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Are Corporate Takeovers In The Nation's Interest?

Ellen B. Magenheim
Swarthmore College, emagenh1@swarthmore.edu

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ARE CORPORATE TAKEOVERS IN THE NATION'S INTEREST?

ELLEN MAGENHEIM

Ellen Magenheim is an assistant professor of economics at Swarthmore College.

Economists, lawyers, and investment bankers often predict the recent high level of corporate mergers and acquisitions cannot be sustained. Yet in the first half of 1987 alone, 2,056 takeovers were announced totaling $106.3 billion.

Some of last year's largest takeovers included US AIR Group's purchase of Piedmont Airlines, Inc. for $1.7 billion and Security Pacific Corporation's buy out of Rainier Bancorp for $1.1 billion (the latter may have been the largest bank merger in U.S. history).[1]

Despite recent tax law changes, insider trading scandals, anti-takeover measures adopted by potential target companies, and regulatory restraints imposed by wary state legislatures, the frenetic pace continues. Mergers and acquisitions are not only a high stakes drama on Wall Street; they have become a significant force in the U.S. economy.

Some claim corporate takeovers affect the economy positively—a belief reflected in the following passage from the 1985 *Economic Report of the President:*

> The available evidence. . . is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management.[2]

A comprehensive evaluation of existing evidence, however, indicates these assertions may be too sanguine. Takeovers may indeed have some positive economic impacts, but they have some negative ones as well—inside and outside the firm. Equally important, we simply do not have sufficient evidence for a definitive conclusion. Corporate takeovers may increase the wealth of some stockholders but decrease the wealth of others. They may improve management efficiency or simply cause disruptions. They may strengthen the financial standing of some but cripple other companies with debilitating debt. And certainly, there are unanswered questions about a takeover's unsettling impact on employees and communities.

Such uncertainties suggest a black and white analytical sketch of the impact

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of corporate mergers and acquisitions will not do. What we need is a full portrait of their impact—one that conveys the various shades of meaning embodied in this powerful economic trend. That evaluation will take time; but given the extent to which mergers and acquisitions are reshaping the U.S. economy, it is an exercise we cannot afford to neglect.

AT ISSUE

Questions regarding takeovers can be divided into four broad areas: (1) What motivates a firm to make a takeover bid, and why do particular firms become targets for acquisition? (2) What are the effects of takeovers on stockholders in both the acquiring and acquired firms? (3) What are the external effects of acquisition, especially on employees and local communities? (4) How have state and federal policymakers responded to the increasing importance of takeovers in the economy?

Mergers and acquistions are not only a high stakes drama on Wall Street; they have become a significant force in the U.S. economy.

Why Takeovers Occur. There is much debate about why bidders pursue mergers and acquisitions. Supporters of the current wave of takeover activity, such as Professor Michael Jensen of the Harvard Business School and Mesa Petroleum Chairman T. Boone Pickens, argue that corporate acquisitions, especially hostile takeovers, effectively discipline entrenched management and restore the competitive spirit of U.S. corporations.[3]

This view is based on two assumptions that can be tested empirically. First, it suggests target companies perform poorly relative to other non-target firms and especially to those firms seeking to acquire them. Second, it suggests target companies will perform better after a takeover than they did before.

Research shows, however, target companies are at least as profitable as other corporations and in many instances as profitable as the firms acquiring them.[4] For example, 15 target companies in large hostile takeovers that occurred in 1982 and 1983 had provided their shareholders with an 18-percent rate of return, well above the average rate of return for all corporations during those years.

Evidence, then, does not support the hypothesis that economically inferior corporations serve as targets for stronger, more aggressive competitors. This, however, is only one theory as to why acquisitions occur. Others fall into two general and somewhat contradictory categories: Acquiring firm managers are motivated either by the desire to increase shareholder welfare or by a desire to increase their own welfare, perhaps at the expense of shareholders.

For target firms, stockholders benefit regardless of the motivation behind the acquisition. Shareholders in acquired firms walk away with premiums that are on average 50 percent more than pre-bid share prices. In some cases shares double in value. Such was the case when Greyhound acquired Verex and Johns Manville acquired Olinkraft. This is an undeniable acquisition benefit.

For shareholders in acquiring firms, however, takeover announcements may be cause for concern, not celebration.[5] Stockholder wealth in acquiring firms may increase (or at least not decrease) following acquisition, as the firms gain financial strength or perhaps even monopoly power in the marketplace. If the acquisition is designed to enhance management (not shareholder) welfare,

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however, shareholders could find their shares declining in value. For example, if managers acquire a firm because their compensation is tied to asset growth, or to gain "psychic" income, or to make their companies larger as protection against a takeover, shareholders may suffer losses if the merger is not a good one. In effect, although managers may benefit, the acquisition lowers the market's expectation of the firm's future performance, which, in turn, causes stock prices to fall.[6]

Indeed, growing evidence shows shareholders in acquiring firms suffer economic losses, especially in the long run, after an acquisition. Shareholders in acquiring firms can expect a rate of return that is five percent to 16 percent less than projected for one to three years after a takeover.[7] The projection is based on the acquiring firm's performance before the takeover.[8]

Takeovers may indeed have some positive economic impacts, but they have some negative ones as well—inside and outside the firm.

The reasons for these losses are not well understood. Possibly, the market becomes wary of the substantial increases in debt often associated with takeovers, or it loses confidence in the acquiring firm's ability to manage effectively an acquired firm's assets. Whatever the explanation, these losses may translate into millions of lost dollars for shareholders in acquiring companies.

Although takeovers may have a negative effect on shareholder wealth in acquiring firms, comparing average losses to the average gains among shareholders in acquired firms yields a positive dollar amount. (Estimated outcomes for specific companies, however, vary greatly.)[9] This suggests acquiring firm shareholders need to pay more attention to what managers are doing with a company's equity. Are they reinvesting capital into the company? Are they rewarding shareholders? Or are they making acquisitions that benefit themselves at the expense of shareholders? In other words, are managers using shareholder equity efficiently and productively?

The Effects of Rising Debt. A takeover's impact, however, is not limited to shareholders. Given the significant role debt plays in takeover financing, the effects on bondholders also must be considered. Acquisitions are often financed with so-called junk bonds or higher grade bonds.[10] After acquisition, acquiring firms may be saddled with heavy debt. For example, for 56 firms that organized hostile takeovers between 1976 and 1983, the average weighted debt/equity ratio rose from 52 percent in the year before the takeover to 77 percent in the year after the takeover.[11]

Bondholders in target firms, or even in potential targets, also may feel the effects of takeover activity. One way to fight off unwanted takeover bids is through recapitalization in which companies reduce equity and increase debt—thus making themselves less attractive to would-be raiders. The most dramatic example of recapitalization is Phillips Petroleum's reaction to separate bids by Mesa Petroleum and Carl Icahn. To avoid takeover, Phillips added $4.5 billion to its debt burden and reduced its equity base by $5 billion. As a result, it became the most highly leveraged company in the oil industry.[12]

Another defense against an unwanted takeover bid is "greenmail;" i.e., a target firm buys back a raider's shares at a substantial premium. Such payments are often financed through borrowing. For example, to avoid takeover, Safeway paid Dart Group $139 million in greenmail, and Gillette paid Ronald Perelman's Revlon Group $34 million in greenmail.[13]

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As debt rises, bond ratings are often downgraded because of a company's more precarious economic condition. In 1986, Standard and Poor's reassessed ratings on 513 bond issues; 364 were downgraded. An additional 205 corporate credits were subject to review because of mergers.[14]

For stockholders, takeovers could mean greater profits or greater losses—often depending on whether they have investments in the acquired or the acquiring firms. For bondholders, greater indebtedness could reduce the face value of their investment. These two groups, however, are not the only ones affected by a corporation's changing fortunes in a takeover, particularly when it comes to the consequences of indebtedness.

What will heavily leveraged companies do during an economic downturn, when they face difficulty in making fixed interest payments? One option is for a debt-laden acquirer to retire some of the debt by selling divisions of the recently acquired target. Other options include reducing investments, assuming even more debt to finance the existing debt, or declaring bankruptcy. How such actions may affect the company's future profitability is unclear.

For shareholders and the economy at large, these are not attractive options. Consider the effects of widespread declarations of bankruptcy. Not only will the bankrupt firm's debt-holders and equity-holders be affected, so too will suppliers, customers, and companies that did business with the firm. In short, if bankruptcy follows, the effects of takeovers are no longer restricted to stockholders and bondholders, and the takeover issue is raised beyond a problem of private corporate governance.

Research shows...target companies are at least as profitable as other corporations and in many instances as profitable as the firms acquiring them.

Changes in Investment Behavior. The tendency to increase debt as a means to influence management's investment and operating decisions is magnified by the growing importance of institutional investors in the stock market. The increase in institutional ownership, some economists argue, is associated with a growing emphasis on short-term performance, perhaps at the expense of investments that pay off only in the long run.

As in other management decisions, the effect of emphasizing immediate profitability at the expense of future returns is not limited to a firm's stockholders and bondholders. Consider research and development (R&D) investments. In the best of economic times, R&D investments are risky. If a company is heavily indebted and fearful of takeover and/or of meeting substantial debt payments, investment in a highly risky project is unlikely to be approved. Avoiding R&D investments will not only be felt by the firm, through losses in future profitability, but also by society. For example, successful R&D programs in the pharmaceutical industry translate into both higher corporate profits and increased public welfare through more effective medicines.

Evidence to date shows no statistically significant changes in R&D investments after takeovers.[15] What is not yet known, however, is whether changes in the types of investments take place. For example, there could be a shift toward less risky investments or toward investing abroad, either of which could have important consequences for the nation's future economic welfare.

Employee and Local Community Effects. The effects of a takeover on employees in target firms may be divided into two categories: absolute changes in the number and location of employees and more subtle changes

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in employee attitudes and productivity because of changes in the work environment and uncertainty associated with corporate takeovers.

Direct evidence on either effect is hard to come by. However, much anecdotal evidence culled from corporate takeover accounts suggests substantial cuts in employment follow a takeover. For example, after the creation of Unisys by the merging of Sperry and Burroughs, 9,000 jobs were eliminated. Unfortunately, insufficient systematic analysis of a takeover's absolute and distributional effects on employment has been done; consequently, no general conclusions can be drawn.

What is clear, however, is the complexity of the issue. How one sees the employment impact is often determined by the analytical lens one uses. For example, while the number of jobs in a particular location may fall, new employment opportunities in a company's headquarters located elsewhere may rise. Thus employment opportunities may be redistributed. And, even if the absolute number of jobs decreases, this may reflect more efficient use of a firm's resources—an outcome that may eventually result in lower prices. Counterbalancing this positive effect are the economic and social costs of increasing unemployment. For all these reasons, reductions in the labor force or redistribution of employment opportunities will be viewed differently from a local perspective than from a national one.

For shareholders in acquiring firms...takeover announcements may be cause for concern, not celebration.

A less ambiguous issue is the effect of takeovers on employee attitudes. Acquisitions in general, but more so in hostile takeovers, may negatively affect employee attitudes and performance because of rising uncertainty about future employment and working conditions. Increasing employee turnover and falling employee morale often follow a takeover. For example, when Diamond Shamrock took over Natomas, 75 percent of Natomas's staff left with severance pay; when Connecticut General merged with INA to form CIGNA, the CIGNA work force fell by 4,200, with most employee losses coming from INA.[16] Because firms invest in employees through on-the-job training and because employees develop firm-specific human capital, an increase in turnover may indicate an inefficient use of human capital by the firm.

Employees and others may also be affected by local community changes. This issue was important in the recent proposed takeover of Minnesota's largest retailer, Dayton, Hudson Company, by the Washington, D.C. based Dart Company. Dayton, Hudson is noted for its high level of philanthropy. There was great concern that if the company were owned by interests outside Minnesota, civic funding would decline. Nonprofit organizations and communities that had benefited from Dayton, Hudson's generosity to the arts and social services feared diminished corporate commitment to community welfare.[17]

STATE AND FEDERAL REGULATIONS

The Williams Act in 1968 represented the first expression of concern among policymakers over the impact of corporate takeovers on both private and public interests. This statute (and its subsequent amendments) not only had important direct effects on takeovers, but also paved the way for passage of state takeover statutes.

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The Williams Act stipulated an acquiring firm would have to meet specified disclosure requirements and wait a certain amount of time before a takeover could be finalized. The intent was to provide managers and shareholders in a target firm sufficient time and information to fully evaluate a takeover bid. This gave them protection from unexpected offers in which shareholders might feel compelled to respond quickly. Taking time to evaluate an offer—in the absence of mandated legislated delay—raised the risk of missing the opportunity to tender at all or of being in the second, lower-priced tier of a two-tier offer.

"First generation" state takeover laws basically emulated the Williams Act, although some contained stricter reporting requirements and longer waiting periods. One striking effect of these laws has been the increased premiums paid shareholders in acquired firms. A recent study estimates the Williams Act raised average premiums from 32 percent in the pre-regulation period to 53 percent in the nine years following its passage; state takeover laws have added another 20 percent. The Williams Act and subsequent state takeover laws also may be responsible for fewer takeover bids, perhaps because they increase takeover costs.[18]

...if the effects of takeover are felt outside the firm, public policy becomes relevant.

Following the Williams Act, 36 states passed takeover statutes. Several of these statutes were struck down by the courts. They were ruled to conflict with the Williams Act (which intended to maintain neutrality between target and bidding firm interests) and with the Constitution's commerce clause (which granted Congress sole power to regulate interstate commerce). Such judicial opinions might have deterred state legislatures from maintaining or enacting new state takeover statutes. Takeover activity, however, changed significantly in the 1980s, most notably in the growth of hostile takeover bids and in the number and types of anti-takeover defenses, such as golden parachutes, poison pills, and dual-class recapitalizations.[19] These changes brought forth a "second generation" of takeover statutes, the characteristics of which may be illustrated by examining Indiana's takeover legislation recently upheld by the Supreme Court.

The most controversial provision of the Indiana statute is granting certain shareholders the right to decide if other shareholders may vote. "Disinterested" shareholders, which typically excludes management and bidders, may vote to restrict other shareholders from exercising their votes on a takeover bid. Through this provision, raiders and managers can be prevented from voting on a takeover bid, thereby leaving the decision to the other shareholders. The Supreme Court upheld this highly controversial statute on the grounds shareholder voting rights are an internal corporate matter traditionally governed by state law. This ruling paved the way for other states to adopt similar anti-takeover regulations; since the Indiana ruling, 12 states have adopted anti-takeover legislation or modified existing legislation.[20]

A second aspect of the Indiana statute that touches on a central point in the takeover debate is a required 50-day waiting period between the announcement of a takeover bid and its completion, which is 30 days longer than the time required by federal statute. Lengthening the delay raises two important policy concerns: the statute's neutrality between competing corporate parties

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and the conflict between national and state interests. Such delays make it easier for a target firm's management to launch an anti-takeover defense or to search for a "white knight." A longer waiting period is thus advantageous to a target firm, a consequence that conflicts with the Williams Act's intent to keep the arm of government neutral in takeover battles. Assessing this point requires consideration of the second issue: the conflict between state and national interests. Assume, although this contradicts some evidence cited above, takeovers occur because they promote efficiency. From a national perspective, closing plants or reducing the number of workers by eliminating overlapping functions reduces domestic production costs. However, for the community that depends on one or two companies for jobs or charitable donations, a different perspective takes hold.

...the evidence does not support the assertion that takeovers increase national welfare.

This difference in federal and state perspectives is manifested most clearly in Ohio's takeover statute. In evaluating takeover proposals, directors are ordered to consider not only the interests of shareholders, which is the standard responsibility of directors, but also the interests of employees, suppliers, customers, and the local economy.[21] The combination of a longer delay period and a broadened policy perspective emphasizes Ohio's desire to put state interests in a primary position.

Although the most dramatic changes in takeover legislation have occurred at the state level, the future is likely to bring changes in federal legislation as well. Bills introduced in the first session of the 100th Congress addressed issues related to both target and acquiring firms. The bills propose a longer waiting period before a takeover is finalized. They also prohibited managers in target firms from using greenmail, golden parachutes and other anti-takeover devices without first receiving stockholder approval. The bills are intended (1) to give managers and shareholders in target firms sufficient time to evaluate offers and (2) to restrict managers from blocking a takeover bid at the expense of the company's future financial health. Despite these trends, the final form of state and federal legislation is not yet clear.

CONCLUSIONS AND IMPLICATIONS

Takeovers have an internal effect on a firm's stockholders and bondholders and an external effect on employees, communities, and the economy.

Effects purely internal to the firm do not alone demand a public policy response. If only shareholders suffer financial losses resulting from acquisitions, one can argue that only internal corporate policies and/or corporate governance regulations should be changed. In that relatively simple situation, no reasonable economic arguments exist to justify public intervention with regard to takeovers.

However, if the effects of takeover are felt outside the firm, public policy becomes relevant. If takeovers generate positive externalities, government might want to subsidize takeovers to ensure an optimal number take place; this argument is analogous to the one applied to public investments in socially beneficial R&D efforts. Conversely, if takeovers generate negative externalities, controls on their character or quantity should be developed.

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Despite evidence that acquiring firm shareholders often lose, research shows the positive net economic effects of acquisitions. This indicates that, from the perspective of the acquiring firms, corporations face a problem in the domain of corporate governance. There may be internal company problems that allow acquiring firm managers to pursue actions that do not serve shareholder interests. From a nationwide perspective, this does not make takeovers a public policy issue. Such findings suggest public intervention in corporate takeovers may be justified only if a company is motivated by a desire to avoid taxes or to attain monopoly power.

Analyzing the internal effects of takeover activity on corporate firms, however, is only part of the story. If takeovers are shown to exert significant external effects on workers, communities, R&D, and the macroeconomy, public policy intervention may be justified.

Based on this evidence, two general conclusions can be drawn. With its conflicting findings and unresolved issues, the evidence does not support the assertion that takeovers increase national welfare. Further, it also suggests takeovers are not all the same and to make policies on that misperception could be damaging to the economy.

The assumption underlying most analyses, although rarely stated explicitly, is that takeovers are a homogeneous class of events. In fact, great variety exists—e.g., acquisitions can be made as tender offers (in which the bidding firm's managers appeal directly to target firm stockholders) or as mergers (in which a takeover bid is negotiated between the managers of the bidding and target firms; moreover, they may be paid for with cash or by exchanging stocks). The public and private effects of takeovers will undoubtedly vary with these different characteristics. When considering the benefits and costs of takeovers to society, policymakers must recognize the different impacts of different types of takeovers.

When considering the benefits and costs... policymakers must recognize the different impacts of different types of takeovers.

This relationship needs to be better understood before appropriate options can be developed. The policy most likely formulated will neither encourage nor discourage all takeovers but create an environment that nurtures publicly and privately beneficial takeovers and inhibits those that are not beneficial.[22] Before that policy is developed, many questions regarding the effects of different types of takeovers must be answered.

NOTES

1. For statistical information on 1987 corporate takeovers, see *Mergers and Acquisitions Magazine.*
2. *Economic Report of the President* (Washington, D.C.: Government Printing Office, February 1985), p. 196.
3. Michael Jensen also is the LaClare Professor of Finance and Business Administration at the William E. Simon Graduate School of Business at the University of Rochester. Other pro-takeover advocates are Greg Jarrell, the former Chief Economist of the Securities and Exchange Commission, who is now with ALCAR Group, Inc., and Joseph Grundfest, a Commissioner on the Securities and Exchange Commission.

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4. Edward S. Herman and Louis Lowenstein, "The Efficiency Effects of Hostile Takeovers," Working Paper –20, The Center for Law and Economic Studies, Columbia University School of Law, Revised, April 1986; David J. Ravenscraft and F. M. Scherer, "Life After Takeover," February 1986, mimeographed; and David J. Ravenscraft and F. M. Scherer, "Mergers and Managerial Performance," in John C. Coffee, Jr., Louis Lowenstein, and Susan Rose-Ackerman, eds., *Knights, Raiders and Targets: The Impact of the Hostile Takeover* (Oxford: Oxford University Press, forthcoming).
5. For a survey of this research see Michael C. Jensen and Richard Ruback, "The Market for Corporate Control," *Journal of Financial Economics* 11 (April 1983): 5-50 and Richard Roll, "The Hubris Theory of Corporate Takeovers," *Journal of Business* 59 (1986): 197-216.
6. For a discussion of different motivational hypotheses see Peter O. Steiner, *Mergers: Motives, Effects, Policies* (Ann Arbor: University of Michigan Press, 1975).
7. See Ellen B. Magenheim and Dennis C. Mueller, "Are Acquiring Firm Shareholders Better Off After an Acquisition Than They Were Before?" John C. Coffee, Jr., Louis Lowenstein, and Susan Rose-Ackerman, eds., *Raiders and Targets: The Impact of the Hostile Takeover* (New York: Oxford University Press, forthcoming), Paul H. Malatesta, "The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms," *Journal of Financial Economics* 11 (April 1983): 155-81.
8. Much of the debate on the effects of takeovers on acquiring firm owners focuses on the methodologies used for measuring these effects. For a discussion of the sensitivity of results to particular aspects of methodology, see Magenheim and Mueller, "Are Acquiring Firm Shareholders Better Off?"
9. Estimates of net effects are presented in Paul J. Halpern, "Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers," *Journal of Business* 46 (October 1973): 554-75; Malatesta, "The Wealth Effect of Merger Activities;" Michael Bradley, Anand Desai, and E. Han Kim, "Specialized Resources and Competition in the Market for Corporate Control," Working Paper, University of Michigan.
10. Such was the case in Ted Turner's failed bid in 1985 to assume control of CBS and Carl Icahn's attempted takeover of Phillips Petroleum in 1984.
11. Herman and Lowenstein, "The Efficiency Effects of Hostile Takeovers."
12. In another example of recapitalization, Unocal—to fight off a hostile tender offer by Mesa Partners II, raised its debt level from $1.1 billion to $5.5 billion.
13. See *Mergers and Acquisitions* (May-June 1987): 20
14. The easy response to this troubling pattern is bondholders with lower ratings are compensated with higher potential returns (the higher risk yields greater returns).
15. Bronwyn Hall, "The Effect of Takeover Activity on Corporate Research and Development," Working Paper No. 2191, National Bureau of Economic Research, March 1987.
16. See Myron Magnet, "Help! My Company Has Just Been Taken Over," *Fortune,* July 9, 1984.
17. See Neil R. Peirce, "When Good Works Can Pay Big Dividends," *National Journal,* September 26, 1987.
18. See Greg A. Jarrell and Michael Bradley, "The Economic Effects of Federal and State Regulations of Cash Tender Offers," Journal of Law and Economics 23 (1980): 371-407. For discussions of the content of the Williams Act and of first generation state takeover statutes, see Jarrell and Bradley, "The Economic Effects of Federal and State Regulations," *Journal of Law and Economics.*
19. For more information see Richard Ruback, "An Overview of Takeover Defenses," Working Paper #1836-86, Sloan School of Management, Cambridge, Massachusetts.
20. Sharon Pamepinto, "States" Rush to Adopt Protective Anti-takeover Laws Continues," Investor Responsibility Research Center, *Corporate Governance Bulletin IV* (September-October 1987): 152-156.
21. Steven Greenhouse, "Ohio's Tough Takeover Curb," New York Times, December 16, 1986, p. D2.

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22. At the time this article went to press, it was still too early to assess the impact on takeover activity of the historic 508-point fall in the Dow Jones Industrial Average that took place on October 19, 1987. In fact, it is possible that two conflicting trends will emerge from the crash: (1) in some areas, takeover activity could increase as many companies become takeover bargains available at a fraction of their pre-crash selling price; (2) in other areas, takeover activity could decrease as companies use their resources to buy back their own, now lower priced shares. Under the second scenario, there would be a decrease in the number of outstanding shares for these firms, thus making a takeover more difficult.

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