in 46 cases; price relative data are unavailable for seven more[2]; five successful acquisitions occurred 40 or more weeks after the last unsuccessful bid (a period we consider too long for suitable comparisons to be made); and five unsuccessful bids were made after control had passed or was on the point of passing to the successful bidder. Because the offerers in these last five cases made

[2]Unfortunately for the purposes of this study, four of these bids involved Industrial Equity Ltd, a listed company that in the earlier days of its acquisition program frequently was not traded on an Australian stock exchange.

bids when there was a negligible chance control would pass to them, their offers are excluded from our sample. For these five cases, the unsuccessful bid was worth more than the successful bid. Although ostensibly this evidence is inconsistent with a competitive takeover market, it must be recognised that the bids were made when the majority of the outstanding shares had already been committed to the successful offerer.

The second data set consists of 38 other contested bids made by and for listed companies from 1973 to 1985. Table 1(b) details the selection criteria that were used.

Table 1

Unsuccessful Takeover Bids, 1966–1985

(a) 1966–1972

Total bids		97
Deduct:		
No successful bidder	46	
Price relative data not available	7	
Successful bid at least 40 weeks later than unsuccessful bid	5	
Unsuccessful bid made after control already had passed to successful bidder	5	63
Useable sample of unsuccessful bids		34

(b) 1973–1985

Total bids		64
Deduct:		
Unsuccessful bidder not listed	6	
Price relative data not available	5	
Control determined by single shareholder	5	
Unsuccessful bid made after control already had passed to successful bidder	4	
Government intervened to block takeover	3	
No independent valuation available for bid	2	
Parent company did not fully control the unsuccessful bidder	1	26
Useable sample of unsuccessful bids		38

Table 2 presents the time distribution of the final sample of 72 unsuccessful bids. This distribution is based on the announcement date, which is defined as the day on which the news of the bid first appeared in the *AFR*. The first bid by the unsuccessful offerer precedes the first bid by the successful offerer in about 80 per cent of cases. The average

Table 2
Time Distribution of Unsuccessful Bid Announcements

Year	All Bids	Final Sample
1966	4	0
1967	6	2
1968	14	1
1969	22	7
1970	15	6
1971	16	9
1972	20	9
1973	6	4
1974	4	2
1975	4	3
1976	—	—
1977	4	4
1978	8	1
1979	5	3
1980	5	—
1981	6	4
1982	4	3
1983	8	6
1984	9	7
1985	1	1
Total	161	72

value of a successful bid is 11 per cent more than that of the highest unsuccessful bidder. By contrast, Ruback (1983) reports a 23 per cent difference between the successful and unsuccessful bids. However, his figure is based on the initial offer made by the unsuccessful bidders, whereas our figure relates to the unsuccessful bidder's highest bid. For all but one of the takeovers in the final sample, target shareholders accepted the most valuable offer.[3] Other descriptive details of the sample are summarised in Table 3.

Table 3

Summary Description of the Sample of Takeover Offers

	Unsuccessful Offerers	Successful Offerers
Mean value of offers	$15.55m	$17.22m
Frequency Consideration was:		
Cash	40	44
Shares	24	14
Cash or shares	8	14
Total	72	72
Number of revised bids	17	24
Average equity value of unsuccessful bidder two weeks before its bid	$60m	

Results

Rates of return to unsuccessful offerers. Table 4 summarises the abnormal returns on the shares of the 34 firms in the sample drawn from Walter (1984). The cumulative abnormal return is measured by averaging the individual firms' abnormal returns for each event week, and summing the average abnormal returns over event time. The cumulative average residual (abnormal return) for the two weeks up to and including the week of the takeover offer's announcement is 1.19 per cent, which is not significantly different from zero (t = 1.13).

[3]The exception is Ozapaper Ltd's bid for Drawing Office Industry Ltd in March 1969. The offer was to be financed by a one-for-one share exchange. Given that Ozapaper's last sale prior to the bid's announcement took place at $2, the offer valued the target company's ordinary shares at $1.8 million. In the following month Reprographic Ltd made a revised cash offer of $1.90 per share. This bid valued the target at $1.71 million, an offer that ultimately was to be accepted by target shareholders. Further examination of the share price behaviour of Ozapaper Ltd reveals that on the day Reprographics gained a majority control in the target (13 June 1969), the price of Ozapaper's shares fell from $2.12 to $1.72. For the purpose of assessing whether the takeover is consistent with a competitive market, the value of Ozapaper's offer is estimated using the 13 June 1969 share price.

Unsuccessful offerers not only earn normal returns during the announcement period, but they continue to do so over the next 20 weeks. Thus it appears that, on average, the net effect of making 'unsuccessful' offers is zero. Our finding is generally consistent with Dodd and Ruback (1977) and Ruback (1983), who also report no significant abnormal returns to unsuccessful offerers during and after the tender offer announcement.

Table 4
Cumulative Abnormal Returns Averaged Over 34 Unsuccessful Takeover Offers Announced in the Period 1966–1972

Event Time Period (weeks)	CAR[a] (%)	*t*-statistic[b]
−20 to −11	2.10	1.20
−10 to −5	2.21	1.24
−4 to −3	−0.08	−0.08
−2 to −1	1.75	1.33
−1 to 0	1.19	1.13
0	0.13	0.15
0 to +1	1.33	0.75
+1 to +2	1.66	0.93
+3 to +4	0.27	0.30
+5 to +10	−0.80	−0.38
+11 to +20	2.14	1.12

a Returns are calculated using a market-adjusted model (i.e. a market index is subtracted from the raw return).

b The *t*-statistic is a simple test of whether the observed mean differs significantly from zero.

Since our sample criteria require control of the target to pass to a rival bidding firm, our results in Table 4 can be compared directly with those of Bradley et al. (1983). They separate their sample of 94 unsuccessful offerers into two groups: (a) incumbent management retained control; and (b) control passed to another party. For the 67 cases in the latter group, they estimate that the unsuccessful offerer experiences average abnormal returns of 1.53 per cent over the five days ending with the first public announcement of the tender offer. In the next 100 days the cumulative average falls by 8 per cent, which they interpret as being consistent with a synergistic effect. They argue that the successful bidder acquires the resources to achieve significant economies of scale, which leads to lower product prices. The unsuccessful offerer is placed at a competitive disadvantage, and its shareholders are among the losers.

In contrast to the return pattern predicted by the Bradley et al. 'synergy view', the results we report in Table 4 contain no significant decline in investment performance subsequent to the announcement date. The lack of a downward drift (on average) could be explained by the combination of post-bid announcements made by the unsuccessful offerers. Walter (1984), in rationalising the **upward** drift in the abnormal returns of his 97 unsuccessful bidders after the bid announcement (average CAR for the 97 unsuccessful offerers increased by 21.3 per cent in the 100 weeks following the week of the bid), details a variety of favourable post-bid announcements (e.g. bonus and rights issues, returns of capital, dividend increases, etc.). Walter suggests that a second and more likely explanation for this result is the extraordinary investment performance of Industrial Equity Ltd (IEL). Only 1.5 per cent of the post-announcement gain of 21.3 per cent was **not** associated with IEL. However, we found that the two IEL bids included in our sample do not bias our results.

Table 5 presents the frequency distribution of the takeover offer

Table 5
Frequency Distribution of Event Period Abnormal Performance for the Sample of 72 Unsuccessful Bidders

Abnormal Performance Range (%)	Absolute Frequency	Relative Frequency (%)
$20 < U$	2	2.8
$10 < U < 20$	4	5.6
$5 < U < 10$	9	12.5
$2 < U < 5$	12	16.7
$1 < U < 2$	2	2.8
$0 < U < 1$	8	11.1
$-1 < U < 0$	6	8.3
$-2 < U < -1$	3	4.2
$-5 < U < -2$	13	18.1
$-10 < U < -5$	9	12.5
$-20 < U < -10$	3	4.2
$U < -20$	1	1.4
Total	72	100.0

Note: Event Period is defined as the week before and the week in which the takeover offer was announced in the *Australian Financial Review*.

abnormal returns for the 72 unsuccessful bidders. Although the average is positive over the bid period, both negative and positive returns were earned by shareholders in individual companies. Three-quarters of the observations exceed 2 per cent in absolute value; the average of the 37 gains is 5.62 per cent, and the average of the 35 losses is -6.02 per cent.

Assessing competition in the takeover market. The market for corporate control is competitive when the price of the target firm is bid up until a takeover by the unsuccessful bidder would be a negative net present value investment at the successful bid price.

According to the Ruback approach (which we are following), the assessment of competition requires a measure of the potential gain or loss that would accrue to the unsuccessful bidder if he were to match the successful bid price. Table 6 summarises the potential gain or loss at the successful bid price for the 72 unsuccessful bidders, assuming $\pi = 1$ in equation (6). The average outcome is a potential loss of $1 530 000 ($t = -2.29$), which is significantly different from zero at the 5 per cent confidence level.

Table 6

Frequency Distribution of the Potential Gains to the 72 Unsuccessful Offerers at the Successful Offer Price

Gu(Ps) = X $million	Absolute Frequency	Relative Frequency (%)
$X < -2.0$	21	29.2
$-2.0 < X < -1.5$	3	4.2
$-1.5 < X < -1.0$	4	5.6
$-1.0 < X < -0.5$	9	12.5
$-0.5 < X < 0.0$	22	30.6
$0.0 < X < 0.5$	4	5.6
$0.5 < X < 1.0$	2	2.8
$1.0 < X < 1.5$	—	—
$1.5 < X < 2.0$	2	2.8
$2.0 < X$	5	6.9
Total	72	100.0

Note: Assumes that the *ex ante* probability of success for all bids is equal to one at the time of the announcement.

Although the evidence on the whole is consistent with competition in the takeover market, it cannot be regarded as conclusive for the following two reasons. First, the formula we use to measure the potential gain reported in Table 6 assumes that the *ex ante* probability of success equals one. Second, the result may be driven by a few large takeovers.

A more detailed analysis is presented in Table 7. The cases are divided into three categories, in the manner described above. The top left-hand cell contains the number of cases in which the abnormal equity change is negative and hence is unambiguously consistent with competition. For these 35 bids, the negative abnormal equity value experienced during the announcement period implies that the market

Table 7
Frequency of Negative and Positive Potential Gains[a] to Unsuccessful Bidders at the Successful Offer Price

	$Gu(Ps) < 0$	$Gu(Ps) > 0$
Number of times the sign of the inequality **does not** depend on πs[b]	35	13
Number of times the sign of the inequality **does** depend on πs[c]	24	0[d]

a The potential gain to the unsuccessful bidder at the successful offer price is calculated as:

$$Gu(Ps) = (E_{t-2}CAR_{t-1,t}) / \pi s - (Ps - Pu)$$

where E_{t-2} is the unsuccessful bidder's equity value two weeks before the announcement of the successful bid, $CAR_{t-1,t}$ is the cumulative average residual for the unsuccessful bidder from one week prior through to the end of the unsuccessful bid's announcement week, πs is the *ex ante* probability that the unsuccessful offer would have been successful, Ps is the successful offer price and Pu is the unsuccessful offer price.

b The direction of the inequality does not depend on πs when $Gu(Ps)$ and $CAR_{t-1,t}$ are of the same sign.

c The direction of the inequality depends on πs when $Gu(Ps)$ and $CAR_{t-1,t}$ differ in sign.

d No observations can occur in this cell since $Gu(Ps) > 0$ only when $E_{t-2}CAR_{t-1,t} > Ps - Pu > 0$.

perceived *ex ante* that the takeover would be a negative net present value action. The unsuccessful bid exhausted all potential gains that could be made from the takeover. Since the offerer subsequently withdrew from the bidding process, the observations are consistent with a competitive market for corporate control, though they beg the question of why the bid occurred in the first place.

For the 13 bids in the upper right cell of Table 7, the abnormal equity change is positive and greater than the additional cash flow that equates the unsuccessful offer to the successful bid price. Thus the potential gain to these firms, had they matched the successful bid, was positive. This result is again independent of the *ex ante* probability of success. It indicates that the market would have viewed the potential acquisition as a positive net present value investment if the offerers had raised their bids to the higher successful price. Since the bids were not raised, the 13 bidders' behaviour is unambiguously inconsistent with a competitive takeover market. The average potential gain for the 13 unsuccessful bids is about $4 400 000 ($t$ = 2.78), based on the assumption that the prior probability of success is one. (The lower the probability, the less the likelihood that the 13 bids are consistent with a competitive market.)

For the 24 observations in the lower left-hand cell of Table 7, the abnormal change in equity value is positive but less than the difference between the successful and unsuccessful bid prices. Inferences concerning their consistency with a competitive takeover market depend on the prior probability of success. In the event that this value was equal to one, all observations are consistent with a competitive market. If however the probability of success was less than one, then the abnormal equity change underestimates the net present value of the unsuccessful offer.

Table 8 presents the frequency distribution for the critical values of the *ex ante* probability of success that equates $Gu(Ps)$ with zero in equation (6). For the 24 observations, the average value of πs is 0.24; the maximum value is 0.98. If we use Walter's (1984) measure of 0.67 as the unconditional probability of success for each bid, then only one observation in Table 8 is inconsistent with a competitive market. Even if we assume no offerer would launch a bid that did not have at least an equal chance of success (Ruback, 1983), then 20 of the 24 still would be classified as consistent with competition.

Sensitivity Analysis

We conducted several tests to check the sensitivity of our results to assumptions we had to make to obtain our results. We used Walter's (1984) extensive data files to verify that our results are insensitive to the alternative of adopting the Sharpe-Lintner Capital Asset Pricing Model

Table 8
Critical Value of the Probability of Success πs for the 24 Observations where Inferences Concerning Competition Depend on πs[a]

Probability of Success	Absolute Frequency	Relative Frequency (%)
$0.8 < \pi s < 1.0$	1	4
$0.6 < \pi s < 0.8$	3[b]	13
$0.4 < \pi s < 0.6$	—	—
$0.2 < \pi s < 0.4$	8	33
$0.0 < \pi s < 0.2$	12	50
Total	24	100

a The critical value of the probability of success is

$$\pi s = E_{t-2}CAR_{t-1,t}/(Ps - Pu)$$

where E_{t-2} is the equity value on the second Friday before the announcement of the unsuccessful bid, $CAR_{t-1,t}$ measures the sharemarket abnormal return on the unsuccessful bidder's shares over the two weeks ending with the week of the bid, Ps is the successful bidder's offer price, and Pu is the unsuccessful bidder's offer price.

b All three are greater than 0.67.

to estimate abnormal returns. We also verified that our results hold up for an extended leakage period of eight weeks. Beyond eight weeks, the extra noise in the share prices blurs the results too much to detect competitive behaviour. We estimated the maximum tolerable bias in the CARs is –2 per cent; that is, our results hold up as long as the CAR estimates are not biased downwards by more than 2 per cent.

Finally, the potential gain to the unsuccessful offerer at the successful bid price was recalculated by using the lower-valued bid in circumstances where the bidder made a combination of offers. This test reaffirms our previous results for the seven instances where alternative bids were made.

Conclusion

The objective of this study is to provide evidence of the competitiveness of the Australian corporate acquisitions market. Competition in the takeover market is defined as a situation where the successful offer price exhausts the potential gains for all unsuccessful bidders.

Our results mirror the main findings of Ruback (1983), who found that only seven of 48 takeovers in the US were unambiguously inconsistent with a competitive takeover market. We found only 14 inconsistencies out of 72 we studied.

For these 14, the unsuccessful offerers withdrew from the bidding process in circumstances where matching the higher bid would still have led to abnormal gains for their shareholders. Our conclusions are predicated on the assumption that the abnormal returns, on average, capture the potential gains from a successful takeover. The apparent failure of these unsuccessful offerers to make a higher-valued bid could be due to bidder collusion, strategic behaviour, legal impediments, or, as is always possible with studies like ours, confounding events.

Appendix

The purpose of this appendix is to evaluate, individually, three takeovers in terms of whether the behaviour of the unsuccessful offerer is consistent with the notion of a competitive takeover market. Ruback's methodology, sketched in the section on Research Methods, provides the framework.

Takeover 1: Onkaparinga Woollen Mills Coy Ltd (OWM) bid for Warnambool Woollen Mills Coy Ltd (WWM)

In August 1969 OWM offered WWM shareholders seven OWM shares for every two WWM shares. The total value of the OWM bid for 100 per cent control of WWM is estimated to be $2.634 million.

In the week subsequent to the OWM bid, Dunlop Australia Limited offered $2.822 million for WWM, an offer that was accepted by target shareholders. To assess whether the takeover is consistent with a competitive market, additional information concerning OWM was collected.

- CAR(– 1,0) = – 1.94%
- Equity value two weeks prior to announcement date = $3.952 million.

Equation (6) is used to measure the potential gain in matching the successful bid price:

$$
\begin{aligned}
Gu(Ps) &= E_{t-2} CAR_{t-1,t} / \pi s - (Ps - Pu) \\
&= -\$264\ 800 \text{ (assuming } \pi s = 1\text{)}
\end{aligned}
$$

At the time of the announcement of the offer, the market viewed OWM's bid for WWM as a negative NPV investment. OWM's decision not to make a higher offer for the target company is consistent with a competitive takeover market.

Takeover 2: David Jones Ltd (DJ) bid for McDowells Ltd (M)

In November 1971, DJ made a $5.18 million bid for M. During the takeover offer period (– 1,0), DJ's shareholders had abnormal returns of 6.4 per cent. This represents a $3.4 million increase in equity value.

The shareholders of M rejected DJ's offer and instead accepted, in the following month, a $6.63 million bid by Walton's Ltd.

From this information we can establish that the potential gain to DJ shareholders from matching the Walton's bid is positive for all possible values of πs. Thus the evidence indicates that not only did the market view DJ's initial bid for M as a potentially positive NPV investment, but also under circumstances in which DJ could at least have matched the Walton's bid and still achieved a positive NPA investment, in the market's view. Thus the actions of DJ's management are inconsistent with a competitive takeover market.

Takeover 3: CC Bottlers Ltd (CCB) bid for Refresh Holdings Ltd (RH)

In June 1972, CCB made a takeover offer for RH that involved two bids. The first was a cash offer of $2.15 a share, which valued RH ordinary shares at $5.32 million. Alternatively target shareholders were offered two CCB shares plus $3.50 cash for every five RH shares. This bid valued the target company at $6.04 million. Both these bids were later rejected. Instead, target shareholders accepted an offer made by British Tobacco Ltd which valued RH ordinary shares at $6.81 million.

During the period of the announcement, the CCB shareholders experienced abnormal returns of 5.46 per cent. This indicates that the market viewed the initial bid of CCB as a profitable investment. CCB equity value two weeks prior to the announcement of the bid was $8.61 million. If we assume that target shareholders would have accepted the higher-valued alternative bid, then the potential dollar gain to CCB shareholders at the successful offer price can be calculated as follows:

$$
\begin{aligned}
Gu(Ps) &= E_{t-2}CAR_{t-1,t} / \pi s - (Ps - Pu) \\
&= \$470\,000 / \pi s - \$769\,000
\end{aligned}
$$

In this case, the abnormal change in the equity value is positive but less than the difference between the successful and the unsuccessful offers. Inferences concerning the competitive nature of the bid depend upon πs. The critical value of πs is 0.61. Thus if the market perceived the probability of CCB successfully acquiring RH to be greater than 0.61 at the time of the announcement, then CCB shareholders would have been worse off if the company revised its unsuccessful bid up to the successful bid price. An *ex ante* probability of less than 0.61 would mean there was a potential gain to CCB shareholders from a revised bid and consequently that the company's failure to bid again is inconsistent with a competitive takeover market.

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Takeover Announcements and Share Price Reactions: New Zealand Evidence 1968–1985

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Takeover Announcements and Share Price Reactions: New Zealand Evidence 1968–1985

David Emanuel

Introduction

This paper examines the share market performance of New Zealand listed public companies that have been involved in business combinations over the period 1968–1985. 'Performance' is evaluated by measuring share market returns, after removing the overall market effects and taking into account the extent to which the share prices of the companies being examined typically vary with market movements. As this is a capital market study, analysis is restricted to companies that are listed on the share market.

Appendices 1 to 5 at the end of the the paper list the companies that are subject to analysis, together with dates that are relevant, as best they can be determined. Companies are described as 'successful' if the combination actually took place, and 'unsuccessful' if it did not. Appendix 5 lists companies that were involved in what are described as 'mergers'. In the context used here these combinations normally involved the establishment of a new company and the issue of scrip. These mergers involved very little cash consideration and correspond to what accountants in some countries describe as pooling of interests.

The distribution of the combinations in Appendices 1 to 4, together with the return on the market (measured by the Barclay's index), are shown below in Table 1.

The assistance of Mark Amery is acknowledged. Jarden & Co., stockbrokers, provided the database for this research. Their support is gratefully acknowledged.

Table 1
Distribution of Firms Analysed by Year

Year	Successful Offerers	Successful Offerees	Unsuccessful Offerers	Unsuccessful Offerees	Return on Market (%)
1968	5	2	1	2	39.9
1969	9	1	2	1	15.8
1970	8	2	—	—	−10.6
1971	7	2	3	—	−0.3
1972	7	3	1	—	19.7
1973	8	4	2	2	−2.1
1974	5	3	2	—	−21.3
1975	3	2	6	1	11.5
1976	5	2	—	—	4.5
1977	2	2	—	1	−0.6
1978	9	6	3	2	12.2
1979	7	7	6	5	10.9
1980	4	8	5	2	53.2
1981	6	10	6	3	27.6
1982	8	9	2	—	−10.3
1983	11	14	9	6	101.6
1984	8	15	2	2	15.7
1985	25	32	6	3	27.9
	137	124	56	30	

The excess returns (that is, returns in excess of what might be expected, given the shares' normal relationship with the market) are examined relative to two events, the announcement date and the outcome date, according to the following time line.

```
                    Announcement          Outcome
                        Date                Date
Pre-Announcement Period   Period to Outcome   Post-Outcome Period
--------------------------|-------------------|--------------------
(Period)               (Event)    (Period)  (Event)      (Period)
```

Research of this type is useful in approaching the following questions: Do takeovers create value? Do managers in these situations take actions that increase their own welfare but decrease shareholders' wealth? What kind of sharemarket performance typifies offerers and offerees in the various periods referred to above?

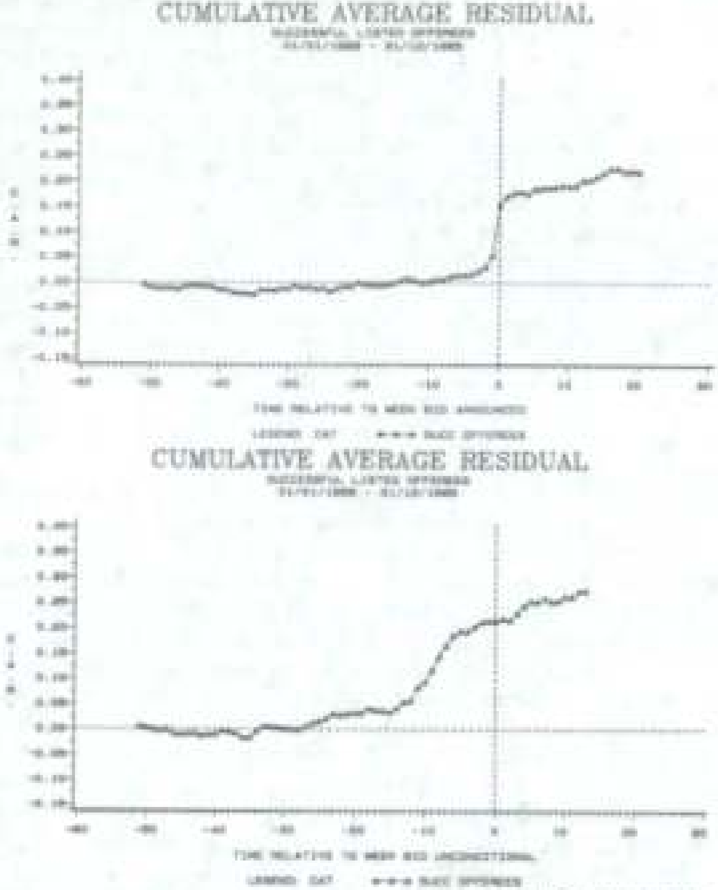
The research avoids using accounting and other ratios (such as measures of growth, leverage, return on investment, etc.) to evaluate the success or otherwise of a business combination. A major difficulty with using accounting figures is how to determine a valid benchmark comparison for offerer companies in periods before and after the combination and offerees in the period before the combination. Takeover companies self-select, and as a consequence there may be a wide range of fundamental differences between them and the benchmark or control companies. Second, the use of different accounting policies makes systematic comparison of the groups difficult. Third, the event of the combination itself can generate changes in accounting policies, and the New Zealand Society of Accountants Statement of Standard Accounting Practice No. 8, 'Consolidated Financial Statements', requires the revaluation of the assets of the acquirer to fair values when 'purchase accounting' is practised. Finally, it is difficult to know what to expect in such a comparison. There is no reason to expect growth by takeover to be a systematically superior strategy when compared with growth through profit retention, for example. The fact that after the event offerers' ratios are not different from the pre-offer ratios might simply reflect the fact that the offerer paid the market price for the acquisition.

Results

The major results of this paper are shown in Figures 1 to 6. All the Figures have the same form, measuring time relative to the event of interest (either announcement date or outcome date) on the horizontal axis, and the cumulative average residual (CAR) on the vertical axis. 'Time 0' is given in Appendices 1 to 5 and is a different calendar time for each combination. The CAR involves accumulating the average abnormal performance measures on a week-by-week basis. To illustrate, if the average abnormal performance in week –51 is +1 per cent and the average abnormal performance in week –50 is 0.7 per cent, then CAR –50 is 1.7 per cent. The average abnormal performance for any week is calculated by taking the difference between the security's return and the market's return (the market's return is adjusted by taking into account the security's normal variability with the market) over the week for each of the securities subject to analysis, and then averaging these abnormal performance measures.

Figure 1 shows the CARs for successful offerees. In the first half of the year prior to the takeover the offerees' average share performance was below that of the market. This is consistent with one of the hypotheses frequently promoted as a motivator for acquisitions, namely the 'inefficient management hypothesis'. That is, if a share's abnormal return can be regarded as an appropriate way of measuring managerial efficiency, then these offerees were being run inefficiently. Other plausible hypotheses advanced to explain acquisitions include the

Figure 1
Abnormal Share Price Performance for Successful Offerees



Time	Abnormal Performance Around Announcement date	Abnormal Performance Around Outcome Date
Week –51 to Week –15	–0.001	0.033
Week –14 to Week –4	0.018	0.160
Week –3 to Week +3	0.163	0.037
Week +4 to Week +20*	0.040	0.045

*Accumulated only to Week 13 after the outcome date as the companies get delisted.

'growth-resource mismatch hypothesis' (for example, assets-rich, earnings-poor companies), the 'industry disturbance hypothesis', the 'size hypothesis' (that is, small firms are more likely to be acquired than large ones), and hypotheses based on price/earnings or market-to-book-value ratios.

From Week –14 the CAR is positive, rising by 10.2 per cent in the week of the takeover announcement. Tests of statistical significance, based on average residuals scaled by the security's residual standard deviation, indicate that the average residuals in Weeks –2, –1 and 0 are significantly different from zero at the 1 per cent level. The CAR continues to rise in the post-takeover announcement period by 6.5 per cent. This is probably due to the revision of some of the bids in that period, and the success of the bids becoming more certain as time progresses.

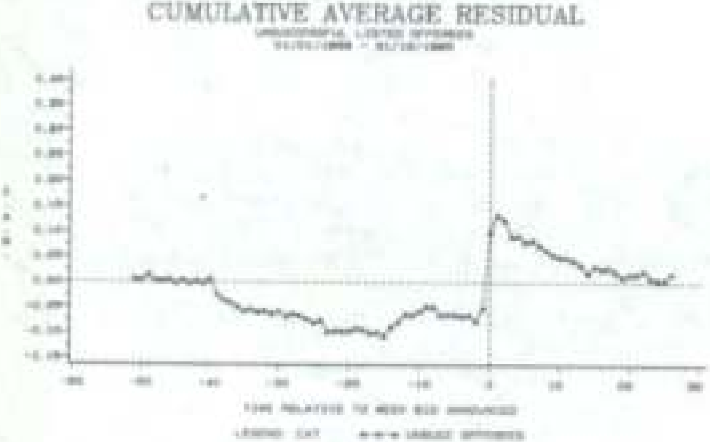
Figure 2 shows the CAR for unsuccessful offerees. These firms have been clearly underperforming the market, virtually throughout the year prior to the takeover bid. In Week 0 the CAR rises by 14.3 per cent, which is statistically significantly different from zero at the 0.1 per cent level. However in the post-bid period the average residuals are mainly negative, and by Week +26 the CAR has fallen to 0.005. That is, if an investor had bought these companies in Week –52 and held them to Week +26, he or she would have earned an abnormal return of one-half of one per cent. One plausible explanation for the fall in the CAR in the post-takeover-announcement period is that the news that the bids are (likely to be) unsuccessful is interpreted by the market as bad news, and hence share prices fall. This is clearly indicated in the second part of Figure 2, where Time 0 is the outcome date. By Week –2 the CAR has reached 9.9 per cent and in Week 0 it is 8.8 per cent. In the following six months the CAR drops by a further 7.8 per cent to end at 1 per cent over the entire 18-month period of analysis.

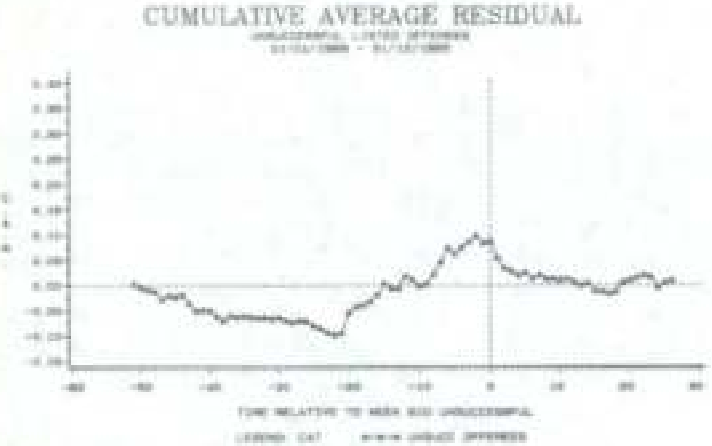
Both sets of results show that takeovers create value. There is a dramatic increase in share price on the announcement of a bid. However, where the bid is unsuccessful the gains quickly evaporate. (The 20 biggest Time 0 increases are reported in Appendix 6.)

Figure 3 shows the CARs for successful offerers. In the period prior to the bid being made, offerers have been performing abnormally well. The CAR reaches its high of 5.2 per cent by Week 0, although the increase in Week 0 of the 128 companies that traded over the –1 to 0 interval is only 0.003 and the majority of the residuals in Week 0 were negative.

The announcement of the bid did not generate any major revisions of the offerer's share price, either around the time of the bid or around the time of the announcement of the successful outcome. One possible explanation for this is that the market for corporate control is competi-

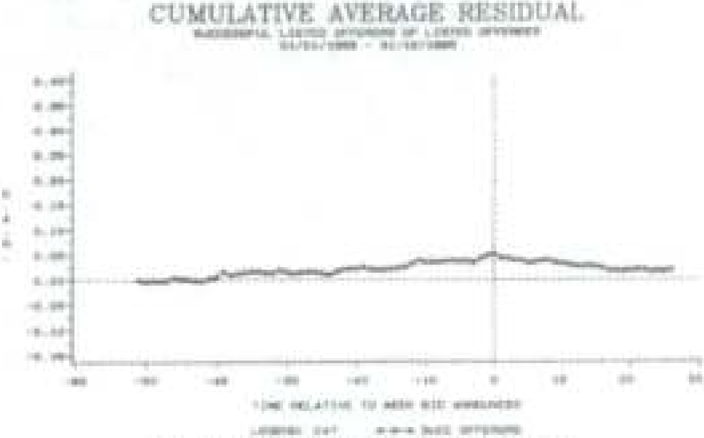
Figure 2
Abnormal Share Price Performance of Unsuccessful Offerees

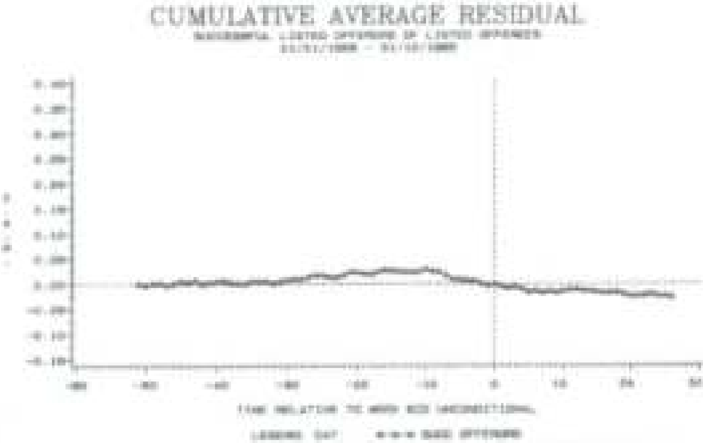




Time	Abnormal Performance Around Announcement Date	Abnormal Performance Around Outcome Date
Week –51 to Week –15	–0.109	0.004
Week –14 to Week –4	0.049	0.072
Week –3 to Week +3	0.144	–0.047
Week +4 to Week +26	–0.079	–0.019

Figure 3
Abnormal Share Price Performance of Successful Offerers





Time	Abnormal Performance Around Announcement Date	Abnormal Performance Around Outcome Date
Week −51 to Week −15	0.023	0.027
Week −14 to Week −4	0.016	−0.020
Week −3 to Week +3	0.001	−0.013
Week +4 to Week +26	−0.014	−0.015

tive, forcing takeover bidders have to pay a price that absorbs abnormal profits. It is conceded, however, that as the offerees are typically smaller than the offerers, the impact on the offerers' share price will be smaller. (One extension of this work, therefore, will be to examine the dollar value gains in absolute terms, rather than returns.) Also, to the extent that the offerer has announced, either explicitly or implicitly, a strategy of growth through acquisition, the time zero impact observed here will understate the total impact and measure only the unanticipated aspects of the particular transaction being examined.

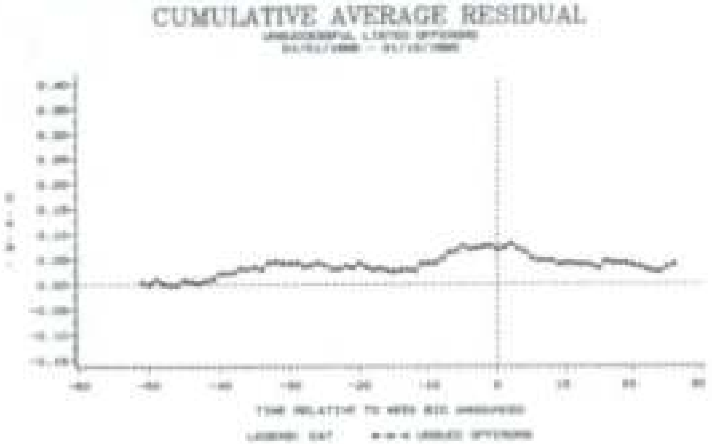
In the six-month period after the announcement of a takeover bid the offerers' excess returns are negative, with the CAR dropping from 5.2 per cent at Week 0 to 2.6 per cent at Week +26. Similar results have been found in the early Australian takeover studies (Dodd, 1976) and in some American research (Asquith, 1983; Dodd, 1980). Several explanations could be advanced for this inferior performance, although none is very plausible. One reason might be that the prices paid in the acquisition turned out to have been too high. It is interesting to note that the CAR by the week of the announcement of the success of the bid is exactly zero, and in the half year following falls by a further 2.1 per cent, with the majority of companies trading earning negative abnormal returns in 21 of those 26 weeks.

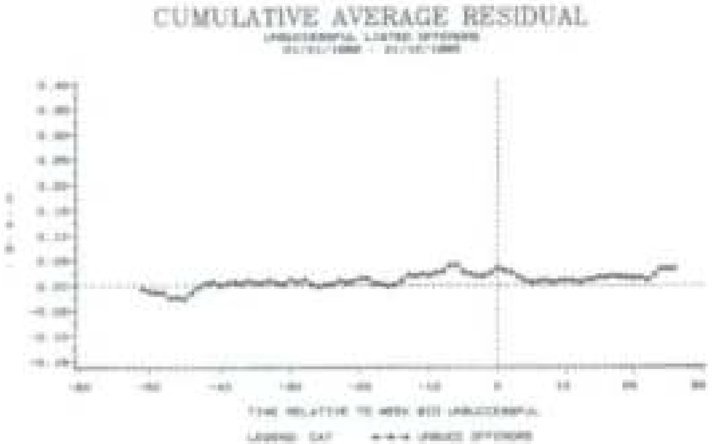
Figure 4 shows the CARs of unsuccessful offerers. As in the previous case, bidders have been earning positive abnormal returns, on average, over the period prior to the bid. In the post-bid period the average excess returns become negative. When time zero is the outcome date, the Week 0 CAR is 3.6 per cent and the Week +26 CAR is 3.4 per cent, so the negative excess returns seem to be related to the period when the outcome of the bid is uncertain. In this respect Figures 3 and 4 tell similar stories — takeover bids involve negative excess returns to shareholders in the offerer, at least initially.

Figure 5 reports on the performance of Brierley Investments Limited (BIL) around the time of BIL's bids. Due to the frequency with which BIL makes bids, the impact of any bid made within 52 weeks before or 26 weeks after a bid being made at Week 0 will also be analysed in those figures. Further, as mentioned before, BIL is identified as a company with a clear takeover strategy so any time zero reaction will reflect that policy only to the extent that the bid is unexpected. It is no surprise to see that BIL has earned positive abnormal returns, with Week 0 CAR being 9.6 per cent for the 20 successful BIL bids analysed.

Figure 6 reports the CARs for offerers of all successful takeovers of all companies, whether public or private. In the announcement week here is a 1 per cent abnormal share price adjustment, which is different from zero beyond the 1 per cent level of significance. This compares with the 0.3 per cent increase at time zero for the successful listed

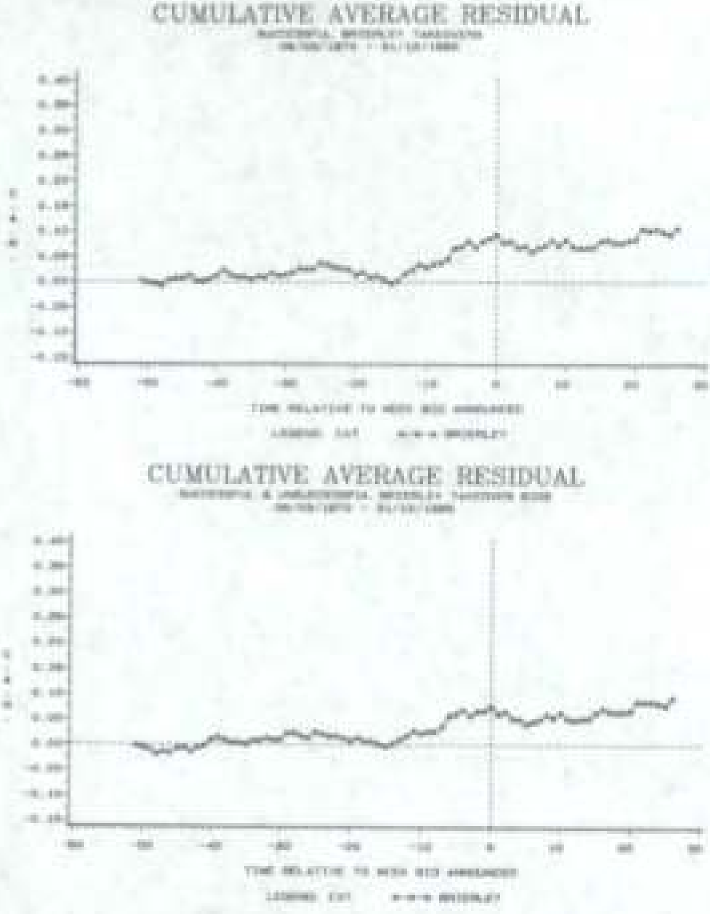
Figure 4
Abnormal Share Price Performance of Unsuccessful Offerers





Time	Abnormal Performance Around Announcement Date	Abnormal Performance Around Outcome Date
Week –51 to Week –15	0.026	0.001
Week –14 to Week –4	0.044	0.023
Week –3 to Week +3	0.001	–0.008
Week +4 to Week +26	–0.032	0.018

Figure 5
Abnormal Share Price Performance of Brierley Investments Limited



offerers acquiring listed offerees. Perhaps this implies that while the market for control of listed companies is competitive, there is a belief that bargains exist in the acquisition of private companies.

Figure 7 shows the CARs for a handful of 'mergers'. Because of the small number of cases and problems in identifying candidate companies, this analysis is very tentative.

The abnormal share price performance in Week 0 is 6.3 per cent, which is highly significantly different from zero. Seventeen of the 22 shares that traded in the –1 to 0 interval had positive residuals. A large

Figure 6
Abnormal Share Price Performance of All Successful Offerers

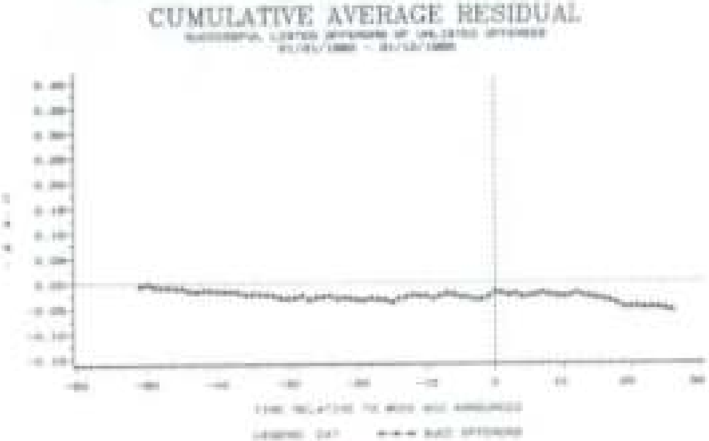
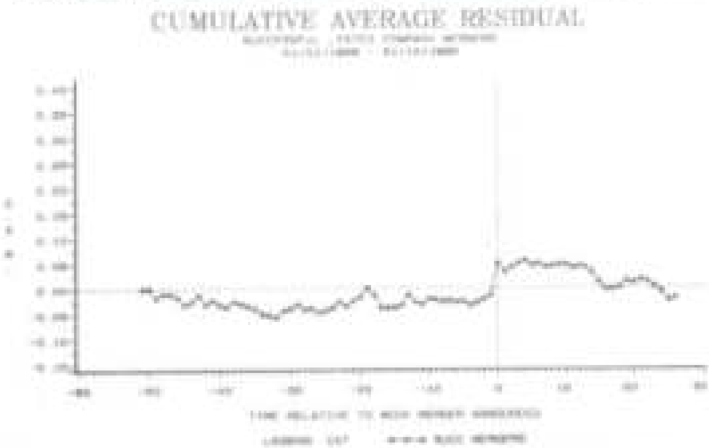


Figure 7
Abnormal Share Price Performance of Mergers



Time	Abnormal Performances Around Announcement Date
Week –51 to Week –15	–0.037
Week –14 to Week –4	0.005
Week –3 to Week +3	0.087
Week +4 to Week +20	–0.075

part of this abnormal performance is attributable to share price movements associated with the Fletcher Challenge merger. In the week of the announcement, Fletcher's share price rose by 19.4 per cent, Challenge's by 21.7 per cent and Tasman's by 21.2 per cent. However, over the following few months as the mergers are consummated, abnormal share price performance is clearly negative.

Conclusions

This paper analyses the abnormal share price performance of New Zealand firms involved in combinations. Firms are divided into offerers and offerees, and described as being successful or unsuccessful. Abnormal returns are accumulated around the takeover announcement and outcome dates.

The following conclusions can be drawn:

(a) Business combinations create value in that shares of the offeree companies rise substantially at the time of the announcement of the combination.

(b) For successful offerees, share price continues to rise, probably due to the provision of more information relevant to the pricing process.

(c) For unsuccessful offerees, share prices fall, also probably due to the provision of more information that is interpreted negatively by the market.

(d) Offeree companies show inferior share price performance in the year prior to the combination.

(e) There is no adjustment to the offerer's share price on announcement of a takeover bid, or on announcement of the outcome.

(f) Offerer companies appear to have been performing abnormally well in the year prior to the offer being made.

(g) The share price performance of offerer companies after a takeover announcement is slightly negative, whether the bid is successful or not. The drop is greater when the bid is unsuccessful.

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Dodd, P. (1976), 'Company takeovers and the Australian equity market', *Australian Journal of Management* 1, 15-36.

———(1980), 'Merger proposals, management discretion and stockholder wealth', *Journal of Financial Economics* 8, 105-37.

Appendix 1

137 Successful Offerers of Listed Companies 1/1/67–31/12/85

Week Offer Announced	Company	Week Offer Unconditional
20/9/68	DIC	1/11/68
27/9/68	Watties	15/11/68
8/11/68	Broadlands(a)	
22/11/68	Watties	10/1/69
29/11/68	NZ Forest Products	14/2/69
17/1/69	Sharland	21/3/69
24/1/69	Dominion Breweries	14/3/69
14/3/69	Dominion Breweries	9/5/69
25/7/69	Dominion Breweries	19/9/69
18/7/69	NZ Breweries	5/9/69
29/8/69	Waitaki Industries	24/10/69
14/11/69	UEB	20/3/70
5/12/69	Winstones	13/3/70
5/12/69	Golden Bay Cement	13/3/70
30/1/70	Smith & Brown	3/4/70
13/2/70	NZ Forest Products	17/4/70
7/2/70	Wellington Publishing	17/4/70
6/3/70	Broadlands	29/5/70
3/7/70	Taupo Totara Timber	14/8/70
21/8/70	NZ Towel Services	6/11/70
18/9/70	Broadlands	11/12/70
19/2/71	Taupo Totara Timber	2/4/71
9/4/71	Scott	23/4/71
16/4/71	ICI	7/5/71
13/8/71	NZ Motor Corporation	24/9/71
17/9/71	Brierley	15/10/71
15/10/71	UEB	3/12/71
26/11/71	Winstone	28/11/72
11/2/72	Neil Holdings(a)	
3/3/72	Odlins	28/4/72
24/3/72	NZ Forest Products	2/6/72
30/6/72	Mosgiel	1/9/72
1/9/72	MSD-Spiers	6/10/72
14/7/72	Mt Cook(a)	
18/12/72	Brierley	2/2/73
16/2/73	Feltex	18/7/80
20/4/73	Winstone	1/6/73

Appendix 1 continued

Week Offer Announced	Company	Week Offer Unconditional
25/5/73	Zip	27/7/73
1/6/73	Brierley	3/8/73
20/7/73	Waitaki Industries	31/8/73
24/8/73	Carter Holt	19/10/73
19/10/73	Waitaki Industries	1/3/74
23/11/73	NZ Pastoral Holdings	1/2/74
25/1/74	Dominion Breweries	17/5/74
1/3/74	Feltex	19/4/74
24/5/74	Waitaki Industries	30/8/74
30/8/74	Cable Price Downer	25/10/74
15/11/74	Steel & Tube	31/1/75
31/1/75	Brierley	22/2/80
30/5/75	Fletcher Holdings	8/8/75
22/8/75	General Finance	19/9/75
27/2/76	Brierley	19/3/76
9/4/76	Odlins	30/7/76
30/4/76	A.S. Paterson(a)	
22/10/76	NZ Towel Services(a)	
29/10/76	Marac	17/12/76
22/7/77	Kempthorne Prosser	21/10/77
14/10/77	Atlas Majestic	2/12/77
3/2/78	National Insurance	12/5/78
10/2/78	Ceramco	7/4/78
26/5/78	Brierley	2/6/78
23/6/78	A.S. Paterson	1/9/78
25/8/78	NZ Farmers Fertilizer	22/9/78
15/9/78	Collingwood	1/12/78
10/11/78	L.D. Nathans	12/1/79
24/11/78	NZ Farmers Fertilizer	1/6/79
8/12/78	Fletcher Holdings	2/2/79
9/2/79	Cable Price Downer	23/3/79
16/3/79	Ceramco	11/5/79
6/4/79	UEB	8/6/79
22/6/79	L.D. Nathan	7/12/79
21/9/79	NZ Farmers Coop	29/2/80
9/11/79	Yates	2/12/79
9/11/79	Challenge	18/1/80
27/6/80	Brierley	5/9/80
3/10/80	Yates	26/12/80
10/10/80	Fletcher Holdings(b)	

Appendix 1 continued

Week Offer Announced	Company	Week Offer Unconditional
19/12/80	Crown	13/2/81
10/4/81	Alex Harvey Industries(b)	
21/8/81	Ceramco	9/10/81
28/8/81	Brierley	30/4/82
18/9/81	City Realties	27/11/81
25/9/81	Carter Holt	25/12/81
13/11/81	Bunting	19/2/82
5/2/82	Ballins Industries	9/4/82
19/2/82	Bunting	2/4/82
26/2/82	Healing	16/4/82
18/6/82	Yates	13/8/82
19/7/82	Lane Walker Rudkin(b)	
6/8/82	Welgas	27/8/82
13/8/82	NZ Motor Corporation	11/2/83
1/10/82	Endeavour	11/2/83
11/2/83	Brierley	1/4/83
4/3/83	Repco	6/5/83
11/3/83	Otago Press & Produce	15/4/83
18/3/83	John Burns	6/5/83
18/3/83	Brierley(b)	
12/8/83	Crown	4/11/83
23/9/83	Carter Holt	18/11/83
28/10/83	Brierley(b)	
28/10/83	Brierley	13/4/84
9/12/83	Brierley	8/6/84
23/12/83	Colyer Watson	13/4/84
13/1/84	Brierley	6/4/84
10/2/84	Rothmans	30/3/84
9/3/84	Cable Price Downer	18/5/84
13/4/84	DIC	22/6/84
13/4/84	NZI	1/6/84
31/8/84	Feltex(b)	
14/9/84	Brierley(b)	
23/11/84	Winstone	5/4/85
4/1/85	Wilson & Horton	1/3/85
8/2/85	Brierley(b)	
22/3/85	Carter Holt	4/10/85
22/3/85	Brierley	5/4/85
26/4/85	Brierley(b)	
3/5/85	Mair	9/8/85

Appendix 1 continued

Week Offer Announced	Company	Week Offer Unconditional
3/5/85	Newmans(b)	
28/6/85	Fletcher Challenge	4/10/85
5/7/85	Equiticorp(b)	
5/7/85	Ceramco	6/9/85
5/7/85	Brierley(b)	
12/7/85	Steel & Tube	29/11/85
12/7/85	Jedi	13/9/85
18/10/85	Brierley(b)	
25/10/85	John Edmond(b)	
	Unity(c)	1/11/85
8/11/85	Charter	17/1/86
15/11/85	NZI	13/12/86
15/11/85	Corporate Investments(b)	
6/12/85	DIC	21/2/86
6/12/85	R & W Hellaby	31/1/86
13/12/85	Bendon	14/2/86
13/12/85	Brierley(b)	
20/12/85	Welgas(b)	
20/12/85	Equiticorp	31/1/86

(a) Insufficient data to determine the week that the offer become unconditional.
(b) These takeovers involve the acquisition of a controlling interest (50 per cent or greater of the issued capital) only, not a complete acquisition of 100 per cent of the offeree's issued capital, hence these takeovers do not become unconditional.
(c) The offerer was not listed when the offer was announced.

Appendix 2

124 Successful Listed Offerees
1/1/68–31/12/85

Week Offer Announced	Company	Week Offer Unconditional
27/9/68	General Foods	15/11/68
20/12/68	Taranaki Breweries	14/3/69
5/12/69	Wilson Cement	13/3/70
13/3/70	Claude Neon	22/7/77
20/3/70	Reid Rubber	28/8/70
13/8/71	Amalgamated Pacific	24/9/71
26/11/71	Pty Industries	28/11/72
3/3/72	R & E Tingey	28/4/72
24/3/72	Taupo Totara Timber	2/6/72
30/6/72	Kaiapoi Textiles	1/9/72
16/2/73	Smith, Brown, & Maple	18/7/80
17/8/73	Sharland	19/10/73
26/10/73	Cooks Wines(a)	
19/10/73	South Otago Freezing	1/3/74
1/3/74	Consolidated Pacific	19/4/74
24/5/74	Nelson Freezing	30/8/74
15/11/74	A & T Burt	31/1/75
31/1/75	Niven Industries	22/2/80
30/5/75	Milne & Choyce	8/8/75
9/4/76	Zip	30/7/76
29/10/76	Associated Group Holdings	17/12/76
22/4/77	Pye	22/2/80
22/7/77	Dominion Fertilizer	21/10/77
31/3/78	Kempthorne Prosser	22/9/78
23/6/78	Bonds (NZ)	1/9/78
18/8/78	MSD-Spiers	3/11/78
10/11/78	Woolworths (NZ)	12/1/79
24/11/78	Medical Supplies	1/6/79
8/12/78	Firth Industries	2/2/79
16/3/79	Tappenden	11/5/79
6/4/79	Trans Holdings	8/6/79
25/5/79	NZ Pastoral Holdings	8/6/79
22/6/79	McKenzies	7/12/79
21/9/79	Haywrights	29/2/80
9/11/79	Hodder & Tolley	21/12/79
9/11/79	Broadlands	18/1/80
1/2/80	UDC	14/3/80

Appendix 2 continued

Week Offer Announced	Company	Week Offer Unconditional
22/2/80	General Finance	14/3/80
11/4/80	Brambles Burnett	23/5/80
3/10/80	J.E. Watson	26/12/80
10/10/80	Transvision	16/8/85
10/10/80	Marac(a)	
19/12/80	Canterbury Farmers Coop	13/2/81
26/12/80	Pavroc	5/6/81
13/2/81	NZ Land Securities	10/4/81
27/3/81	Phillips & Impey(a)	
10/4/81	Vacation(a)	
24/4/81	Wilson Distillers	24/7/81
14/8/81	Motor Traders	18/9/81
21/8/81	Midland Coachlines	9/10/81
28/8/81	Bing Harris	30/4/82
4/9/81	BNZ Finance(a)	
25/9/81	Canterbury Timber	25/12/81
13/11/81	T.J. Edmonds	19/2/82
5/2/82	J. Rattray & Sons	9/4/82
19/2/82	NZ Farmers Coop	2/4/82
26/3/82	Intertasman(a)	
16/4/82	Vacation(a)	
18/6/82	Allied Farmers	13/8/82
6/8/82	Christchurch Gas, Coal & Coke	27/8/82
13/8/82	Healings	11/2/83
3/9/82	Schofield Holdings	5/11/82
1/10/82	Deanes	11/2/83
11/2/83	Printing & Packaging	1/4/83
4/3/83	Andrews & Beaven	6/5/83
11/3/83	Teltherm(a)	
18/3/83	Chenery	6/5/83
18/3/83	Morrison PIM(a)	
25/3/83	Dingwall & Paulger(a)	
10/6/83	Scott(a)	
5/8/83	NZ Motor Bodies	7/10/83
12/8/83	Dalgety (NZ)	4/11/83
22/9/83	Henderson Pollard	18/11/83
30/9/83	John Burns(a)	
28/10/83	Hauraki(a)	
28/10/83	Hawkes Bay Farmers Coop	13/4/84
9/12/83	Sucklings	8/6/84

Appendix 2 continued

Week Offer Announced	Company	Week Offer Unconditional
13/1/84	Bunting	6/4/84
3/2/84	Scott(a)	
24/2/84	Manawatu Knitting Mills(a)	
10/2/84	Ballins Rattray	30/3/84
9/3/84	Rex Consolidated	18/5/84
13/4/84	George Courts	22/6/84
31/8/84	Chemby	4/10/85
31/8/84	Aurora(a)	
14/9/84	DIC(a)	
29/9/84	Dunlop (NZ)	7/12/84
19/10/84	D. McL. Wallace(a)	
23/11/84	Odlins	5/4/84
30/11/84	Rheem (NZ)	15/2/85
7/12/84	Collingwood	1/2/85
21/12/84	Christchurch Press(a)	
4/1/85	United Publishing & Printing	1/3/85
8/2/85	Cooks Wines(a)	
22/2/85	Jedi	31/1/86
1/3/85	Repco (NZ)(a)	
8/3/85	Tolley(a)	
15/3/85	Hawkes Bay Transport(a)	
22/3/85	Alex Harvey Industries	4/10/85
22/3/85	Neil Holdings	5/4/85
29/3/85	Freightways	17/5/85
26/4/85	Consolidated Metals(a)	
26/4/85	Canterbury Frozen Meat	31/5/85
3/5/85	Colner Watson	9/8/85
7/6/85	Mount Cook(a)	
5/7/85	Feltex(a)	
5/7/85	Atlas	6/9/85
12/7/85	Emco	29/11/85
12/7/85	Yates	13/9/85
6/9/85	DRG (NZ)	18/10/85
4/10/85	R.W. Hellaby(a)	
11/10/85	Stevens Corporation	13/12/85
8/11/85	Goodman(b)	
8/11/85	Regina	17/1/86
15/11/85	Marac	13/12/85
15/11/85	Montana(a)	
29/11/85	Endeavour	10/1/86

Appendix 2 continued

Week Offer Announced	Company	Week Offer Unconditional
6/12/85	Apparel	21/12/86
6/12/85	Abacus	31/1/86
13/12/85	John Webster	14/2/86
13/12/85	Winstone(a)	
20/12/85	East Coast Gas(a)	
20/12/85	AM Bisley	31/1/86
27/12/85	Otago Press & Produce(b)	

(a) Offeree had a controlling interest (50 per cent or greater of issued capital) taken up in it and was not the target of a complete takeover.
(b) Offer became unconditional too late for it to be included.

Appendix 3

56 Unsuccessful Listed Offerers
1/1/68–31/12/85

Week Offer Announced	Company	Week Offer Unsuccessful
6/12/68	Waitaki Industries	25/4/69
18/4/69	Phillips & Impey	18/7/69
25/4/69	ICI	16/5/69
5/2/71	Brierley	9/4/71
16/4/71	Brierley	23/4/71
16/4/71	Phillips & Impey	7/5/71
14/1/72	Broadlands	18/2/72
16/2/73	George Courts	30/3/73
30/11/73	Southland Frozen Meat	25/1/74
15/2/74	NZ Breweries	1/3/74
25/5/74	Canterbury Frozen Meat	30/8/74
7/2/75	Southland Frozen Meat	3/10/75
16/5/75	NZ Motor Bodies	23/5/75
20/6/75	Atlas Majestic	4/7/75
4/7/75	Niven	31/10/75
12/12/75	General Finance	9/4/76
	Brierley(b)	2/12/77
30/6/78	Canterbury Farmers Coop	21/7/78
1/12/78	Ceramco	22/12/78
8/12/78	Motor Traders	2/3/79
23/2/79	Rothmans	20/4/79
23/2/79	Brierley	6/7/79
6/7/79	Scott	27/7/79
7/9/79	Transvision	2/11/79
14/9/79	Mount Cook	19/10/79
30/11/79	Collingwood	14/3/80
25/1/80	Marac	1/2/80
22/2/80	Allied Farmers	14/2/80
4/4/80	Fletcher Holdings	31/10/80
14/11/80	Watties	21/11/80
14/11/80	Motor Holdings	26/12/80
13/3/81	City Realties	27/3/81
27/3/81	Allied Farmers	8/5/81
8/5/81	Feltex	29/5/81
10/7/81	NZ United Corporation	24/7/81
18/12/81	Yates	25/12/81
	Smith Biolab(a)	12/3/82

Appendix 3 continued

Week Offer Announced	Company	Week Offer Unsuccessful
5/3/82	J. Edmonds	12/3/82
	Rothmans(c)	8/4/83
18/3/83	Chase	25/3/83
1/7/83	McConnell Dowell	22/7/83
	Waitaki NZR(c)	2/9/83
7/10/83	TNL	6/1/84
4/11/83	NZ Forest Products	18/11/83
9/12/83	Yates	6/1/84
16/12/83	Teltherm	13/4/84
23/12/83	Investment Finance	30/12/83
23/12/83	NZ Forest Products	17/2/84
14/12/84	Goodman	31/5/85
21/12/84	Cory, Wright, & Salmon	1/3/85
8/2/85	INL	15/2/85
19/4/85	Brierley	10/5/85
5/7/85	Charter	19/7/85
26/7/85	Newmans	29/9/85
18/10/85	Stevens	1/11/86
20/12/85	Omnicorp	24/1/86

(a) The offerer was revealed only upon the bid's failure.
(b) Offer withdrawn in the week of announcement.
(c) Examiner of Commercial Practices has declined an application for approval to take over another company.

Appendix 4

30 Unsuccessful Listed Offerees 1/1/68–31/12/85

Week Offer Announced	Company	Week Offer Unsuccessful
27/7/68	George Court	23/8/68
6/12/68	Canterbury Frozen Meat	25/4/69
1/8/69	Henry Berry	1/8/69
16/2/73	Milne & Choyce	30/3/73
30/11/73	South Otago Freezing	25/1/74
7/2/75	NZ Refrigerating	3/10/75
	Kempthorne Prosser(a)	2/12/77
30/6/78	NZ Farmers Coop	21/7/78
1/12/78	MSI	22/12/78
23/2/79	Cooks Wines	20/4/78
23/2/79	John Burns	6/7/79
6/7/79	Bunting	27/7/79
7/9/79	General Finance	2/11/79
30/11/79	Schofield	14/3/80
4/4/80	Carter Holt	31/10/80
14/11/80	Goodman	21/11/80
27/3/81	R.W. Hellaby	8/5/81
8/5/81	Henderson Pollard	29/5/81
18/12/81	Allied Farmers Coop	25/12/81
	Ballins Rattray(b)	8/4/83
	Southland Frozen Meat(b)	2/9/83
7/10/83	Mt Cook	6/1/84
4/11/83	Odlins	18/11/83
16/12/83	Wilson Neil	13/4/84
23/12/83	Watties	17/12/84
3/8/84	Williams Property	10/8/84
23/11/84	AHI	18/1/85
5/7/85	Kiwifruit Industries	19/7/85
11/10/85	Arthur Ellis	8/11/85
18/10/85	Viko	1/11/85

(a) Offer withdrawn in week of announcement.

(b) Examiner of Commercial Practices has declined an application for approval to take over another company.

Appendix 5

23 Successful Mergers
1/1/68–31/12/85

Company	Week of Merger Announcement
Magnus Motors	26/9/69
Whitcomb & Tombs	18/12/70
Coulls, Summerville, & Wilkie	18/12/70
Carter Consolidated	23/7/71
Robert Holt	23/7/71
Baillie Motors	10/9/71
Prestige	21/3/75
Waitaki Industries	25/7/75
NZ Refrigerating	25/7/75
Fletcher Holdings	24/10/80
Tasman	24/10/80
Challenge	24/10/80
Hawkins Holdings	25/6/82
Repco	6/5/83
MSI	6/5/83
E. Lichenstein	18/5/84
Cooks Wines	31/8/84
General Properties	15/2/85
Mair	26/4/85
City Realties	29/11/85
National Insurance	29/11/85
Salmond	20/12/85
Smith Biolab	20/12/85

Appendix 6

Top 20 Successful Offerees
1/1/68–31/12/85
(based on bid announcement week returns)

Company	Return (%)
1. A & T Burt	57.09
2. McKenzies	54.23
3. Consolidated Plastics	46.04
4. Scott	35.14
5. Pavroc	32.88
6. DRG (NZ)	32.62
7. Brambles Burnett	31.78
8. Consolidated Metal Inds	29.54
9. Associated Group Holdings	28.77
10. Taranaki Breweries	28.52
11. Canterbury Timber	28.05
12. John Webster	27.33
13. Taupo Totara Timber	27.26
14. NZ Land Securities	26.57
15. Pty Inds.	25.45
16. Firth Inds.	24.90
17. Woolworths (NZ)	22.54
18. Motor Traders	21.78
19. Sharland	21.19
20. Medical Supplies	19.36

Summation

Gregg Jarrell

I would like to start off by applauding the Centre for Independent Studies and the New Zealand Centre for Independent Studies for their efforts in organising these conferences. It is often difficult to inject these kinds of results into the public policy forum, but this is the kind of work that must contribute to good public policy prescriptions no matter which way the results come out. So my congratulations to all the authors for a truly impressive effort.

We have had some excellent research presented, and also some that I think suffers from methodological problems. I will begin my comments by concentrating on the studies by Emanuel and by Officer and Dodd; then I will turn to the McDougall and Round study.

I want to start by noting that the Emanuel and the Officer and Dodd studies both focus on stock market values. Essentially they ask what effect various events have on stock prices. There is nothing sacrosanct about using stock market data; other researchers have used different types of data, particularly accounting data, to try to assess the effects of mergers and takeovers. I will deal with this question in more detail when I turn to the McDougall and Round study. Dodd and Officer's paper goes through several reasons why stock market data are superior in many respects for these questions than accounting data. I second everything they say there.

Both Emanuel and Officer and Dodd use the efficient market methodology, which basically tries to eliminate the influence of general market movements on the stock. This methodology has been used with great success in many, many applications. The efficient market hypothesis is not the result of some harebrained academic scheme, it is a very sensible hypothesis that works and has gained widespread acceptance because it works.

The strong form of the efficient market hypothesis that we hear about so much, of course, is nonsense. The strong form hypothesis says that the market is so efficient that the moment someone thinks of a better idea, the moment a raider considers making a premium bid, the stock market adjusts to reflect those changes. The strong form is rejected as soon as we realise that insiders have an advantage. Insiders can make above normal profits because they have information that the market does not have.

However, the efficient market methodology and the market model rest on the semi-strong form. The semi-strong form says that the stock market is tolerably efficient at understanding the information that is publicily available, and that it tests that information in an unbiased fashion. Among people who work with stock market data, either as academic researchers or as practitioners, there is widespread acceptance of that theory. Mountains of evidence indicate that it is very robust. As further testimony to its acceptance, the courts accept this methodology, clients of consultants accept it, regulators and legislators pay careful attention to it. So I applaud not only the focus of these two studies but also the methodology.

On the other hand there are always those who ask how we can look at the stock market performance of a firm over one week or some other short period of time and learn anything about its prospects. Who knows, in the first week of a bid, what is going to come of a merger? Who knows what lies ahead for that combination? Aren't we making some tremendously heroic assumptions by relying on the efficient market hypothesis? Those are good points. But in fact it is fairly easy for the stock market to revalue a target. There is a known bid, we know there are going to be gains, and we have to calculate exactly how big the gains are and what the probability is that the offer will go through. The job is much more difficult for bidding firms. We know the premium and we have some idea of what the bidder is going to do by knowing his track record, but it is very, very difficult.

Nonetheless, this is the best methodology we have. To compensate for the problems we try to get a large sample and aggregate the results. Both of these studies have healthy samples. The Dodd and Officer study is remarkable for its size. We are also starting to get studies from many, many countries. Dozens, maybe hundreds of studies have been done in the US; I have seen studies on the Canadian experience; stock market studies have been done on France; and now we are adding Australia and New Zealand. Now we are starting to learn and get a lot more confidence in the overall results because there are so many commonalities.

But that is no reason to completely ignore studies that do not rely on stock price evidence. It would be extremely valuable if we had a well-done study using non-stock market data, a study that looked at everything possible, earnings, output, growth of assets, and so on, to try to get at what might be called the real economic value underlying the stock market. For example, a researcher at the Office of the Chief Economist of the SEC has got hold of a tape that contains an enormous amount of data from the investment analysis community on quarterly earnings forecasts and how they change. If the argument is that targets are undervalued by the market, then when a bid is made for a target and the bid is subsequently defeated, we would expect market analysts to notice that fact and re-examine their evaluations of the target. We would expect this to lead to some significant revisions in the earnings forecasts. In fact we do not find this. These kinds of data are independent of the stock market, and when put in conjunction with stock market figures they can convince the sceptics who won't believe the stock market data and can strengthen the confidence the rest of us have in them.

Another example: a researcher named Claudio Laudierer is looking at something as simple as dividend growth. He looks at dividends of the bidder and the target after they merged over five years and compares that with the trend of dividends for the entities before they were merged, and he finds impressive gains in dividends. Now that is something people can readily understand. While they might not understand the scientific mumbo jumbo behind some of these more sophisticated studies, they are more than willing to believe you if you can show them something that they understand.

With those general comments let me first talk about Professor Emanuel's paper. He shows impressive gains to target shareholders, but he has the same difficulty that many studies have in finding returns to bidders. Perhaps this is why I am so sympathetic towards bidders. Bidders are shareholders too. One of the problems is in the measurement, as Emanuel recognises: bidders are generally so much larger than targets. It is a bit like trying to measure the weight of a fly by weighing an elephant, first without the fly, then with the fly, then subtracting. In theory if you do this a million times you will get an unbiased estimate of how much the fly weighs — but obviously there are many extraneous events that could affect the measurement.

One thing I want to point out in Emanuel's paper. He notes that the share price of successful offerees continues to rise in the few weeks after the bid. I just want to note that the reason for that is that in the announcement week the market will revise upward, but at that point the market doesn't know whether the bid will be successful. It needs more information and more time to distinguish which bids are unsuccessful, at which point the price begins to drop, and which are successful.

Now let me turn to the Dodd and Officer paper. Their sample is simply huge. It looks like every third firm in Australia must have been involved in a tender offer at some point over the last three years. From this excellent data, the paper gives us results that are truly surprising. These are the kinds of results that raise as many questions as they answer, and this is the kind of study that can truly be a lot of fun.

The first thing I note is that bidders in Australia are not of such desperate size as they are in many of the studies I have been doing in the States. There the average bidder is six to eight times as big as the target. Here they are not quite as big, but still by any measure the returns to bidders in the Australian data are enormous and a lot of work has to be done on those cases to find out why. The unsuccessful bidders do so well that we need a new adjective — it will no longer do to call them unsuccessful. Australian bidders do well if the bid fails. What is going on here? These are truly exciting data.

A completely new result that I have not seen in any other study is that the prices of unsuccessful targets do not revert after the takeover attempt is over. We have seen something similar in the US with the modern restructuring defences. For example, some of the oil firms have restructured in an effort to avoid being taken over. They see it coming and they try to carry out the strategy themselves: they hire a fancy investment banker to tell them what to do; they restructure and sell some assets; they make a big self-tender offer; and so on. Their returns are good and they usually do not revert after the offer has been defeated. The Officer and Dodd results look a little like those, and it is very exciting.

The most important chart in the Dodd and Officer paper though, for the public policy result, is Figure 11. That graph very neatly and intuitively summarises the most important points for the public policy question, and for many, many cases it is all you need to look at. This graph represents in a sense a portfolio of bidder and target firms, weighted according to the size of the firms. Returns to this 'portfolio' are charted beginning three years before the merger or takeover, and through the event of the merger or takeover itself. What this does is to measure not the returns to the target, not the returns to the bidder, but in a sense the returns to the whole pie, the total gain regardless of how it is distributed. That is very, very useful for the public policy question because when someone asks 'Are takeovers beneficial, are takeovers good on average?', that graph says no doubt about it, they are very good for shareholders. That is the most important thing for regulators to remember because regulators are supposed to protect shareholders — not target shareholders, not bidder shareholders, but shareholders.

This graph also emphasises what a tremendous amount of national wealth is at stake here. There is a 15 per cent increase in the value of the pie for these cases. If we take the dollar values involved and the number of cases involved, this would be a truly enormous figure. I would be interested to see a calculation of how much of the increase in the general value of market capitalisation in the Australian economy has been attributable to this particular type of activity over the last four or five years. It would be a significant fraction.

So that is the golden goose we are fiddling with. To my mind equity concerns must be balanced against the risk of killing or at least severely injuring the goose. Someone had to invent something and learn something and discover something to cause this increase, and they must be rewarded for that.

Now I would like to move on to the study by Round and McDougall, and Professor McDougall's summary of its results. As I intimated earlier, I think the methodology is a problem. This comes not from any kind of personal bias or any kind of ideological background; it's just that I have worked with both stock market data and accounting data, and I have seen dozens of studies that attempted to use both, and I know that it is extremely difficult to learn much using accounting methodology, whereas we have made a great deal of progress using stock prices based on the efficient market methodology.

As I mentioned earlier, the main difficulty with accounting data is that they do not discount the benefits from takeovers, and it takes time for these benefits to show up in the accounting numbers. For example, suppose two acquiring firms borrow the same amount to finance acquisitions. In one case the debt is to be paid off with a balloon payment on the tenth year after the acquisition; in the other case everything else is the same except the debt is to be paid off in ten yearly instalments. This will obviously dramatically affect the accounting numbers. In fact the McDougall methodology will miss this situation entirely because it looks only three years forward. In the accounting figures one acquisition would look completely different from the other, whereas the capital market would, in theory, be completely indifferent between these two set-ups.

I don't want to go too far. I think it is very important to try to relate the two methodologies. I think it is good for people who rely on stock price studies to try to get some kind of accounting data as well to see whether there is some association between the two types of measurments. For example, it would be very interesting to take the Dodd and Officer sample with its hundreds and hundreds of cases and use the capital market results to break the acquisitions into two camps, good takeovers and bad takeovers. Then go to the accounting data to see whether they tell a similar story. That would be a very nice check on the efficiency of the capital market and on the robustness of the tests used in capital market studies. If that comparison came out in the way that I predict would, then it would be tremendous ammunition to use against those who are, I think without reason, sceptical of the capital market methodology.

But I think it is a big mistake to declare the Mueller methodology superior, which the Round and McDougall study appears to do. Even Dennis Mueller may not think that any more, because in his latest study he relies exclusively on capital market data.

Besides the general question of methodology, I want to raise several other points about the McDougall paper. First, it looks at 88 cases. The Dodd and Officer study looks at over 1000 cases. It is impossible to say anything important about policy using a sample size of less than 10 per cent of the actual cases. Those who disagree with you can count, and they will simply say, well now it is possible that I could pick another 88 firms that you don't have and perhaps the results would be different? Yes, they could be different. Why should I look at these particular 88 firms? Because of my testing criteria. The hell with your testing criteria, we are trying to support policy and make important decisions. The results are simply not convincing unless you look at all the cases you possibly can. If your methodology constrains you and forces you to toss out all kinds of cases, then you are in serious trouble with the methodology.

Three years is too short a period of time to look at accounting figures. Before the event it is too short to establish trends. The industry may be in a recessionary period or going through some kind of turbulence and the results could be completely misleading. After the event it is too short a period to be confident of capturing all the effects of the takeovers. It is not fair to insist that entrepreneurs turn these things around in three years or else they do not get credit with the NCSC for their results.

There is at least one conclusion of this study that I can agree with. It once again shows without a doubt that target shareholders gain from takeovers. Economists have done a very good job of showing that.

Another conclusion is that there is no evidence that takeovers reduce risk on the part of acquirers. I have a couple of comments on that. First, I think risk is measured incorrectly. All the studies I have seen using the capital market methodology measure the financial risk of the combination of the bidder and the target, and compare that with their financial risk before they were combined. These results indicate that financial risk indeed declines. A second comment is that 44 per cent of these 88 cases are horizontal mergers, and the theory doesn't really operate very well on horizontal mergers. Risk declines when unrelated or contiguous operations are combined.

I have some other rather picky problems with the study. It says that in all cases there was no strong evidence to suggest that takeovers in general led to an improved performance by the acquiring firm or to a higher relative return for shareholders in the acquiring company. Now this last phrase cannot possibly be right. Shareholders do not receive accounting figures, they receive dividends and capital gains. Dividends and capital gains are not measured by this study, so that has to be wrong.

The other point is, all I am saying is that it is hard, using accounting data, to find consistent answers to answer the question, what do these entrepreneurs do? Now it comes as no surprise to many people that academic economists cannot figure out what real world practical businessmen do, and I do not think they are going to find out using accounting data. What we do know is that, in Australia and in the United States, stock price results indicate that there are big gains from takeovers. I would ask Professor McDougall this question: how in the world do entrepreneurs who pay these premiums repay the costs of their borrowed capital unless there are real gains somewhere down the road, on average? How do they attract the capital? How do they talk to bankers and merchant bankers and others who loan them their money? Why do stock prices respond positively?

Let me quote one paragraph from the McDougall paper:

> First, these conclusions suggest that the emphasis of exisisting takeover regulation on the protection of the shareholders in target firms may be misplaced. Some attention should be paid to the shareholders of acquiring firms who, in some situations, appear to have been powerless observers of the actions of corporate managers, and yet who will suffer the consequences of a poor decision. Top management should have to justify the gains expected to flow from a takeover in the light of the investment necessary and perhaps should be required to seek shareholder approval for major takeovers.

I ask, justify to whom? Justify to the bankers who are giving them the lines of credit to make these acquisitions and who wouldn't do it if they didn't expect to get repaid? Justify to the buyers of the bonds that finance these activities? Justify to the stock market, which consistently revalues these actions positively? Or justify to academic economists who use an accounting methodology to try to figure out what they are doing?

The McDougall paper asks the question, has the considerable activity in this market contributed significantly to the economic growth of Australia in the last 15 to 20 years? I think the answer to that is a resounding yes. Over $2 billion of gains to shareholders were created as a result of this activity in the last 13 years. A conservative estimate of the spillover benefits would probably add another $2 to $4 billion. This is real money to pension fund holders, to mutual fund holders; these people would be poorer but for this economic activity. I need look no further than that to answer that particular question.

And finally I would say if the author really believes in his evidence, really believes that there is no economic value or in fact negative economic value to takeover activity, then I would suggest that he start a fund. The fund would simply, on the announcement of a bid, sell the bidder short. And by the way, hold the position for three years because we have three years of accounting data that say they won't do so well. If you really believe these results start such a fund, and my money will not go into it.

I would like to close with a few remarks about the US stance over the years towards takeover activity. I think the United States made a fundamental mistake in its tender offer policy. I think that we have gone too far and that we pay a heavy price for it. In talking to people it is clear that there are some very seductive political forces that have pulled the United States down this road.

The US is a marvellous place to experiment and to learn about these political forces because you have not only the federal government but also the state governments. By watching the states and what the state administrators propose for their anti-takeover laws, and by looking at the lobbying process, we can see who really wants the law. What are the excuses being used to get the law passed? Laws are generally passed in the name of shareholder protection or equity. Believe me when those words are used it is not a good signal.

The states always pass laws that go way beyond the federal government. Why? Because of parochial interest. Who helps to write the laws? General councils of the major corporations. Who is in favour of the laws? Corporate heads and unions. Who is against the laws? Three academics from the University of Chicago who need eight years to come up with data to show that is might not be a good idea.

So we go beyond the state and look at the federal government. At the federal level there are more voices looking out for the shareholder and protecting the market from regulations that redistribute wealth for political reasons but generally reduce national economic welfare. But congressmen and the SEC still face considerable political pressure, and regulators have an interest in expanding their domain. Regulators, and I am one of them, take potshots at corporate executives for being overly aggressive in mergers and trying to expand their empires, but unfortunately regulators are guilty of the same thing.

If the United States had had the kinds of data we have seen today, and if economists had had a voice in policy making back then and had said that regulation was probably a bad idea, that it would redistribute premiums a great deal and discourage takeover activity, I think that the United States would not have gone this far. I also think that we will see some genuine deregulation in the US in the years ahead. It will take a courageous political leader to start down this road because regulations are easier to keep out completely than they are to get rid of once they are in place. But I do think there is genuine concern at the federal level that we have gone too far in the name of fairness and equality and good conscience, and that we have taxed a little too much the process that creates this wealth.

Panel Comments

Auckland

Rob Cameron
John Collinge
Alan Gibbs
Norman Johnston

Sydney

Reg Barrett
John Green
David Knott
Leigh Masel

Commentary

Rob Cameron

I just want to make a few simple observations about the general debate about takeovers, some observations about the empirical evidence that has been presented at this conference, and then briefly draw some conclusions.

The papers presented at this conference clearly indicate that takeovers are not simply about inefficient management. As the speakers have pointed out, a broader perspective of takeovers views them as a process where existing management teams with skills and abilities that have become less valuable due to changes in business conditions, get displaced by new management with more valuable skills. It is part of a general theory about a market for 'corporate control'. This is an important point. The benefits of an active market for corporate control do not just relate to the direct efficiency-improving effects of takeovers. They relate also to the positive **incentive effect** on other companies arising from the monitoring of managerial performance by directors, shareholders and analysts, and the ability of competing management teams to displace incumbent managers. In this respect, while the conference papers clearly show that the direct impact of takeovers is best measured by share prices, it is important to recognise that results based on such analysis cannot measure the indirect benefits of an active takeover market. As such, they understate the gains to the corporate sector and economy.

A central issue that has emerged from debate at this conference is the importance of companies being able to protect valuable information used in identifying a takeover opportunity. This issue is at the centre of the debate concerning the promotion of 'auctions' by pause and publicity provision. As my co-panelist John Collinge will know from the wide range of market arrangements he is called on to examine, auction-type mechanisms that may have simple stage-one economics appeal do not necessarily guarantee the best interests of either buyers or sellers in the

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market. This is especially so in complex markets in which information plays a key role. Investments in information are like any other investment. They are taken to generate returns to investors and should not be treated as a 'free' good.

My next point relates to the idea of shareholder equity. The notions of equity that lawyers talk about are rather peculiar. They do not relate to the notions of equity that are commonly used in political/economic discussions. Equity in the legal sense relates instead to the rights and duties one expects to be entailed in a share purchase. A number of people have speculated on how this might be best guaranteed. Among the economists there appears to be agreement that the best way to ensure shareholder equity in this sense is to allow companies the freedom in their articles of association to define what those rights and duties will be, and then to permit investors to decide for themselves whether to enter into such contracts. In short the interests of shareholders are most likely to be served by maximising contractual freedom and ensuring that the terms of contracts are enforced.

The final point to note in this debate is not about the relative merits of regulation versus a free market, although that is often the way it is posed. It is, instead, about the appropriate role of government in this market. The difference relates to whether the government should intervene directly in the takeover market, or whether takeovers should simply be treated like any other type of economic transaction or activity, subject to general rules of economic behaviour covering contracts, enforcements, fraud, tax, competition policy and the like.

What does the empirical evidence say about these issues? All the evidence presented at this conference (based on the share price view) is consistent with the hypothesis that takeovers do create value. However, this evidence looks only at takeovers that have actually taken place. As I have already noted, the benefits of an active market for corporate control relate not just to companies that have been taken over but also to companies that have been forced to get their act together as a result of the increasing threat of being taken over. In New Zealand we can think of a number of large industrial companies which have been placed in this situation.

Another important aspect of the evidence relates to returns to bidders. David Emanuel's evidence, which is consistent with overseas evidence, shows normal returns to bidders and higher returns to targets. It is interesting to relate this to current developments in New Zealand's corporate sector. We frequently hear that there are too many investment companies. But that is just what should be expected during a period of unprecedented economic change requiring redirection and better utilisation of corporate assets. The increased number of investment companies is simply a reflection of the competitive process whereby new entrants bid away high profits through competition for aquisitions.

That is consistent with the evidence that today, very few takeovers go uncontested by other bidders. Another observation that emerged from the evidence is that there are positive returns to successful bidders.

Much of the argument in favour of takeover regulation rests on an assumption that there is a bias against offerees — that target shareholders in an unregulated market will lose out. The results presented at this conference clearly refute that claim. As the speakers have said, the onus is on those who wish to regulate to provide their evidence. None of the evidence presented so far provides justification for any specific regulation of takeovers.

Commentary

John Collinge

Securities and Competition Regulation Compared

Much of the discussion at this conference has involved the regulation (or otherwise) of the interests of buyers and sellers of shares and securities, particularly where such activity results in a transfer of control of a company. Another issue raised by takeovers is the degree to which competition in the goods and services provided by companies involved in mergers and takeovers is foreclosed. Such issues are, of course, governed by the Commerce Act 1986. Not unnaturally, I propose to confine my comments to the control of competition in relation to shares and securities and in relation to the merged concern.

The Activities of 'Takeover Raiders'

I hear, as you do, complaints that businessmen are unable to get on with producing goods and services because they are defending themselves against takeovers — and also that such defences can be costly. The complaint, mostly from companies vulnerable to takeover, is that businessmen are worrying about having to defend their rears at the cost of moving forward.

The fallacy in this seems to me to lie in the proposition that the market for goods and services is somehow different from the market for securities. The proposition seems to be: 'We want to compete in goods but we do not want to have to worry about competition in the securities market — particularly in the market for control of a company'. On the other hand, if businesses are looking over their shoulders perhaps it will give them incentive to improve their performance in producing goods and services and to make sure such performance shows in company results and rewards for shareholders.

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Competition is an uneasy state. It is a process and a particularly dynamic one at that. It involves looking for opportunities, deciding how to exploit them, observing how others react, and deciding how to react in return. It is the opposite of a 'quiet life', which happily appears no longer to exist in the market for shares and securities.

My observations lead me to believe that, on the whole, we are the better for 'takeover raiders' and the competition they have provided in the securities market. Shareholders have benefited from increased share prices. Management has been challenged to improve performance. Directors are more aware of the totality of their responsibilities. In theory, these should result in benefits to the economy in terms of economic efficiency, but whether or not this is so in practice I leave to the research economists to decide.

The Commerce Commission's Role

With such a competitive environment in the shares and securities market, the Commerce Commission's role is thankfully lessened.

I compliment the securities industry for its general competitiveness, but that does not mean that the regulator will have no role. In fact, the Commission has two main roles in relation to mergers and takeovers:

(a) Ensuring the absence of restrictive trade practices in the market for shares and securities.

(b) Examing the effect upon competition of the merger of two or more concerns.

Suppose a number of takeover specialists have an agreement that when one is bidding for a target company the others will not intervene. That would be illegal under the Commerce Act 1986 and would be likely adversely to affect the shareholders concerned. The Commission will take action against such a practice and I think you would all agree that it should. 'Stand-off' agreements, i.e. agreements between companies not to bid for shares in each other, may also reduce competition in the securities market and prevent others from capturing control of the companies. If they do so, then the Commerce Commission should perhaps intervene there also.

If a merger means that any substantial market in New Zealand will be left with only one supplier, should we accept the absence of domestic competition without question? I think not. The Commission should examine whether the domestic market is contestable or whether overseas competition is sufficient to provide an adequate discipline upon such a market.

Mr Patterson's comment that mergers and takeovers are largely unregulated in New Zealand is no doubt true from the perspective of buyers and sellers of securities. It is not true in respect of competition between buyers or between sellers or in respect of the merged concern itself. The Commission considers itself charged by the Commerce Act 1986 with responsibility for such matters and will act where it considers that it is necessary to preserve competition.

Regulation or Not?

Drawing from these above examples, I am unable to endorse the idea that there should be no regulation of competition in the market for securities. Potential problems clearly exist. However, it is the grounds for regulation that are for me the crux of the issue. What competition laws seek is to present the private sector regulating markets, particularly after deregulation by governments. It is regulation with the purpose of encouraging competition. That is not to say that all regulation is bad. Take for example the Stock Exchange Rules. Such rules, even insofar as they create restrictions or disciplines, may be positively beneficial in defining a forum in which buyer and seller may meet.

Some economists say that if the market is contestable as a whole, then we need not worry about restrictive practices within it since potential new entrants provide the discipline that causes the practices to founder. Even if this is true, there may still be adverse effects in the short and medium term, before the market is in fact contested. Further, such practices are a voluntary barrier to entry and may affect the degree of contestability of the market or the extent of competition in any given market.

The method of regulation is also important. Regulators must act systematically, and not in an arbitrary or ad hoc manner. There should be stated policies and principles, verification of the facts, wide exploration of the interests involved, and careful assessment of the reasons for intervention and its consequences. One thing is certain: regulators intervening for good and sound purposes should act with care and caution for fear of doing more harm than good.

Commentary

Alan Gibbs

I would like to make two totally unrelated points that have not really been touched on today but strike me as important in this discussion. The first is the extremely strong investigatory powers of the Securities Commission. I find the powers of the Commission to be excessive in regard to what I think we have found today to be victimless crimes. In all the time I have been an investment banker I have never come across any pressure for or interest in the formation of a minority shareholders' committee of any sort. The principal thing I get asked by potential investors is: Who's going to get taken over next? That's where they want to be. They never ask me who is going to do the taking over. They have no fear whatsoever that they will get locked in or that they will in some way suffer. I don't know of a single example in a New Zealand public company of anybody actually being exploited if they chose not to sell their shares and become a minority. I'm not saying it has never happened, but we have not had any evidence of it.

So I say it is a victimless crime; therefore why should the regulators of this area have power equalled only by the drug enforcement administrators? These powers enable the investigating body to look into 'possible mischief', and possible mischief now includes phrases such as 'unacceptable conduct', which nobody has bothered to define. But we have seen in Australia recently, in the guise of an 'unacceptable conduct' investigation, the business affairs of some of the top and most reputable businessmen in Australasia paraded before the investigators. All their correspondence with their bankers, all their bankers' correspondence with their overseas principals, paraded day after day before what seems like nearly every second barrister in Australia, in public. Now that to me is an appalling indictment of the system.

The same powers exist in New Zealand, and I must congratulate the New Zealand Commission and its chairman on using those powers with much more moderation. I think on occasion in New Zealand they have

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Alan Gibbs is the Chairman of Gibbs Securities Limited.

been used more than was absolutely necessary, but they have certainly been exercised with a great deal more restraint than in Australia. But those powers exist and I for one see no reason for them. I do not believe a man should be treated like a criminal before he is charged with a crime.

The second point I want to make is this. I have had a very interesting experience lately, along with John Fernyhough who is here today. We are on the establishment board of the Forestry Corporation, and our experience has thrown a new light on the tremendous role of takeovers. We are one of a number of boards established to oversee state-owned enterprises that account for about 12 per cent of New Zealand's gross national product, including the energy department, the electricity department, the post office, the forest service and the like.

As businessmen we are confronting a problem of mammoth proportions. The state-owned enterprises, although representing 12 per cent of the gross national product, contribute nothing in terms of return on assets employed. The average rate of return in the private sector is 10 per cent. To change this public service culture into one that is able to stand on its feet, make a buck, pay interest, pay tax, pay dividends and hopefully make some net economic contribution is a massive task. Now how the heck are seven poor gentlemen, being paid to come down one day a month, going to give enough energy and drive and input to these massive bureaucracies to make them into anything resembling commercial enterprises? There must be some other disciplinary force that can keep them in line and motivate these people to behave in a truly commercial way.

The Forestry Corporation Board has already confronted this and we have tried to address the issue in our report. We said that without public listing and the discipline of takeovers the job will be extremely difficult. The discipline that takeovers provide in the public market is fundamental to the efficiency of our economy. It is probably one of the most positive driving forces for effective management that we could dream up. If you really analyse it, the performance of our whole public listed sector is dependent on the freedom of takeovers and the threat of takeovers. The Forestry Corporation Establishment Board said that without that discipline we do not see how the state-owned enterprises can ever perform effectively.

Commentary

Norman Johnston

I'm not to sure whether I should confess to being a lawyer or a company director, and I'm sure as hell a bit scared about confessing that I'm a member of the Securities Commission. But this is as good a place as any to pay a well-deserved tribute to the Commission's chairman, Colin Patterson, for the diligence he has used in pursuing a very difficult and controversial task, and I would not want to pass up the opportunity to do so.

I was prepared to give you the benefit of all the experience one has after a long practice in dealing with takeovers, targets and latterly being in the hot seat. Although I recognise that this is scarcely scientific evidence, as Professor Dodd has emphasised, I hope I am allowed to have the luxury of some pretty fond memories, and they tend to linger. I will only say this in relation to that catechism of experiences: if I had ever mentioned to any of the bidders I have known in the course of hostile takeovers that they were vital to the economic activity and well-being of the nation, that they were providing a praiseworthy demonstration of the economic theory relating to the appropriate allocation of resources, the reply in many cases would have been 'What sort of a nut are you?' Because in many instances, as even the economists recognise today, they are not driven at all by the desire to reallocate resources. There are plenty of other motivating elements that propel bidders to bid.

I am not about to express a firm view on the desirability of takeover regulation. I do have some difficulty, certainly less after today, concerning the efficient market hypothesis. I am glad to know that the strong form is now thoroughly discredited and is no longer acceptable at least to most of the economists here.

There are some features of our market, however, that I would like to mention, and these are only my personal observations. First of all I think the market in New Zealand is thin, and second I think there is a

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great deal of incest in it. Third, I think it is rumour-ridden and sometimes rumour-driven. Fourth, I think the total market capitalisation includes a disproportionate level of investment companies' capitalisation compared with other markets. Fifth, it is capable of being, I stop short of saying it is, manipulated. And sixth, as we have all heard, it is largely unregulated.

I guess those qualities stress the role of nominee acquisitions, and I find it difficult to refrain from a degree of anxiety in this regard. I would very much like to pose this question to some of the economists here today: do you accept the desirability of identity disclosure at some level? Is this not important for an open informed market, to say nothing of those whose task and duty it is to manage assets for shareholders? I would add that right now, of all the stock transfer lists that I see in various companies week by week, by far the highest figures are those of nominee companies, and the trend is rapidly increasing.

My second question to the panelists or the economists is this: to those who propose an unregulated takeover regime, do you also advocate free rein for those who see it as their duty to defend against a takeover even when their shareholders approve of it? I am sure this would be unacceptable in New Zealand.

Commentary

Reg Barrett

Everyone here today seems to be concentrating on whether there needs to be more or different takeover regulation. The expert opinions that we have heard, especially this afternoon, have concentrated on whether takeovers are advantageous to the companies concerned — that is, the target company and the bidding company — and their shareholders; on whether takeover activity is good or bad for economic growth; on whether the scales are properly balanced between bidders and targets. The emphasis has been largely on economic theory. But I really wonder whether economic theory is all we need to worry about.

The Australian constitution prohibits the state from establishing any religion. I do not think that prohibition is based on any economic theory. It has nothing to do with the economic welfare of Australia. In other words, economic theory is not the be all and end all of what the community needs.

Legislators say that we need laws to protect consumers, people borrowing money, people buying houses, people dealing with door-to-door salesmen, and so on. Much of this, all of it perhaps, is not based on sophisticated economic analysis. I believe that protecting investors and considering the interests of employees do have a legitimate place in the debate. As a corporate lawyer I suppose my training tells me that one matter that is fundamental is disclosure: the provision of information and the maintenance of an informed market. I believe that we do need regulation towards that end.

I realise that the spectrum I am presenting is very narrow. I know there is a Trade Practices Act, there is restriction on investment in broadcasting and television companies, there is foreign investment regulation, there is gas and electricity legislation, there are all sorts of

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other things that regulate the concentration of corporate ownership for I imagine a variety of political, social and economic reasons.

My real point is that, in the field of corporations and securities law as it relates to takeovers, economic theory, while certainly relevant, is but one factor. The main thrust of those laws is, however, the traditional aim of investor protection and market information. Economic regulation is, by and large, dealt with in other fields of legislation.

I would like to say a few words about the the work of the Companies and Securities Law Review Committee of which I am a member. We have produced two pieces of substantial work on takeovers in the form of reports to the Ministerial Council. One was in late 1984 on the question of the takeover threshold. The basic recommendation was that the 20 per cent threshold should remain, and this is still a subject of debate. The second piece of work was a report released in August 1985 on partial takeover bids. This report is about to be, if it hasn't already been, converted into legislation. We are currently preparing a discussion paper on the ability of companies to buy their own shares. Our paper covers much the same ground as the paper recently released by the stock exchanges.

Commentary

John Green

Mixed in with the debate we have been hearing today about whether there are too many takeovers is the question of what is the best way to regulate takeover activity, or if we need to regulate it at all. Many criticise the legislation we have in Australia now as being overly complex, maze-like, too black-letter, and so on. I have been one of those critics; indeed a couple of years ago I publicly called for the takeover code to be scrapped entirely and replaced by the now popular view of a system of principles with more discretion for the NCSC.

Well I now have a confession. I have changed my mind. This is partly because of my sensitivity to political reality rather than any clear economic analysis. If I were starting afresh like New Zealand I would have an open, unregulated system of takeovers, but in Australia I think we have gone too far for that. I now call as loudly as I can not for the code to be scratched but for it to be maintained — and in addition that there be a moratorium on any changes to it for a period of three years. I support what Professor Baxt said earlier this morning in that respect. The takeover legislation has been basically in its present form for five to seven years, depending on whether you take into account Queensland's early entry. During that period a number of changes have been made and even more frequently have been threatened and then abandoned. Some changes relating principally to partial bids are now pending. Those partial bid changes have been hanging over our heads in one way or another since last December and they are not yet law. In my view all of this leads to great uncertainty and higher transaction costs. The most recent legislative changes took effect in April 1986; now we are told that the Ministerial Council is to review a whole range of issues at its July meeting. One such issue is the question of whether to drastically change our present system for the now popular system of principles and

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discretion. And no doubt that will be related in some way to the debate on the desirability of takeovers per se.

Yes, the takeover laws are complex and in many cases vaguely and inefficiently drafted. But now, five years since their introduction, I believe the main players in the market and most advisers, usually merchant bankers, stock brokers and lawyers, have reached a generally high level of takeover law literacy. Most people in the game know, often from bitter experience, how it works. Sure there are and will continue to be ridiculous, strained or contrived arguments about the construction of the laws we have. There will continue to be ambiguity. With what laws is there not? But if we give this law some time to operate without any radical changes to it, those ambiguities or strained constructions will disappear. How will they disappear? Two things will happen.

First, because it will be able to look at cases on a case-by-case basis, the NCSC will have lots of opportunities to make section 60 declarations of unacceptable conduct. These declarations will act as deterrents to other players who are trying to do the same thing. I do not believe we should underestimate the deterrent effect of section 60 declarations. As an adviser I have seen that effect.

The second thing that will happen is that there will be litigation over the meanings of many of these contrived and strained arguments. I'm sure we've all heard the very trendy slogan, 'There is too much litigation in takeovers'. Well, is there? I don't believe so. There is a lot of litigation right now but I don't really believe excessive litigation will continue, particularly if we can convince our regulators to keep their hands off the takeover code for a few years.

Why do I say that? Because the cause of much takeover litigation is the fine interpretation of those ambiguities I spoke about before. The longer we leave the rules to stand the more chance there is that ambiguous points will simply disappear because they will have been decided. There will be little to litigate except, for example, whether particular directors have breached their duty to shareholders or whether the bidder or target has mislead shareholders or the market during the bid. Those sorts of issues will remain of vital importance to the parties and their legal rights.

The more change or threatened change we have, the harder it is for those who are active in the field to keep up. Perhaps more importantly, the more likely it is that parliamentary draftsmen will create more loopholes and ambiguity. For example, the pending partial takeovers legislation which is about the take effect was hurried through. It is full of loopholes — a great Christmas present for lawyers, bidders and even target directors. The draftsmen have been uniformly generous in spreading the loopholes and new tactical devices around.

Having recommended that we leave the black-letter aspect of the law basically where it is, I would suggest major changes to the power of the NCSC to make the system work better. Should we give them new discretions? Categorically, no. I wouldn't give them any new discretions at all; they have all they need. Let me give you a list of some of them: the power to investigate and collect information even by compulsion; the power to hold hearings; the power to declare conduct unacceptable; the power to prosecute; the power to intervene in other people's court proceedings; the power to revoke dealers' licences; the power to issue guidelines about how they believe the system should work; and the power to register part A statements.

I would expand one of their existing powers and remove two of them. I would expand section 60. The wording in section 60 is narrow, restrictive and outmoded. We need to make a much clearer statement that section 60 declarations can be made where there is a breach of the spirit of the law. Equally importantly, I would extinguish the NCSC's power to hold hearings, not because I don't trust them or because they don't do it well. They work hard and are under terrific pressure. But I believe it is inappropriate that the public watchdog should sit as inquisitor, judge and jury at the same time, a view that, I think, Professor Baxt shares with me.

Rather, I would create a takeover tribunal, which would be constituted by a panel of experts including at its head someone with the status of a judge but not necessarily a judge. It could be a banker, a solicitor, an economist, a stockbroker, someone who would have the status and reputation that people would respect. It wouldn't be bound by the rules of evidence; that would stop it be oming a lawyers' picnic perhaps. The NCSC would make its investigations and when it was satisfied or when it suspected that there was a breach of the code or unacceptable conduct, it would convene the tribunal. It would put its case to the tribunal, call witnesses and cross-examine people, and other interested parties would also have that right. The tribunal would decide if conduct was unacceptable, not the NCSC.

Commentary

David Knott

I would like to single out one or two matters. First I would like to put a slightly different emphasis on what John Green just said about black-letter law and how we should be regulated. I have long been a proponent of moving to a system that encourages a greater reliance on discretion and that discourages further growth in complex legal issues of regulation. In particular I would welcome a regulatory regime that lessens the incentive for takeover protagonists to use the court system as part of their tactical weaponry. I can only say that recent pronouncements and conduct by the NCSC have in my opinion done a great disservice to those who advocate this approach, at least insofar as it is contemplated that the NCSC might play a prominent role in the expanded exercise of discretion. In view of the legal proceedings that were instituted in the Victorian Supreme Court last evening I am constrained from developing these comments as I had originally planned. In particular I must avoid any matters that are now before the court. So I shall simply observe that market perceptions of standards of impartiality and of procedural and intellectual competence are fundamental to the questions of what discretions should exist and by whom and under what processes they should be exercised. Rightly or wrongly one is forced seriously to question whether the NCSC could command sufficient confidence within the securities industry to make a successful transition to a more discretionary regime in which it would play a leading role.

Second, from a banker's perspective I would like to comment on one aspect of the investigative powers and procedures of the NCSC in the takeover context. As you know the NCSC has very extensive powers. It conducts hearings both in camera and in public. In recent times borrowers and their bankers have been subjected to complete public scrutiny of the funding arrangements supporting takeover bids. Now I don't for a moment suggest that evidence of banking arrangements should be immune from the inquiry process, nor am I

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directing my comments to the merit of any specific investigation previously undertaken or presently underway. But by way of general caution I would strongly stipulate that arrangements between bankers and borrowers are of such an essentially private and commercially sensitive nature that their confidentiality should be respected as a matter of presumption. If and only if, after a preliminary private inquiry, there is reasonable cause to believe that disclosure of those arrangements will assist in establishing a breach of the code or an act of unacceptable conduct, should the NCSC be at liberty to expose those matters to public scrutiny. Warthogs, elephants and other such species may make for amusing reading but they hardly indicate any reasonable expectation that the investigatory powers will be exercised with a sympathetic regard for the legitimate claims of commercial confidentiality. We and the NCSC alike should be alert to the possibility that defenders will increasingly seek exhaustive examination and disclosure of all banking arrangements surrounding the offer purely for tactical reasons and with no real relevance to the takeover itself.

Third, at the risk of stating the obvious or restating what has been spelt out by others, may I just reflect on the enormity of the challenge confronting those who seek to ensure that the takeover debate is well balanced. They of course initially confront the politically motivated, whose survival depends on maintaining the class warfare mentality that for so long has arrested the progress and economic well-being of this country. Additional problems in promoting a valid debate arise first from the sheer complexity of the subject matter and the difficulty of communicating the facts and issues to the public. Second, most politicians are not interested in coming to grips with the subject. Third, the apparently interventionist preferences at senior levels of the NCSC, although normally couched in the sweet voice of reason, are widely suspected throughout the securities industry to have become quite deeply ingrained. Fourth, ironically, there is short-sighted and introspective lobbying from business leaders who either have completed their takeover expansion phase and would be happy to deprive competitors of similar opportunities, or more likely simply want to cushion themselves against takeover threat. These are usually the very same people who wholeheartedly support economic deregulation and promote free market practices in other areas.

The combination of these forces is extremely powerful and may even prove to be irresistible. Yet there may be some hope when the Australian Treasury can produce and publish a paper of the quality of its recent 'Some Economic Implications of Takeovers'. There has also been some very fine material indeed delivered today by keynote speakers. I hope that those of us who feel able to make a contribution to the political process will not simply lie down because we fear that the odds are insurmountable.

Commentary

Leigh Masel

My one regret today is that this debate did not take place in 1980 when the NCSC was first established. I don't think it is appropriate for me to get involved in back-seat driving, but I do want to say something about when the NCSC was first established and what the early published thoughts of the NCSC were, and I want to conclude by repeating some remarks I made in January 1985, shortly before I stepped down as chairman of the NCSC

First of all I have to tell you that in 1980 there was economic illiteracy on the whole question of takeovers in this country. I searched in vain at that time to get some illumination from various people concerning the impact of economic principles on the takeovers code. All the noise was coming from lawyers or merchant bankers or lawyers who had become merchant bankers or vice versa. Very few people were interested in this particular field. I would like to acknowledge a debt of gratitude to Bob Officer on this score. In that early period he visited the United States and he was good enough to send back to me advance copies of some of the papers that were being given by people such as Bradley, Jensen and Gregg Jarrell. I really valued his contribution at a time when we were trying to establish something new. I would also like to pay a tribute to Professor Henry Manne who was present with us at this conference. He was the pioneer of takeover thought and philosophy. He was talking about this subject way back in 1964–65, and his remarks always seemed to capture much of my own mood, thought and philosophy.

Having come from the private sector to the NCSC I believed that the market could be a powerful regulating force. I was familiar with the arguments about corporate control; I used that terminology in those early days when I was trying to establish a coherent ideology for the NCSC. My one reservation was that the market should be informed,

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efficient and competitive, and those who are lawyers will know that those words have been enshrined in section 59 of the Companies (Acquisition of Shares) Act. I also tried to put those words into section 60, which gives the NCSC power to declare an acquisition unacceptable and power to declare certain conduct unacceptable. I was very disappointed to find that those words, 'to ensure that acquisition takes place in a competitive and efficient market', were rejected by the parliamentary draftsman who believed that they would prevent the court from reviewing a decision made by the NCSC.

Another observation I would like to make about those days is that I asked for an economic research unit to be established within the NCSC. The SEC appeared to have been in trouble in the early 1980s because the regulatory system was dominated by lawyers and by people who seemed to have favoured positions because of their knowledge of the SEC and its workings. I studied those problems very carefully and it was clear to me that an economic research unit was essential if we were going to pursue effectively the question of market control. That appeal fell on deaf ears.

I want to conclude by referring to some observations I made in 1985, before I knew who my successor as chairman would be. In January 1985 I identified two recurring problems: the relationship between the courts and the NCSC; and the relationship between the NCSC and parliament.

On the question of the relationship between the courts and the NCSC, I said at that time that I believed that there was some misunderstanding of the role of the court and the role of the regulatory commission, particularly as regards their different methods of decision making. The regulatory process in some cases may take the form of fact finding. But in some matters it may also assume a quasi-legislative function, which has prompted learned commentators to describe regulatory commissions as 'government in miniature'. The public interest or the striking of a balance between parties in issue is achieved by the commission through the formulation of policies. Policies are achieved by rationalising experience. The methodology of a regulatory commission tends to be deductive, inasmuch as the decision-making process begins with an investigation, then reaches conclusions, and then draws inferences from those conclusions, in some cases in order to make decisions about a particular situation and in other cases to formulate policy. On the other hand, the methodology adopted by the court tends to be inductive. The task of the court is to find the facts and to estimate the weight of evidence to be attributed to those facts in light of the legal principles that assert something about those facts. The judiciary has the responsibility of settling controversy among private parties and interpreting the law — but not of formulating policies.

As I said in January 1985, it was to be expected that differences in the methods of decision making will in time cause tension. When the courts are called upon to handle economic subject matter, they must frequently adjudicate upon issues intimately connected with the public interest. The traditional methods of interpreting statutes by and through the courts have been aligned more to received categories of common law thought than to articulation of government policy. Whenever the law is used to advance an economic policy, for example takeover regulation, difficulty will be encountered at times in the court in an attempt to blend legal concepts with economic concepts.

I also had something to say about the relationship between the NCSC and parliament. I see this as a task of assessing what the work of a regulatory commission should be and how it should be expanded or indeed curtailed. Isn't that the final responsibility of parliament? Since parliament controls the purse strings, it ultimately determines what a commission can and cannot do. Parliament offers frustration, as well as opportunities for new directions. Parliament determines the character of the legislative standards under which a regulatory commission may operate. Those standards will most certainly determine the success or failure of the commission's operations. The full potential of a commission as an administrative body cannot and will not be realised if the legislature is unable to define its objectives with clarity or, assuming that they are clearly defined, if the commission lacks flexibility in carrying out those objectives. A regulatory commission that inherits directions that may be overly explicit and mechanical on the one hand, or standards that are vague and contradictory on the other, is in an unenviable position. Instead of parliament having the final power to govern, it will in effect be abdicating its responsibilities to the courts. And I think that this in fact is the stage we have reached in Australia.

Professor William Carey, a former chairman of the SEC, said of government regulatory agencies that they were like step-children whose custody is contested by both congress and the executive but without much affection from either of them, and that any agency is literally helpless if congress or the executive is either uninterested or unwilling to lend support. Professor Carey was speaking of his experience in Washington, but I believe as far as Australia is concerned the NCSC is more like a step-child that has been wholly abandoned by the parliament. I believed in 1985 and I still believe that many of the difficulties the NCSC is experiencing have arisen because of the administrative and political model that has been created. Because the NCSC is not directly accountable to parliament in the Westminster sense, it is almost impossible to obtain support for the work of the commission either at Commonwealth or at state parliamentary levels.

I want to conclude by elaborating on something that was mentioned by John Green from the floor concerning the role of the NCSC and the

Ministerial Council. The mandate that has been given to the Ministerial Council and to the NCSC arises as a result of a political compact that relates to power sharing between the Commonwealth and the states. That mandate is fairly limited and it speaks about the need to have uniformity of legislation and uniformity of administration in the area of company law and regulation of the securities industry and sifts out those public interest factors which were relevant.

A number of public interest issues arise out of takeovers, many of which have been mentioned today. They range from labour employment policies and external debt for financing takeovers to competition law. My belief is that while the debate certainly should take place at a Ministerial Council level on some of the issues, decision making involves a much wider area than the Ministerial Council. I think there is a perception that some decisions are being made by the Ministerial Council on public interest factors other than those relative to the well-being of the securities market, and those referred to in the 'Formal Agreement' which, of course, is the political compact arrived at between the Commonwealth and the states, and upon which the cooperative scheme for companies and securities is based.

Discussion
Auckland

Max Bradford (Chairman): The time has come to open the floor to questions. First I would like to propose that Colin Patterson have the last word today, so when the general discussion is finished he will have the opportunity if he wishes to respond to the comments and to sum up today's discussions. Just before I open the floor to questions, Alan Gibbs would like to comment on Norman Johnston's point about nominee companies.

Alan Gibbs: I have never seen any justice of any sort or any merit whatsoever in this concept of disclosure of ownership. It is an absolute right of normal law to be able to conduct one's affairs in private. You can do just about anything through a nominee. You can buy and sell real estate, you can enter into a contract, you can run a whole business through a trustee as a front. The only reason people want disclosure of ownership in regard to shares is so they can benefit from it. Why should I as an investor know that Mr Brierley owns 7 per cent of a company or that he is increasing his shareholding? The only reason for me to know that is so I can make a profit out of his skill, out of his intention. Why should I need to know what his intentions are unless I want to steal them? The whole concept of disclosure of ownership is really about trying to steal the benefits of other people's intentions and it is a matter on which I feel extremely strongly. I have never heard a justification for the idea of disclosure of ownership that did not amount to transferring property rights from one shareholder to another by trying to piggy-back on a shareholder's intentions by knowing his identity. I would like to hear of any other reason, if anyone can give us one, why there should be any form of disclosure. Disclosure may be justified for people in positions of responsibility such as directors or insiders, but I am not referring to that situation. I am referring to another participant in the market place being required to disclose his identity at any level.

Question: I would like to address a point that was touched on early this morning and then dismissed: the question of defensive tactics. The papers delivered today suggest that the poison pill and other such defense tactics should not be regulated against because they are part of a free market. Now I will just raise this question: is the analogy appropriate to the raider situation, that an open market is important simply because it allows people to make proper decisions, really applicable to poison pills? I ask because what happens with poison pills is that while the company is going along smoothly and there is no raider on the horizon, a general meeting is called to pass the resolutions to put them into place. Then the raider comes along and bang! the poison pill pops out and the company is takeover-proof. The shareholders have no discretion about what happens. Now if shareholders were voting on the poison pill at the same time as they had the offer for a high price, to my mind as a non-economist, that would be a true comparison. But in fact companies are being locked up by shareholders who do not understand what is going on and at a time when they do not have a proper comparison to the price they might get as opposed to whatever benefits there are for locking the company up.

Jarrell: I think that you have focused on the right thing, which is shareholder approval. In the United States poison pills are not subject to shareholder approval, whereas traditional shark repellents, which are amendments to corporate charters, need shareholder approval to go forward. Poison pills are essentially a special type of preferred stock issue or some other device, the authority for which has already been voted in. Twenty years ago it was a standard business practice for shareholders to give directors and managements standing authority to offer a special type of preferred stock as the business conditions warranted. That was usually back in the days when nobody had even heard of a poison pill, but that is the authority upon which, in the United States, the modern poison pill is being put in. It is very objectionable because it has not received shareholder approval. Other types of shark repellents, although they are not as effective as the poison pill, must receive shareholder approval. We have done studies of this at the SEC and there is no evidence whatsoever that shareholders are not capable, given a little time and a little experience with these devices, of figuring out whether they will be helpful or harmful to their interests.

Let me just point out that no matter how effective a poison pill or a defence tactic is, to call it bad for shareholders is to judge how directors would use it and that is very difficult to do. All a defense tactic can provide in the limit is veto power to managing directors over unwanted takeover bids. That is the most it can do and to say that it is harmful is to say that directors would abuse this veto power to defend themselves. That conclusion is not at all clear just from the evidence itself, but what we can learn from the evidence is how managements actually use these devices and how courts allow them to be used. The stock price reactions to putting in a poison pill have not been pleasant but they have not been excessively bad either.

Having said that, let me point out that poison pills are probably public enemy number one with the SEC right now, especially with the chairman. He thinks they are a fundamental recapitalisation that shareholders should get a shot at. But there is no suggestion whatever that if shareholders voted on something the vote would be wrong because it came well before a bid was known. That is a rather paternalistic attitude. If you are a shareholder you have to know what you are doing when you vote, and if you vote something in you cannot come back a year later and say I wouldn't have voted for it if I had known this.

I am not in favour of the federal government regulating poison pills. I think the federal government should stare at them and think about them, the chairman of the SEC should give speeches about them, we should do studies of them, we should try to tell institutional shareholders about them, we should try to encourage corporate chairmen of the board to think seriously about what they are doing, and so forth. But I prefer to rely on the individual states for any specific regulation. I think that promotes a lot of activity, a lot of discipline between the states, a lot of national competition between those court systems.

Question: I would like to ask Alan Gibbs a question on nominee companies. The reputation of the securities market at the moment is under scrutiny because of the question of insider trading, and the importance of about five to six weeks' trial for the bid is seen in the graphs that we have had presented today. I'm not sure whether that five or six week period of speculation, rumour, insider trading and so on is important in the whole concept of this or whether it just drags down the reputation of the market further. If we favour nominee companies from your point of view, should we weigh that against the problems of insider trading damaging the reputation of the whole market?

Gibbs: That is the same old story: if you have a problem in terms of a crime do you treat everyone like a criminal? Insider trading is not a crime in New Zealand, and if it was deemed to be a crime I think there would be a huge debate about what constitutes an insider and what constitutes superior information. Most participants in the market place have different information, and many people legitimately acquire information superior to that of so-called insiders. So you cannot just assume that there is one big crime called insider trading and that all the people who do it are wicked and all the others are good.

But even if it were like that, why should the goodies be deprived of a normal commercial way of conducting their affairs in private, because there are some baddies out there doing the same thing? I suspect the baddies would have no trouble using individuals with proper names and identities to do their covering for them if they wanted to, and the absence of nominee companies as such would not in any way inhibit an inside trader.

Question: May I ask Mr Johnston his view on nominee companies?

Johnston: I do hold a strong view on nominee companies and I think it is now and has always been the view of the Commission as a whole. I believe there are real reasons, lots of them, for the disclosure of shareholder participation beyond a given level. The reason for that belief is that the whole structure of corporate law is based on the fact that directors owe duties to their shareholders, and it is impossible for them to owe these duties to nameless people. We have felt on the Commission, for that and a number of other reasons, that the directors are entitled to know, as are the other shareholders, who their fellow shareholders are. The reason directors sometimes wrongfully restrict the availability of the register is simply that they do not want other people to know who the shareholders are. The register is supposed to tell the members of the corporation who their fellow members are. This is pointless, of course, when the register is full of nominees.

This is not just little old New Zealand doing its own thing, because I know of no sophisticated jurisdiction in the Western world that does not have this requirement.

Peter Gorringe (New Zealand Treasury): There is one small part of the economic argument that has not been brought out yet today and I would like to say a little about it. In at least one of the studies cited today we have seen that offeror companies in a series of takeovers have not improved their performance, but have stayed around about the same performance. I would like to make two points about that. The first is that this is quite consistent with the share price evidence we saw, that at the time of takeover there was not any substantial movement of the share prices of offering companies. Second, it is not correct to infer from this evidence that takeovers do not create value because, as we have had explained to us, the proper measure of the value created in a takoover has to take into account the changes in performance of both offerer and target companies. These studies did not do that and so do not say anything directly about whether takeovers create value.

Comment: I think this is completely consistent with the idea that in fact the market for corporate control is pretty competitive. There are not many excess returns available. Also, just elaborating on your point about it not proving that takeovers are value-creating, for a number of those acquiring companies there is an acquistion program already built in. This means that any expected gains are already reflected in the share price.

Chairman: If there are no more questions, I will ask Colin Patterson to exercise his right of last reply.

Colin Patterson: I do not mind telling you that this question of regulating takeover activity is the most difficult commercial law question that I have faced, and I have faced some pretty tough ones in my day.

I was for some twelve years chairman of the Contracts and Commercial Law Reform Committee (CCLRC). I suppose my first essay into commercial law reform followed the collapse of the Securitibank Organisation, when the pressure was very strong to amend the Bills of Exchange Act in order to prevent the kind of activity that Securitibank was carrying on. It may interest you to know that I held the view that if those amendments had been enacted it would have been the end of the commercial bill market, and I therefore opposed them because I saw in the market for bills of exchange a novel financial instrument as far as New Zealand was concerned that showed tremendous promise of being of the greatest value to our commercial sector. The committee wrote a report saying that we wanted to preserve the commercial bill market as a financial medium operating in New Zealand, and fortunately, you may think, our advice was accepted and the bill market now stands as a remarkable financial tool. We have had experts from Hong Kong coming down to see how our bill market works, and I think at the moment something like $1 500 000 000 is outstanding in commercial bills. So I come to you with a fair body of experience in commercial law reform and I confess to you that I find this question of takeovers the most difficult I have ever encountered. Our notable contributors today, if I may single out names, are obviously Dr Jarrell and Professors Emanuel, Dodd and Officer, and on your behalf and certainly mine I want to compliment them on their presentations and thank them very much for bringing an international perspective to New Zealand.

Of the three empirical studies we have discussed today, those from the United States, Australia and New Zealand, there is one feature that arrested me, which I intend to explore. I thought the three studies showed a remarkable broad similarity of results. This is again a matter of first impressions, but looking at the graphs does it not seem odd that the pictures presented in the three jurisdictions seem to be broadly similar? Dr Jarrell observed minor differences in the pre-bid phase, but the overall pictures look remarkably similar. Yet we have profound differences in the three legal regimes. I mentioned eight points of difference between US law and New Zealand law because my mind was directed towards the US position by Dr Jarrell's fascinating paper. There are equally profound differences between ourselves and Australia, not least in the types of activities we see going on across the Tasman now in front of the National Companies and Securities Commission. But there is a deeper difference too in that Australian companies, so I am told, may not purchase their own shares. So if in fact these three empirical studies do show a remarkable similarity, and we will have to test that, what inference do we draw from that about the impact of the legal regime?

We all go away from today's conference with much to think about. I think an appropriate note to close on might be another quotation from Adam Smith. He wrote in *The Wealth of Nations* something like this: 'If you are in doubt, by far the best policy is to allow events to take their natural courses'. I'm not sure whether I am persuaded yet on the shape of law reform, but I will go back to the exercise with that overriding policy in mind. When the Commission meets to come to conclusions on these questions, you can take it from me that we will allow events to take their natural course.

It has been a very interesting day for me and I can only compliment the New Zealand Centre for Independent Studies for the quality of the speakers they brought here, excluding myself of course, and thank them for initiating the kind of debate that the Securities Commission has always been anxious to support and foster.

Discussion
Sydney

Maurice Newman (Chairman): I will open this afternoon's discussion by giving the floor to Fred McDougall if he would like to respond to Gregg Jarrell's comments on his research.

Fred McDougall: Since I consider that our study has been the subject of a conspiracy today I do think it is important that I respond to some of the comments made. It is a great pity that Dr Jarrell did not have the opportunity to look at the major study by David Round and myself. My paper today was very much condensed and was by no means supposed to be a rigorous analysis of our study. His criticisms are answered in the major study rather than in the paper I read today. In particular, he is quite wrong when he says we relied only on accounting measures of return to shareholders. We do provide an analysis of dividends and capital gains to shareholders in both bidding and target companies in a takeover. It is also incorrect to say that we looked at only three years before and after. In the major study we look at up to five years before and five years after. Our sample consists of 88 takeovers because we were concerned only with successful takeovers. Dodd and Officer are concerned with successful and unsuccessful takeover offers, which makes a big difference in the numbers.

I have no argument with value creation. I don't understand why that argument arose because we clearly pointed out in our paper that returns to shareholders in target companies were substantial. I think we found gains of something like 30 per cent, which is not all that different from the Dodd and Officer paper. It is interesting to note that Dodd and Officer agree with us about the performance of acquiring companies. We both identify them as being good performers, in terms of both abnormal returns and accounting profits. Where the differences occur is after the takeover. This raises a question in my mind about the measurement of abnormal returns after a takeover. Is a relationship established sometime before the takeover offer appropriate to measure returns after a takeover? A takeover can have a significant impact on the model used to measure returns for particular companies.

Question: First I would like to endorse Mr Masel's comments that it is unfortunate that this discussion did not take place in 1980. There were a few voices urging this sort of discussion then; unfortunately those voices were not heard.

But to get to the question I want to ask Gregg Jarrell. I wonder if you could expand on what you have learned from the research undertaken by your office about the effect of regulation on the market for corporate control. I have heard for example that premiums have gone up since the Williams Act, and I have heard people say that the fact that premiums have gone up is one of the good things regulation has done. It reminds me of the old trick: we calculate the average height of people in this room and divide them into two groups, those below average and those above average; then we shoot all the short people, recalculate the average and say look what a good thing we have done. I wonder whether regulation has done that. It has stifled the marginal takeovers and so inevitably we are left with a higher average premium.

I would welcome any knowledge we could obtain on just what regulation has done to the relative gains and losses in the whole process.

Jarrell: The evidence on this is very clear and it comes not only from the US but also from data on the French and Canadian experiences. The evidence is that disclosure and delay regulation does indeed result in a rather large increase in the premiums to target shareholders, and that that comes about through inducing an auction-style contest. Consistent with that notion is the evidence that returns to the bidder have been reduced and that gains from takeover activity have been redistributed from the bidding firm shareholders to the target firm shareholders. There is also evidence, and I think this is very important, of a deterrent effect of regulation. That is, if we measure the extent of takeover activity before the Williams Act using certain sorts of scale measures, we can see that there is less takeover activity now. Although it appears to be an absolutely large amount of activity, relative to the activity in the overall economy it is now less. This is also true in the French data and certainly it is true of state takeover laws. The evidence is very striking in the United States.

It is true that there have been good results of regulation as well. Certain practices that people would regard as unfair in the unregulated environment have been made illegal and eradicated. But economists are asking, at what cost? If we deter an activity that is this valuable to society, not only directly but also with respect to the spillover benefits, we must ask ourselves some very serious questions about whether it is worth the cost.

The evidence is clear: regulation of this market can have a very dramatic effect. It is not a trivial issue. Regulations can dramatically affect property rights and information and economic gains in engaging in this kind of activity.

Question: Could I address a question to Mr Masel? What do you think at this stage could be done with NCSC to improve the way it operates? Also, do you think that John Green's idea of having a separate tribunal to chair takeover disputes within the framework of the NCSC as it exists is a good one?

Masel: A view that has been attractive to me for at least a couple of years is to expand the role of the Trade Practices Tribunal, rename it as an Economic Assessment Tribunal or some such name, and refer matters involving the intersection of law and economics to that particular tribunal. I think the Trade Practices Tribunal is underutilised. It has a basic understanding of economic issues; its composition is appealing to me, being a mixture of lawyers, businessmen and economists. My own belief is that the chief role of the NCSC should be to provide input into policy making. That is what it was designed to do, to work out policies acceptable to both the Commonwealth and the states. The concept of an Economic Assessment Tribunal appeals to me, and I think it is something that ought to be pursued.

Question: I understood your earlier comments to mean than you would favour transferring the accountability of the NCSC from the Ministerial Council to the federal government. Can you elaborate on that view?

Masel: Yes, I would like to see a separate securities commission created which would take over the functions of company law administration. In 1978 when the present model was conceived, the type of market with which we are now dealing was unknown. Today the market is both national and international, and it seems to me that the most appropriate way of dealing with it within the Westminster system is to give the necessary powers to the Commonwealth and administer them through a Commonwealth agency, preferably located in a capital city close to the market.

I think the work of the Commission has been downgraded by the inability of parliamentarians to understand what is involved. At present the nature of the political compact is that the Commonwealth parliament must pass the legislation in the form dictated by the Ministerial Council.

Bob Baxt: I would just like to make a comment on one line of argument that has been advanced. I don't agree with the conclusion that we should leave the takeovers code as it is. That is the easy way out. When we have a bad law or a series of bad laws, we pay a very heavy price. It would be lovely to see things stay as they are but I am just not convinced that we are going to see judges hand down some sensible, coherent, consistent judgments in this area. We have six states, litigation can be brought in any one of them. The price business has to pay for that is enormous. I am very surprised that the business community has not lobbied vigorously for the change of this cooperative system to a federal system.

We have been very patient in terms of seeing how this system has been operating. It has been going now for eight years. I am not saying let's throw it all out and start again. What I am saying is that the time has come for us to really look carefully at what we ask judges to do. I recall, only ten years ago, making a very bold suggestion at an education conference that judges might attend seminars to learn about a new economic law. I was told that this was the most ridiculous suggestion the judges had ever heard and that law teachers should not impose their views on judges by trying to teach them the law. I now know that judges do hold conferences and they do ask academics and others to come and address them. But it has taken a bit of time to get those views across.

I think our current regulations are a major problem. I don't think it is as simple as let's wait and see.

Newman: We have had what has clearly been a mind-stretching day and I think it is probably better that we terminate at this stage rather than go on for the sake of going on. It is invidious for a chairman to summarise what has been said but I would like to share with you some of the things that I have got out of today.

This morning I was particularly interested in the paper delivered by Henry Bosch. It confirmed in my mind, if I needed any confirmation, that the NCSC is really an instrument of policy, of social policy and power, wrapped up in the guise of equality of opportunity but usually far more concerned with equality of outcome. If the NCSC intends to preside over an efficient market, it seems to me its course is incompatible with that goal.

The question of whether we need to increase the size of the NCSC leaves me a little ambivalent. I can see the argument that there is considerable work to be carried out by a staff that is inadequate for the task. On the other hand, I know that if you increase the size of bureaucracies you immediately open the opportunity for extending legislation, whereas I suspect that what we should be trying to do is to dismantle some of the existing legislation and give them less to do.

This afternoon I was very interested to hear from Fred McDougall that the NCSC had decided on the methodology to be used in his study, and I know that he and Round had only five months to prepare that study. I wonder if they had that time again and if they had the freedom of choice whether in fact they would use the methodology they did.

Finally I was reminded of a rather off-hand comment George Stigler made ten years ago: he said that shareholders and investors have not benefited by takeover regulation. I am unaware in the United States if anyone has refuted that somewhat innocuous comment. Yet there has been no public demand in the United States let alone in Australia for regulators to prove that they and their regulations have done more good than harm. Perhaps someone should put to them that that is something they should have to prove to us, rather than the other way round.

It only remains for me to say thank you to all of you for having taken the time to attend this conference. I must say I am somewhat disappointed that there were so few practitioners present in the audience. That doesn't reflect very well on the state of awareness or the desire of practitioners to become more fully aware of the various points of the debate; and perhaps it indicates that practitioners are reasonably happy with the state of affairs and may even want to see things become more complex. Nevertheless I think you will agree that the Centre for Independent Studies has put together a collection of speakers the like of which has never before been convened on this topic. I think we have surpassed ourselves today in the quality of papers and the depth and intellectual sustainability of the discussion and debate. And again we owe all of you a debt of gratitude for having come and participated.

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