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Value Maximization and the Acquisition Process

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Like the rest of us, corporate managers have many personal goals and ambitions, only one of which is to get rich. The way they try to run their companies reflects these personal goals. Shareholders, in contrast, deprived of the pleasures of running the company, only care about getting rich from the stock they own. Hence, when managers ignore profits to keep up traditional lines of business, conflicts are bound to arise. While many academic papers teach us that shareholder and market pressure will still force managers to maximize value,[1] the newspapers remind us that this is not always the case. Much corporate behavior seems best understood in terms of managers running the show largely as they please.

The takeover wave of the 1980s put the manager-shareholder conflict to a new test. Where other checks on management failed, hostile takeovers could now wrest control from managers who ignored the interests of their shareholders. More so than ever before, fear of such disciplinary takeovers has forced managers to listen to shareholder wishes. But even now, many acquisitions are not of this disciplinary variety. Ironically, making acquisitions is often just the quickest and easiest way for managers to expand the scope of their control by directing the firm's cash flows into new ventures.

In this paper, we appraise the acquisition process from the managerial perspective. Has the pressure brought by hostile takeovers effectively restricted non-

[1] By value maximization we mean maximization of the net present value of future profits.

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value-maximizing conduct by managers? Are acquisitions themselves driven by non-value-maximizing behavior on the part of acquiring managers? We conclude with some recommendations for improving the takeover process.

Why Are Takeovers Needed? The Failure of Internal Controls

If a manager enjoys non-value-maximizing behavior enough, the first-best complete information employment contract would compensate him in the form of such behavior, rather than paying him to avoid it completely. With imperfect monitoring, the optimal contract would also leave a risk-averse manager some room for non-value-maximizing behavior, even if none of such behavior would be allowed in the first-best world. Incomplete information or a strong preference for non-value-maximizing behavior can thus explain the existence of such behavior even with optimal employment contracts.

But in practice, non-value-maximizing behavior seems vastly to exceed what one would expect to observe under optimal incomplete information contracts. A wealth of evidence suggests that managers often take actions that dramatically reduce the value of the firm. Witness, for example, the ability of managers to defeat hostile tender offers, even when shareholders stand to gain hundreds of millions of dollars from the bid, or the ability to undertake billion dollar oil exploration projects that the market treats as having negative present value (McConnell and Muscarella, 1985). Understanding the limitations of the internal control mechanisms of the firm will help us explain how hostile takeovers serve to reassert the interests of shareholders.

The board of directors is the main internal mechanism through which shareholders can try to constrain managerial choices. The board has at least nominal power to hire and fire the chief executive officer and to block any major corporate projects. In practice, however, boards of directors are rarely effective in stopping the non-value-maximizing behavior of managers. As a rule, managers control the selection of directors (Mace, 1971). The elected directors are often either insiders loyal to the firm's managers, or they are outsiders with a financial interest in the continuity of management, such as lawyers or advertisers for the firm. Even the relatively independent directors are often co-opted by the chief executive officer into putting the interests of managers and employees before those of shareholders. At the very least, directors are usually predisposed to give top managers the benefit of the doubt, rather than eager to find fault with their work. Although Warner, Watts and Wruck (forthcoming) and Weisbach (forthcoming) have found that poor stock performance is followed by higher CEO turnover—thus implying some monitoring by the board—the magnitude of the effect points to only a small employment risk for a top manager bent on non-value-maximizing behavior.

Even when the board of directors is determined to fulfill its fiduciary duty to shareholders and to work toward value maximization, it usually lacks sufficient knowledge to decide that a project is not value-maximizing, and thus has no basis on

which to challenge the choices of managers. Collecting the necessary information can be very costly and it will rarely pay a director without a large ownership stake to do so. Nor are the managers themselves likely to provide the board with the knowledge required for effective monitoring. Among the constraints it faces, limitations on information are probably the most important obstacle to the board's governance.

In discussing the board of directors as a control device, it is important to recognize that a manager is likely to take whatever actions he can to make himself more valuable to the firm, and more costly to remove. Keeping valuable information from the board and from fellow executives is an example of this kind of activity. Perhaps a better way for the chief executive officer to promote self-entrenchment is by investing in the businesses he is good at running. A CEO with a railroad background will upgrade the railroad, rather than raise dividends, even if the railroad investment is not value-maximizing. After the investment is made, this manager might well be the best choice for the job and certainly not worth firing. If the board fails to prevent such investments, the top manager is secure at the helm. The board is at a particular disadvantage in criticizing major decisions about which businesses to enter and exit, since that is where detailed knowledge of a variety of businesses is essential.

A board might best be able to exercise its power at the point of managerial succession, when the future chief executive officer is not yet entrenched. For example, the board can pick a successor whose talents and preferences incline him to maximizing value, or it can write a contract that limits the new manager's options in increasing firm size or investing. However, choosing the next manager is widely viewed as the prerogative of the departing chief executive officer (Vancil, 1987). If the current top executive picks a replacement with an eye to continuing his own policies, he would not necessarily want to choose a value maximizer or to limit this successor's ability to reinvest cash flows.

Absent the possibility of dictating a course of action to the manager, the board can still design a compensation contract to provide incentives for value maximizing. Such a contract would take the form of a direct ownership stake in the firm (or more generally, stock options). Unfortunately, the legal environment in which the corporation operates usually limits large scale payments to executives. For example, take the situation of a chief executive officer in a company with a weak board of directors. This CEO can either engage in non-value-maximizing behavior, or else convince the board to compensate him with a large ownership position in the firm that aligns his interests with those of shareholders. If the CEO pursues the former strategy, he is protected from outside interference both by virtue of his ineffectual board, and by the "business judgment" rule that keeps the court from meddling in the affairs of the company.[2] If,

[2]Gilson (1986) describes the business judgment rule as follows: absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment, whether those mistakes are classified as mistakes of fact or mistakes of law. Gilson also quotes Manne (1967) who writes: "The liability aspects of the rule may well have been incidental to its principal function. The rule is more likely to have survived because it functioned as a quasi-jurisdictional barrier to prevent courts from exercising regulatory powers over the activities of corporate managers."

in contrast, the CEO arranges for a valuable compensation contract, he can be sued by shareholders for breach of fiduciary duty and the business judgment rule no longer protects him. Since under the business judgment rule shareholders can only challenge clear conflicts of interest in court, actual compensation is naturally biased against stock or money and toward non-value-maximizing behavior. Such behavior then becomes a substitute, yet inefficient form of compensation.

Even when the threat of shareholder lawsuits does not constrain the compensation of top officers, other considerations often do. For example, many outside directors think it unethical to "bribe" the top executive to do what he is supposed to do anyway, even when higher compensation is the only effective means of getting the manager to act for the benefit of the shareholders. Indeed, there is an economic justification for maintaining a rule of refusing to respond to a conflict of interest with a bribe. If executives can expect to receive generous payments whenever it looks like they may not act in the interest of shareholders, they will have an incentive to create such situations. Finally, many corporate boards feel constrained to set compensation of top executives by reference to an industry- or economy-wide standard, rather than experimenting with more innovative ways of compensating top officers.

As long as the chief executive officer does not place too much weight on non-value-maximizing behavior, even moderate-sized compensation contracts that will be approved by corporate boards and upheld in court can go some of the way toward preventing such behavior. If managers are rewarded for good stock performance, and penalized for poor stock performance, they will have an incentive to maximize value. Murphy (1985) finds that managers' pay responds positively to stock performance, while studies done by Brickley, Bhagat, and Lease (1985) and Tehranian and Waegelian (1985) show that stock prices rise on announcements of introduction of incentive-based compensation schemes. To interpret these studies as showing that managers are properly motivated to maximize value is, however, to overstate the case.

No study we know of indicates that the incentives provided by extant compensation contracts effectively discourage most non-value-maximizing behavior. For example, the increase in the price of shares observed in the studies of announcements of incentive schemes is much larger when the incentive contract is short term rather than long term. This finding suggests that managers get short-term contracts when they know that good earnings are coming, and the market recognizes this pattern by updating its earnings forecast on the announcement of the plan. The increased stock price reflects this update, not improved incentives. In fact, short-term incentive contracts are followed by announcements of unusually high earnings. Consistent with our scepticism about the efficacy of compensation arrangements, Jensen and Murphy (1986) find that the lifetime wealth of the average chief executive officer of a large firm increases by only about $1.40 for each $1000 increase in the market value of the firm.

In sum, internal control devices are not especially effective in forcing managers to abstain from non-value-maximizing conduct. On the other hand, persuading better-informed managers to limit non-value-maximizing conduct might be very expensive, and possibly infeasible if considerations of fairness and moral hazard preclude the

necessary compensation arrangements. In these circumstances, it is not surprising that external means of coercion such as hostile takeovers can come to play a role.

Hostile Takeovers as Disciplining Devices

In light of the lackluster performance of other disciplining devices, hostile takeovers are probably the most effective way for shareholders to get rid of non-value-maximizing managers without bribing them. In these transactions, a takeover specialist (raider) or a second company bids directly for the shares of the target firm. By doing so, the bidder deals directly with the target's shareholders, rather than with its management. A bidder who gains the requisite votes then assumes control and removes the incumbent managers. He then often increases corporate debt, reduces employment, tightens management contracts and sells off parts of the company. The resulting increases in profitability enable acquirers to pay 30 percent to 50 percent premiums in these deals.

Hostile acquisitions have the elements of both coercion and persuasion. On the one hand, by going over the heads of incumbent target managers straight to shareholders, the bidder is able to remove these managers against their will. Where internal controls have failed, takeovers can often succeed. On the other hand, hostile takeovers are often accompanied by large separation payments to managers of target companies ("golden parachutes"), the purpose of which is to attenuate the opposition of managers to the bid. When top managers are losing their jobs, boards seem to find it more acceptable to give them large bribes. Even so, golden parachutes have often been challenged in court, if not always successfully.

Recent work by Morck, Shleifer, and Vishny (forthcoming) suggests that targets of hostile bids have many characteristics indicative of the need for external discipline. They consider a sample of 371 firms from the 1980 Fortune 500, of which 40 have been acquired between 1981 and 1985 in a contest that was at least initially hostile (many firms escaped into the hands of a friendly acquirer or were ultimately bought by a group of investors including incumbent managers). The average 1980 Tobin's q of a target of a future hostile bid is .524, as compared to the average q of .848 for the sample as a whole.[3] The ability of low q to predict which firm will be the target of a hostile takeover seems to come largely from the firm's being in a low q industry, rather than from just having an especially low q within its industry. Moreover, targets of hostile bids seem to be older firms that are investing a lower fraction of corporate income than does the average Fortune 500 firm.

These findings suggest that hostile takeovers affect industries in decline or sharp change where managers fail to shrink operations rapidly enough or to make other adjustments. In maintaining full-scale operations, managers may be guarding the domain of their control or trying to protect employees from dismissal or wage cuts. In

[3] Tobin's "q" used in this study is the ratio of market value of the firm's debt and equity to the replacement cost of its physical capital.

the case of the oil industry, managers continued costly explorations for additional reserves despite declining oil prices (Jacobs, 1986; Jensen, 1986). In the case of airlines, managers were unable or unwilling to cut union wages that had reached very high levels under regulation.

The example of the declining or quickly changing industry suggests an interesting interpretation of the role of raiders. These takeover specialists acquire companies in a wide range of industries, and usually sell off some parts and curtail the operations of others. It is hard to believe that, say, Carl Icahn can have a simultaneous comparative advantage at running a textile mill, a railcar leasing company, a steel producer and an airline. It seems more plausible that raiders have a comparative advantage at transferring wealth from employees, suppliers and managers of the company to the shareholders. In other words, they squeeze other beneficiaries of corporate wealth in situations where the incumbent is unable or reluctant to do so.

Effectiveness of Hostile Takeovers

In their seminal paper, Grossman and Hart (1980) pointed to the free-rider problem in making a successful tender offer for a firm. They observed that small shareholders of the firm targeted for a takeover have the option of not tendering their shares and staying on as shareholders after management has changed. If they do not sell, they can share in the increase of the profitability of the firm resulting from policies of the new management. Since no single small shareholder can affect the outcome of the bid, the dominant strategy is not to tender unless the value of the bid fully reflects the expected increase in profitability under new management. But if the bidder has to surrender all potential gains to the current shareholders of the firm, he cannot gain from the acquisition. This reasoning implies that if acquiring information to make a bid or bidding itself is costly, no bids will take place.

In practice, this result says more about the difficulty of mounting a profitable bid than about the impossibility of doing so. Bids can in fact be profitable for a number of reasons. Grossman and Hart stress the ability of the bidder to divert some of the value gains his takeover produces. If the bidder need not share these gains with non-tendering shareholders, they will have an incentive to tender and the bidder can make money. Another way to mount a profitable bid, emphasized by Shleifer and Vishny (1986), is for the bidder to accumulate secretly some shares on the open market at a price that reflects the value of these shares under the old management. In this case, the bidder can still realize the full value of any managerial improvements on the shares so accumulated (5 to 10 percent under the current regulation and practice) and hence can profit from the bid. While these results show why making bids is not prohibitively costly, they also suggest that the bidders have to share a lot of the value gains with shareholders of the target firm. With high transaction costs, hostile takeovers can punish only the most dramatic cases of non-value-maximizing behavior.

Managers also have many ways of protecting themselves from hostile bids. Takeover defenses employed by target management range from the relatively innocu-

ous fair price amendment to the practically insurmountable poison pill. The term "poison pill" refers to a class of defenses that impose significant costs on the bidder by diluting his equity holdings, revoking his voting rights or forcing him to assume unwanted financial obligations upon "triggering" the pill. The pill is typically triggered in the event of a tender offer or the accumulation of more than some specified percentage of the target's shares by a single holder. Unlike many other takeover defenses, the poison pill can be adopted without shareholder approval. The latter feature of the pill, along with its potential to exact significant punishment on potential acquirers, has made the pill perhaps the most popular takeover defense recently. Of the 380 poison pill adoptions in the exhaustive sample of Ryngaert (1987), over eighty percent took place in 1986.

We are not suggesting that the hostile takeovers of the 1980s had no effect on non-value-maximizing behavior of managers. Almost 10 percent of the 1980 Fortune 500 have since been acquired in a transaction that started as hostile (and ended either as a hostile acquisition, an escape to a friendly white knight, or a management buyout). Managers of many other companies were probably scared enough to restrain their deviations from value maximization. In fact, some have beaten potential acquirers to the punch by taking on more debt and selling off divisions to escape a hostile bid or to deter one.

While some managers responded to the threat of a hostile bid by implementing the very changes sought by raiders, other managers only dug in deeper. For example, many managers changed their corporate charters in a way that makes them virtually invulnerable to any control challenge, whether through a takeover or through the proxy mechanism. Many state laws have also been rewritten to favor incumbent management. While non-value-maximizing behavior declined in some companies, in others such behavior became even harder to penalize.

Do Acquisitions Serve Managers or Shareholders?

Ironically, the literature that focused on takeovers as devices to eliminate non-value-maximizing behavior has almost completely forgotten the bidders, despite the fact that acquisitions may be the most important decisions about the allocation of corporate wealth that managers make. Acquisitions, especially friendly ones, may provide managers their greatest opportunity for expressing their non-value-maximizing preferences.

The acquisition process is probably the most important vehicle by which managers enter new lines of business. In his sample of 33 large diversified U.S. corporations, Porter (1987) finds that between 1950 and 1986 his firms entered an average of 80 new industries each and that over 70 percent of this diversification was accomplished through acquisition. Large scale movement of U.S. manufacturing toward unrelated diversification is now thought by many observers (including Porter) to have been unsuccessful. The high level of divestiture of peripheral businesses by diversified corporations beginning in the mid-1970s is almost surely a response to that failure.

As mentioned before, the decisions about which lines of business to enter and which companies to pursue are to a large extent the prerogative of the chief executive officer. In making these decisions, managers often feel that they have something to add to the firms they buy, be it a technological synergy, access to new markets, access to capital, or their own talents (Donaldson and Lorsch, 1983). But value maximization is not the only objective of the manager. The CEO also has ideas about the size and the character of the organization he wants to lead. For example, if the company operates in a declining industry, the CEO might want to start moving into faster growing industries. Many corporate acquisitions seem to be governed by this desire of managers to switch into businesses with long term growth potential even when the managers have no special expertise in running such businesses and when the value-maximizing strategy is to distribute free cash flows to shareholders.

Since in choosing the acquisition targets the manager is guided by a number of objectives other than value maximization, he is likely to overpay relative to what the acquisition is worth to shareholders. For in addition to the value gained for shareholders, the manager is also paying for increasing the size of the firm, the opportunity to diversify, and for making himself less replaceable. Examples of acquisitions that were probably motivated by non-value considerations include U.S. Steel's white knight acquisition of Marathon Oil, Mobil's acquisition of Montgomery Ward, Exxon's acquisition of Reliance Electric, and GM's acquisition of Hughes Aircraft. Of course, some managers may raise profitability of companies they acquire even when value-maximization is not their main motivation. Even managers interested only in entrenching themselves will enter businesses to which they have something to add, since this would increase their own value to shareholders.

On these points we differ with Roll's (1986) theory, in which managers infected by hubris try to maximize value, but overestimate the value of what they buy. As a result, they simply overpay. While we agree with Roll's belief that managers overpay, our reasoning is different. It is not that managers make valuation mistakes, but rather that they pay for the benefits of the acquisition that they care about but shareholders do not.

The implication of our story is that friendly mergers can (though they need not) create value, but that in many cases more than 100 percent of these gains will accrue to target shareholders. Shareholders of the target company gain and those of the acquiring company lose, since the latter end up paying the former for the benefits going to acquiring managers. But more than just a transfer between acquiring and target shareholders is likely to be involved here. Acquisition choices based on managerial objectives will not lead to the optimal allocation of managers to businesses. For example, managers of cash cows in declining industries will end up buying businesses that could be run more efficiently by other potential acquirers.

The evidence on the returns to shareholders of bidding firms and on changes in the combined market value of the two firms in a merger is unfortunately ambiguous. Jensen and Ruback (1983) interpret the studies they survey as showing that shareholders of the bidding firms in mergers do not lose. Roll (1986) cites results showing that they do lose on average on the announcement of the merger, but that such losses

are often not statistically significant. Bidding firms seem to have done better recently, as the popularity of conglomerate mergers declined and the leniency of the Justice Department toward potentially anticompetitive mergers increased. Because bidding firms are much larger than the takeover targets in most cases, large positive target returns in conjunction with near zero bidder returns do not necessarily imply a significant increase in the combined value of the merging firms. Still, the combined gains from takeovers appear to be positive, although Roll notes that this conclusion is often not statistically reliable.

In our interpretation of the acquisition process, non-value-maximizing behavior of bidders plays a central role. The willingness of the managers of the bidder to pay for benefits to themselves that are of no value to their shareholders explains negative returns to acquiring firms. This interpretation suggests that before stressing the role of takeovers in eliminating non-value-maximizing behavior by managers of target companies, it is important to remember the managers of bidding firms. For them, the purchase of other companies at inflated prices may be the grandest deviation from value maximization. Just as improvements in acquisition techniques of the 1980s have pressured some managers to maximize value, they have enabled others to deviate from doing so on a previously impossible scale.

The Efficiency of Takeovers

The variety of takeover experiences makes an overall welfare analysis complicated. In many cases, it is difficult to identify the real or even perceived sources of efficiency gains that are to result from a takeover. Moreover, besides changing the size of the pie, most acquisitions also alter its division. Most transactions have both gainers and losers.

Much of non-value-maximizing behavior of managers of hostile targets seems to transfer corporate wealth from shareholders to other nonmanagement constituencies, such as employees, suppliers and customers. Regime changes following takeovers redistribute wealth from these constituencies back to shareholders of the target and to the bidder. Shleifer and Summers (forthcoming) look at the sources of gains in Icahn's takeover of TWA. They show that the takeover premium paid to TWA shareholders is equal to about half the present value of wage losses to members of three TWA unions: pilots, flight attendants, and machinists.[4] While such transfers benefit shareholders and raiders, they cannot be counted as increases in the size of the social pie. Efficiency can improve, as would be the case if union wages were reduced to reflect value marginal product, but this efficiency gain is second order relative to the transfer.

Shleifer and Summers emphasize an important implication of the pervasiveness of transfers in the takeover process. Some analyses have gauged the efficiency

[4] Of course, the takeover premium will at most reflect the *unexpected* component of the value of any wage cuts. In this case, the market may have been counting on current management or a raider reducing wages with high probability. In addition, one must take account of the fact that some portion of the gains from reducing wages probably went to Carl Icahn as a rent to his ability as a raider.

consequences of acquisitions by looking at changes in shareholder wealth. This is inappropriate. If acquisitions entail large transfers, analysts must look at wealth changes of all the relevant parties, including employees, suppliers and managers. For example, if some of shareholder gains in hostile takeovers come from reducing wages, then the calculation of social gains must take account of employee losses. The unfortunate implication of this analysis is that it becomes impossible to gauge the social consequences of acquisitions from shareholder returns alone.

Our emphasis on transfers in hostile takeovers may appear misplaced. If employees and managers have no legitimate property rights to the cash flows of the firm other than their explicitly stated compensation during the time of their contract, then transfers from them cannot be judged more harshly than transfers of stolen property from a thief. That is, if managers take for themselves and for other corporate constituencies what properly belongs to shareholders, then takeovers only correct this wrong. This claim that shareholders have the property right to all the firm's cash flows not allocated by an explicit contract is at the heart of many endorsements of hostile takeovers.

The trouble with this argument is that shareholders do not buy an asset that entitles them to the maximum feasible profits. Rather, they buy an asset whose price reflects the weaknesses of internal and external control mechanisms and the consequent non-value-maximizing behavior of managers. While shareholders of some firms get a raw deal when managers direct an unexpectedly large share of the cash flows to meet their personal goals, in other firms shareholders get more than they counted on when control devices operate better than expected. Because managerial actions are not fully specified in the contract, shareholders are in effect buying a (fairly priced) lottery ticket over the control related outcomes that determine production and dividends. This ticket does not entitle them to a takeover with probability one whenever management does not deliver the maximum feasible profit.

In fact, takeovers that radically change the environment from what shareholders, managers and employees expect may be objectionable, since they can harm parties acting on the basis of an implicit contract. For example, if managers or employees counted on a guarantee of employment with the company and planned their consumption and savings accordingly, then violating their expectations is a cost. Respecting expectations is to some extent an end in itself. One way to counter these unexpected transfers is to require shareholders to compensate, at least partially, displaced managers and employees. The government could also help out by providing benefits to the losers in hostile takeovers, especially if one thinks that such transactions should be subsidized as they create large efficiency gains that cannot be appropriated by the raider.

Increased availability of junk bond financing, the leniency of the Reagan administration antitrust stance, and the deregulation of transportation and banking have all contributed to a surprise change in the takeover environment. The consequences of such an unexpected change are easiest to justify when the gains to shareholders net of employee and management losses are large relative to the harm done from invalidating the implicit contract between them. The compensation princi-

ple from welfare economics can then be used to justify the transaction. Such gains might be especially large when side payments to managers are infeasible, so that shareholder gains from eliminating non-value-maximizing behavior far exceed the private benefits to management from engaging in such behavior. The gains might also be large when an employee layoff following a takeover substantially reduces the wage bill of the company, but most of the laid-off workers obtain employment at comparable wages elsewhere.

In evaluating takeovers from a longer-run perspective, shareholder gains net of losses (or gains) to other constituencies should be compared with the long-run costs of the process. One of the frequently mentioned costs is that of lawyers, investment bankers and other parties organizing the transaction. Jensen (1984) shows that these costs are small compared to the total market value gains (at least in hostile transactions). Furthermore, these costs presumably reflect in large part the superior ability of participating lawyers or bankers to capture rents. Since the social opportunity cost of the lawyers' and bankers' time is probably their social value in other rent-seeking activities, we think that the fees paid significantly overstate the true social cost of the process.

Other costs of takeover activity are potentially more serious. An increase in the incidence of takeovers makes it harder for managers at all levels to rely on long-term employment with the firm and to plan their activities accordingly. As a result, they will make fewer investments in their firm-specific human capital and undertake fewer long-term projects. They will also become less loyal to the firm, and less likely to work hard in hopes of future rewards. Some of the harm from decreased reliance on implicit contracts may be mitigated by switching to more explicit contractual arrangements for things like severance pay. But more explicit contracts will be only an imperfect substitute for managers who rely on the continuity of leadership and of the direction of corporate strategy to plan projects and to make firm-specific investments.

At the very highest levels of management, anxiety that the market's misunderstanding of the firm's strategy will result in a low stock price and a takeover can push investment choices toward those projects that yield the most immediately obvious payoffs, and away from those with the highest long-run payoffs. The focus on the short run at the expense of long-term investments can be particularly damaging to shareholders, as discussed by Stein (forthcoming).

Unfortunately, while shareholder benefits from hostile takeovers stare us in the face in the form of share price increases, the costs of takeovers are not so easily measured. For example, there is not enough evidence to reject the view that the lion's share of shareholder benefits from hostile takeovers comes from pure value transfers, such as union wage reductions with little change in production or employment. Yet our impression is that in at least some cases, hostile takeovers do force managers to move to a more productive (and not just more profitable) use of labor and capital. For example, in basic industries hurt by foreign competition such as steel and textiles, hostile takeovers have facilitated the needed wage concessions before financial distress disrupted otherwise viable operations. Takeovers have also forced reductions in reinvestment rates when even optimistic labor cost projections did not justify adding

capacity to the industry. In the oil industry, for instance, hostile takeovers have prompted curtailment of excessive exploration. And bust-up takeovers of conglomerates have led to sales of peripheral divisions to managers who know them better.

But using takeovers to accelerate the process of adjustment in industries experiencing adverse shocks has its costs as well. In the face of an imminent takeover threat, managers respond with actions very different from those that are part of a long-run optimal retrenchment strategy. The very short planning horizon imposed by a takeover threat can cause panic, disruptions and waste. Even if, *ceteris paribus*, having takeovers is better than banning them, changing the corporate structure so as to avoid relying on takeovers is a still better way of dealing with manager-shareholder conflicts in declining industries. In our concluding section, we suggest some ways to improve the functioning of the internal controls of the firm. Ideally, this would result in lighting a fire under top managers without scorching the firm in the process.

Some Suggestions for Change

The analysis of this paper has stressed the importance of managerial preference for non-value-maximizing behavior and the limitations of the various mechanisms designed to bring manager and shareholder interests closer together. When internal control devices fail, external controls such as hostile takeovers can be effective, but they often entail disruptive changes in management. Whatever form controls take, they often lead to large unexpected transfers from other constituencies of the firm to shareholders. Social policy should then aim to improve the functioning of internal controls, and to alleviate the hardship caused by readjustment, especially in the case of takeovers.

First, the existing constraints on providing managers with share ownership or other compensation that might encourage them to serve shareholders should be removed. Courts should establish the precedent of blocking shareholder lawsuits against excessive compensation in cases where such compensation is necessary to improve the incentives of managers. Granting an ownership stake might be especially critical in the case of a declining firm, where divestment and contraction might be in shareholder interest but against the wishes of the managers concerned with the welfare of subordinates and with the size of the firm. In some cases, like that of Lee Iacocca, large ownership stakes have been given as an incentive device to new managers joining bankrupt firms. We hope that this practice will become acceptable even for firms that are not near bankruptcy. At the same time, courts should try to weaken the force of the business judgment rule as a shield against shareholder challenges to managerial decisions. While we recognize the virtues of the business judgment rule as a guard against disruption of corporate business, the current bias it fosters toward non-value-maximizing behavior is extreme.

Our second suggestion is that the board of directors should be compensated with stock. Upon being chosen for the board, each director should be given in lieu of his

salary the amount of stock equal to what would now be five years worth of director compensation. Directors should be forbidden to sell this stock until they leave the board. While this stock holding might appear small, it is vastly larger than the current ownership of the majority of directors. Directors with relatively large ownership positions would be more likely to insist on value maximization and less likely to be co-opted by the chief executive officer. Taken together, these two suggestions should have the effect of reducing the non-value-maximizing behavior of managers, which in turn should lead to fewer tempting takeover targets and fewer acquisitive top managers running amok.

Third, if it is agreed that hostile takeovers accelerate the necessary adjustment in declining industries to a new economic environment—a judgment that still requires conclusive empirical confirmation—then we should have policies to smooth out such adjustments. In particular, severance pay and provisions to protect labor can alleviate the hardships of employees harmed by acquisitions and make implicit contracts more reliable. Shareholders of target firms should probably pay for at least some of these transfers to affected employees, but the government should also consider subsidizing this activity. Provisions to help employees would also deprive embattled managers of one of their favorite public excuses for opposing hostile bids. The way to deal with transfers that occur in hostile takeovers is to compensate the losers rather than to prohibit altogether acquisitions that might raise efficiency. Prohibiting hostile takeovers altogether would simply throw out the baby with the bathwater.

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