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# MERGERS AND THE MARKET FOR CORPORATE CONTROL<sup>1</sup>

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IN RECENT years many of the traditional economic justifications of our antitrust laws have been seriously questioned. A new sophistication has developed, and economic activities frequently held illegal by the courts are now thought by many to be consistent with our antitrust goals. The rules against tie-ins, vertical mergers, predatory competition, among others, have to a greater or lesser degree had their theoretical foundations considerably weakened. Recently even cartels, the most venerable victim of American antitrust laws, have found their near champion.<sup>2</sup>

One practice, however, remains generally condemned in both the economic literature and the most recent Supreme Court rulings. Mergers among competitors would seem to have no important saving grace. The position has gained considerable legal currency that any merger between competing firms is at least suspect and perhaps per se illegal. The latter result seems especially likely when one of the combining firms already occupies a substantial position in the relevant

market. Antitrust problems in the merger field seem more and more to be confined to discussions of relevant product and geographic markets and perhaps to the issue of quantitative substantiality.<sup>3</sup>

Presumably there is still a so-called failing-company defense to an illegal merger charge. The announced justification for this doctrine was that, if indeed the merged company was failing, then it was not actually a competitor in the industry.<sup>4</sup> But there are strong suggestions that even that defense may be unavailable when a large corporation is making the acquisition, or when there is any chance of absorption by a non-competing firm, or when the acquired company has not "failed" enough.<sup>5</sup>

<sup>3</sup> Among the recent articles and cases bearing out this conclusion are the following: Donald Dewey, *op. cit.*; Richard E. Day, "Conglomerate Mergers and the 'Curse of Bigness,'" *North Carolina Law Review*, XLII (1964), 511-66; James A. Rahl, "Current Anti-Trust Developments in the Merger Field," *Anti-Trust Bulletin*, VIII (1963), 493-515; *United States v. El Paso Natural Gas Company*, 376 U.S. 651 (1964); and *United States v. First National Bank and Trust Company of Lexington*, 376 U.S. 665 (1964).

<sup>4</sup> *International Shoe Company v. Federal Trade Commission*, 280 U.S. 291, 294 (1929); but see Derek C. Bok, "Section 7 of the Clayton Act and the Merging of Law and Economics," *Harvard Law Review*, LXXIV (1960), 226-355, esp. p. 340, where concern for the interests in the failing company is argued to be the most likely reason for the doctrine.

<sup>5</sup> Derek C. Bok, *op. cit.*, pp. 339-47; and see cases cited in anonymous comment, "An Updating of the 'Failing Company' Doctrine in the Amended Section 7 Setting," *Michigan Law Review*, LXI (1963), 566-83.

There is also a "solely for investment" defense to Clayton Act charges. This appears as an explicit proviso in the third paragraph of Section 7, 15 U.S.C.A. sec. 18 (1962). But the famous *du Pont*-

<sup>1</sup> Helpful criticisms and suggestions on this article by Professors Armen A. Alchian, Joseph Aschheim, Donald Dewey, and Joseph P. McKenna are gratefully acknowledged.

A companion article to this one by the same author, entitled "Some Theoretical Aspects of Share Voting," appears in *Columbia Law Review*, LXIV (1964), 1427-45. That article analyzes the strategies available to shareholders when different techniques for taking over control of a corporation are used.

<sup>2</sup> Donald Dewey, "The Economic Theory of Anti-Trust: Science or Religion?" *Virginia Law Review*, L (1964), 413-34. This article also contains references to the other iconoclastic literature (pp. 426-27).

There is general agreement among economists that the courts' approach to horizontal mergers is correct.<sup>6</sup> Professor Donald Dewey, who appears slightly regretful about the severe treatment of mergers by our courts and administrative agencies, concedes that no important economies can be attained through a merger which cannot be gained either by internal growth or, at worst, by a cartel, if that were legal. But Dewey is certainly not as severe in his personal indictment of horizontal mergers as most other economists. He has argued that most mergers "have virtually nothing to do with either the creation of market power or the realization of scale economies. They are merely a civilized alternative to bankruptcy or the voluntary liquidation that transfers assets from falling to rising firms."<sup>7</sup>

Consistent with his alternative-to-bankruptcy explanation of mergers, Dewey points out that, "[i]f the capital

market were perfect and a merger conferred no monopoly power, a rising firm would be indifferent between the two forms of expansion."<sup>8</sup> Thus a rapidly expanding industry with a relatively short life cycle of its firms would be characterized by substantial external growth of successful firms. Mergers then would "most commonly indicate not the decline of competition but its undoubted vigor."<sup>9</sup>

Dewey's argument is, however, only a partial redemption of mergers, since a great many have occurred in industries in which the life cycle of firms is not as short as in the southern textile industry, which he mentions as his example. Further, Dewey's defense of mergers seems to be limited to those cases in which bankruptcy or liquidation is imminent. But, if a merger can be justified at this stage of the firm's life, presumably it is also desirable before bankruptcy becomes imminent in order to avoid that eventuality. If, as Dewey suggests, mergers actually are superior to bankruptcy as a method of "shifting assets from fall-

G. M. case, *United States v. E. I. Du Pont de Nemours and Company*, 353 U.S. 586 (1957), seems to have very substantially weakened the force of this proviso. Also see *Swift and Co. v. F.T.C.*, 8 Fed. 2d 595, 599, reversed on other grounds, 272 U.S. 554 (1925), where it is stated: "It would be difficult to conceive of any case where one corporation purchased all the stock of its competitor solely for investment. Such a case would be a rare one."

There was once thought to be an illegal purpose requirement for convictions under the Sherman Act. See Eugene V. Rostow, "Monopoly under the Sherman Act: Power or Purpose?" *Illinois Law Review*, XLIII (1949), 745-92. But recent Supreme Court decisions in the merger field have left little vitality to that notion. Cf. *United States v. First National Bank and Trust Company of Lexington*, 376 U.S. 665, 669 (1964).

<sup>6</sup> See George J. Stigler, "Mergers and Preventive Anti-Trust Policy," *Pennsylvania Law Review*, CIV (1955), 176-84 (Stigler too recognizes the possibility that some mergers may increase competition, but he finds it "most uncommon" [p. 181]); M. A. Adelman, "The Anti-Merger Act, 1950-60," *American Economic Review*, LI (May, 1961), 236-54 ("The horizontal elements of mergers . . . have been treated severely and—if maintaining competition is the object—rationally" [p. 238]).

<sup>7</sup> "Mergers and Cartels: Some Reservations about Policy," *Market Economic Review*, LI (May, 1961), 257. Dewey analyzed four relatively unimportant cases of scale economies that can be realized only through a consolidation, but he concluded, in substantial agreement with Stigler and Adelman, "that the present experiment discouraging growth by mergers should be continued" with a ban in any industry not generally considered a good example of workable competition (p. 261).

Jesse W. Markham has remarked that some mergers are the "means by which some entrepreneurs make their exit from the industry, selling their undepreciated assets to other entrepreneurs. . . . Since 1930 most mergers appear to have been of the ordinary business variety in that they had neither monopoly nor promotional gains as their objective" ("Survey of the Evidence and Findings on Mergers," in *Business Concentration and Price Policy* [New York: National Bureau of Economic Research, 1955], p. 181). He concluded that "while some mergers impair a competitive enterprise system, others may be an integral part of it" (p. 182).

<sup>8</sup> "Mergers and Cartels . . .," *op. cit.*, p. 257.

<sup>9</sup> *Ibid.*

ing to rising firms," and if mergers were completely legal, we should anticipate relatively few actual bankruptcy proceedings in any industry which was not itself contracting. The function so wastefully performed by bankruptcies and liquidations would be economically performed by mergers at a much earlier stage of the firm's life.

#### THE CORPORATE-CONTROL MARKET

The conventional approach to a merger problem takes corporations merely as decision-making units or firms within the classical market framework. This approach dictates a ban on many horizontal mergers almost by definition. The basic proposition advanced in this paper is that the control of corporations may constitute a valuable asset; that this asset exists independent of any interest in either economies of scale or monopoly profits; that an active market for corporate control exists; and that a great many mergers are probably the result of the successful workings of this special market.

Basically this paper will constitute an introduction to a study of the market for corporation control. The emphasis will be placed on the antitrust implications of this market, but the analysis to follow has important implications for a variety of economic questions. Perhaps the most important implications are those for the alleged separation of ownership and control in large corporations. So long as we are unable to discern any control relationship between small shareholders and corporate management, the thrust of Berle and Means's famous phrase remains strong. But, as will be explained below, the market for corporate control gives to these shareholders both power and protection commensurate with their interest in corporate affairs.

A fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company.<sup>10</sup> As an existing company is poorly managed—in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements—the market price of the shares declines relative to the shares of other companies in the same industry or relative to the market as a whole. This phenomenon has a dual importance for the market for corporate control.

In the first place, a lower share price facilitates any effort to take over high-paying managerial positions. The com-

<sup>10</sup> The claim of a positive correlation between managerial efficiency and the market price of shares would seem at first blush to raise an empirical question. In fact, however, the concept of corporate managerial efficiency, with its overtones of an entrepreneurial function, is one for which there are no objective standards. But there are compelling reasons, apart from empirical data, for believing that this correlation exists. Insiders, those who have the most reliable information about corporate affairs, are strongly motivated financially to perform a kind of arbitrage function for their company's stock. That is, given their sense of what constitutes efficient management, they will cause share prices to rise or decline in accordance with that standard.

The contention is often made that stock-market prices are not accurate gauges, since far more trades take place without reliable information than with it. But there is reason to believe that intelligence rather than ignorance ultimately determines the course of individual share prices. Stock-market decisions tend to be of the one-out-of-two-alternatives variety, such as buy or not buy, hold or sell, or put or call. To the extent that decisions on these questions are made by shareholders or potential shareholders operating without reliable information, over a period of time the decisions will tend to be randomly distributed and the effect will therefore be neutral. Decisions made by those with a higher degrees of certainty will to that extent not meet a canceling effect since they will not be made on a random basis. Over some period of time it would seem that the average market price of a company's shares must be the "correct" one.

pensation from these positions may take the usual forms of salary, bonuses, pensions, expense accounts, and stock options. Perhaps more important, it may take the form of information useful in trading in the company's shares; or, if that is illegal, information may be exchanged and the trading done in other companies' shares. But it is extremely doubtful that the full compensation recoverable by executives for managing their corporations explains more than a small fraction of outsider<sup>11</sup> attempts to take over control. Take-overs of corporations are too expensive generally to make the "purchase" of management compensation an attractive proposition.<sup>12</sup>

It is far more likely that a second kind of reward provides the primary motivation for most take-over attempts. The market price of shares does more than measure the price at which the normal compensation of executives can be "sold" to new individuals. Share price, or that part reflecting managerial efficiency, also measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful take-over and revitalization of a poorly run company can be enormous.<sup>13</sup>

Additional leverage in this operation

<sup>11</sup> "Outsider" here refers to anyone not presently controlling the affairs of the corporation, even though it may include one or more individuals on the corporation's board of directors.

<sup>12</sup> To the extent that executive compensation increases with higher share prices, the take-over is most attractive at the time when it is also most expensive. Indeed, the danger of a take-over may account for managers' voluntarily decreasing their compensation when the company's share price is down.

can be obtained by borrowing the funds with which the shares are purchased, although American commercial banks are generally forbidden to lend money for this purpose. A comparable advantage can be had from using other shares rather than cash as the exchange medium. Given the fact of special tax treatment for capital gains, we can see how this mechanism for taking over control of badly run corporations is one of the most important "get-rich-quick" opportunities in our economy today.

But the greatest benefits of the take-over scheme probably inure to those least conscious of it. Apart from the stock market, we have no objective standard of managerial efficiency. Courts, as indicated by the so-called business-judgment rule, are loath to second-guess business decisions or remove directors from office. Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders. Compared to this mechanism, the efforts of the SEC and the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder's derivative suit seem small indeed. It is true that sales by dissatisfied shareholders are necessary to trigger the mechanism and that these shareholders may suffer considerable losses. On the other hand, even greater capital losses are prevented by the existence of a competitive market for corporate control.<sup>14</sup>

<sup>13</sup> The clearest modern illustration is probably furnished by Louis Wolfson's successful venture into Montgomery Ward. For details of this and other large stock price gains associated with corporation "raids" see David Karr, *Fight for Control* (New York: Ballantine Books, 1956).

<sup>14</sup> Unfortunately the suppression of this market would be the consequence of proposals made by sev-

There are several mechanisms for taking over the control of corporations. The three basic techniques are the proxy fight, direct purchase of shares, and the merger. The costs, practical difficulties, and legal consequences of these approaches vary widely. The selection of one or another or some combination of these techniques frequently represents a difficult strategy decision. An attempt will be made in this paper to analyze some of the considerations involved in a selection of one device over another.

#### PROXY FIGHTS

The most dramatic and publicized of the take-over devices is the proxy fight; it is also the most expensive, the most uncertain, and the least used of the various techniques. Indeed it is somewhat difficult to describe the necessary conditions under which a proxy fight rather than some other take-over form will be indicated. At first blush, the proxy fight appears to be inexpensive since one does not have to own a large number of shares (or for that matter any shares) in order to wage a fight. But this fact is most relevant when the take-over is for the purpose of gaining the incumbents' compensation. If the outsider wants capital gains, he will be interested in owning more, not fewer, shares. This suggests that proxy fights will be relatively more often used when the issue is not one of management policies but of distribution of insiders' compensation.<sup>15</sup>

Even as a device for settling internal power struggles, actual proxy fights con-

stitute only a small percentage of threatened fights.<sup>16</sup> The parties will generally prefer to negotiate a settlement in accordance with their respective strengths than incur the costs of soliciting proxies. The more reliable the information about relative strengths available, the more will settlement be likely to occur. This suggests that proxy fights will be relatively more common when there is widespread distribution of the company's shares than when there are relatively large holdings.

In a number of cases the outsider would probably like to own more shares and take over control without waging or threatening a proxy fight. But if he is unable to accumulate sufficient capital to purchase control directly, he may settle for half a loaf. In effect he indicates his willingness to share the capital-gain potential with all other shareholders in exchange for enough of their votes to put him into control.

When a proxy fight is announced, the shares tend to rise in price, reflecting a rise in both the market value of the vote and the discounted value of potential gain in the underlying share interest if

<sup>15</sup> The courts draw a similar distinction for purposes of determining when contestants in a proxy fight may recover their expenses from the corporate treasury. Generally they may recover if the contest is found to be one of policy rather than a "purely personal power contest" (*Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 129 N.E. 2d 291 [1955]). It does not seem to be too difficult, however, to establish the existence of a "policy" controversy to the court's satisfaction.

<sup>16</sup> In the SEC's fiscal year 1962 seventeen companies were involved in proxy contests, while a total of 253 persons, both management and non-management, filed statements as participants. The respective figures for 1961 were thirty-two proxy contests and 463 participant filings. Many non-management filings are multiple; that is, several people are involved in the same fight. But no breakdown beyond the total number of participants is available. Therefore, it is impossible to prove the point made in the text from published data. See *27th and 28th Annual Reports* (Washington: Securities and Exchange Commission, 1961 and 1962).

eral writers in the field. For a review and a criticism of this literature see Henry G. Manne, "The 'Higher Criticism' of the Modern Corporation," *Columbia Law Review*, LXII (1962), 399-432. For another defense of this market see Harry G. Johnson, *The Canadian Quandary* (Toronto: McGraw-Hill Book Co., 1963), pp. xvii-xviii.

the outsider wins.<sup>17</sup> Other outsiders will find it in their interest to retain their shares or purchase shares, to vote for the outsider seeking control, and to share in the capital appreciation. It may be cheaper to elicit the support of these voters through expenditures on persuasion than through outright purchase of the shares. But to the outsider seeking control, every voter represents another person with whom he must share the potential gain resulting from his more efficient management. These voters are analogous to, or substitutes for, the capital or credit with which the outsider would otherwise purchase control directly.

Proxy-fight expenses have always included direct expenses of mailings, advertising, telephone calls, and visits to large shareholders. But since the Securities Exchange Act of 1934, the cost of waging a proxy fight has probably increased substantially. Prior to the act, the proxy system operated largely through broker intermediaries acting as full agents for the beneficial owners of the shares. To the brokers was delegated not merely the ministerial job of voting but the more important responsibility of deciding how to vote. That practice has been largely replaced because of the SEC philosophy that the proxy system should duplicate actual meetings of shareholders as closely as possible. Thus, today, "giving a proxy" is really tantamount to voting. And, since the shareholder himself is voting, it is also felt that he should be fully and truthfully informed about all aspects of the corporation's affairs. This has tremendously increased the cost of

soliciting proxies. But while the incumbents finance the bulk of their proxy solicitation expenses from corporate funds, the outsider will have this advantage only if he wins.<sup>18</sup>

#### DIRECT PURCHASE OF SHARES

The second mechanism for taking over control of a corporation is the direct purchase of the requisite number of shares of the corporations. There are several techniques that may be used in the direct

<sup>18</sup> The SEC rules on proxy solicitations have aided the insiders in unexpected and curious ways. Outsiders in a proxy fight are not privy to the particulars of corporate information as are the insiders, so they must frequently "guess" why the company is not doing as well as it should. These "guesses" will take the form of broad accusations and innuendoes directed at the incumbents. Outsiders would like the opportunity to include in their proxy solicitation such general statements as "the incumbents are wasting corporate assets"; "the incumbents are paying themselves fraudulently high salaries"; or "the officers of the company have been negligent in failing to acquire new opportunities for the corporation." The SEC generally refuses to allow such statements to be mailed to shareholders unless the insurgents can prove the truthfulness of the allegations. Frequently there is no way the insurgents can find that proof, short of discovery proceedings in a suit, though they might in all good faith suspect the facts alleged. Therefore, the practice has developed of filing shareholder derivative suits when a proxy fight is decided upon. Then the solicitation materials may legally say, "A shareholder's derivative suit is presently pending in the Federal District Court for the Southern District of New York charging the officers and directors with waste of corporate assets"; or "a suit to force the officers to pay back part of their salaries has been filed by a shareholder in Delaware"; etc.

Not only has the Securities Exchange Act increased the cost of waging a proxy fight because of the additional materials that must be cleared through the SEC, but it has also increased uncertainty because of the panoply of SEC regulations. For instance, the Chicago and North Western Railroad's successful fight against the Union Pacific's first bid for control of the Rock Island Railroad was recently voided on the grounds, among others, that unsolicited advice by a broker to his customer advising acceptance of the C. & N.W.'s offer constituted an illegal solicitation of proxies (Union Pacific Railroad Company v. Chicago and North Western Railway Company, 226 F. Supp. 400 [N.D., Ill., 1964]).

<sup>17</sup> See Henry G. Manne, *op. cit.*, pp. 410-13. It is possible, of course, for the vote price to be rising while the market value of the underlying investment interest is declining, though this would seem to be uncommon.

purchase of shares. The most obvious is outright purchase on the open market of the requisite percentage of shares.<sup>19</sup> The outsider might also try to buy the shares from large individual owners, thus preserving secrecy and allowing negotiation on price. Finally, he may make a bid for tenders, that is, a request that shareholders make an offer to sell their shares to him at a certain price, usually above the market. This last form of direct purchase is most apposite when the shares are widely held and there is a chance of a fast increase in market price if the news spreads that there is a heavy buyer in the market for the company's shares. A tender bid is usually stated to be effective only if a minimum percentage of shares is offered at the announced price. Also, the bid will ordinarily be for less than 100 per cent of the shares in order to avoid the problem of many individual shareholders trying to be the sole hold-out. In practice, private negotiation for large blocks of shares may be combined with either open-market purchases or a tender bid.

There are few serious legal problems with any of the direct purchase techniques. In fact, about the only one which has arisen with any regularity in recent years results from Professor Adolf A. Berle's contention that control is a corporate asset.<sup>20</sup> The implication of this notion is that any premium received by an individual for a sale of control belongs

<sup>19</sup> This percentage may range from less than 51 per cent if the purchaser is only interested in establishing a foundation for a proxy fight; to 51 per cent when only simple control is desired; to 66 $\frac{2}{3}$  or 75 per cent, when state law requires that percentage for approval of a merger or reorganization; to 80 per cent, the figure required for consolidation of income statements under the Internal Revenue Code as well as for tax-free reorganizations; to 90 per cent, the figure required for simplified mergers of subsidiaries into parent companies in Delaware (95 per cent in New York); or 100 per cent if no minority interests are wanted.

in equity to all of the shareholders. As a general proposition, the courts have refused to follow this thesis; and there are numerous judicial statements to the effect that one may claim a premium for control.<sup>21</sup>

A number of legal writers, following Berle, continue to press for a rule of equality in share purchase price when an outsider buys control in a corporation.<sup>22</sup> The economic results of such a rule could be most unfortunate. Many holders of

<sup>20</sup> Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1933), p. 244; Adolf A. Berle, "Control in Corporate Law," *Columbia Law Review*, LVIII (1958), 1212-25, esp. 1221.

<sup>21</sup> The difficult cases have been those in which control carried with it peculiar advantages not normally assumed to be part of the standard compensation of corporate managers. The problem is illustrated by the now classic case of *Perlman v. Feldmann*, 219 F. 2d 172 (2d Cir., 1955), in which only a controlling block of shares was purchased, but at a price reflecting the value of the right to allocate the company's steel production to the purchaser at a time when quasi-official price controls existed. The court found the control seller liable to the other shareholders for a part of the premium received over the normal market price of the shares. The most convincing factor, not emphasized by the court, was that the company had probably been receiving a full free-market price for its steel, with the difference over the controlled price taken in the form of interest-free loans and guaranteed future orders. Indications were that the new controllers would sell to themselves at the "quasi-legal" price and discontinue these other valuable practices. Thus the premium paid for the control block of shares was given partly in exchange for a right more appropriately thought of as belonging equally to each share than to the control group. That is, if a "gray-market" profit was to be made, it should go to all the shareholders. The court was explicit, however, that the seller could retain that part of the premium received for control not covering the power to allocate steel.

<sup>22</sup> Richard W. Jennings, "Trading in Corporate Control," *California Law Review*, XLIV (1956), 1-39; and Noyes Leech, "Transactions in Corporate Control," *University of Pennsylvania Law Review*, CIV (1956), 725-839. For a sharply opposing viewpoint see Wilbur G. Katz, "The Sale of Corporate Control," *Chicago Bar Record*, XXXVIII (1957), 376-80; also Alfred Hill, "The Sale of Controlling Shares," *Harvard Law Review*, LXX (1957), 986-1039.



control blocks of shares would refuse to sell at a share price which did not pay them a premium at least sufficient to compensate them for the loss of net values presently being received from their position in the corporation. If all non-controlling shareholders must accordingly be paid a premium over the market price of their shares, then in a substantial number of cases the purchaser will not conclude the bargain. This further suggests that, if control is securely held in one block, the "market price" of traded shares is the price for an underlying share interest without an aliquot portion of control. That is, if one person owns 51 per cent of the shares of a company, nothing will be paid for the vote attached to the other shares,<sup>23</sup> no matter how actively the shares may be traded on the market. The less securely control is held in one block, the more likely are non-controlling shareholders to participate in the "premium," and the less will an outsider be willing to pay one shareholder for control. Both proxy fights and competitive tender bids are more likely to occur under these conditions, since each of them gives shareholders the power to sell their votes at a premium.

#### MERGERS

The third major mechanism for taking over control of the corporation is the merger. Here, by definition, the acquiring concern will be a corporation and not an individual, and the medium of exchange used to buy control will typically be shares of the acquiring company rather than cash. Another major difference between the merger and other take-over forms is that, almost without exception,

<sup>23</sup> This holds true only to the extent that 51 per cent is the relevant majority. If a higher percentage is necessary for some purpose, minority votes will have some value so long as the requisite percentage is not already controlled.

a merger requires the explicit approval of those already in control of the corporation.<sup>24</sup> And most statutes require more than a simple majority vote by shareholders to effectuate a merger. If the merger occurs after an acquisition of shares in a tender bid, then the tender bid and not the merger is the actual mechanism for changing control.

The requirement of management's approval for a merger generates some peculiar results. Generally speaking, managers' incentives and interests coincide with those of their shareholders in every particular except one: they have no incentive, as managers, to buy management services for the company at the lowest possible price.<sup>25</sup> Even if the market for corporate control is working perfectly, so long as the cost to the corporation of the incumbent managers' inefficiency is below the cost to an outsider of taking over control, the insiders will remain secure in the positions with protected high salaries.<sup>26</sup>

In the case of tender bids, as we have seen, a premium for control may be paid; and in the proxy fight situation, in one

<sup>24</sup> There is a slight possibility that outsiders might be able to force a merger vote by shareholders under the Securities Exchange Act's "Stockholder's Proposal" Rule, although the SEC seems to take the position that such a proposal may only be advisory, not mandatory, on the board, if passed. See Louis Loss, *Securities Regulation* (Boston: Little, Brown & Co., 1961), p. 908.

<sup>25</sup> To the extent that the same individuals are also shareholders, their motivation will reflect a conflict. If their ownership interest is great enough, they may sacrifice the emoluments of management in order to improve their position as shareholders. The decision will simply reflect the greater of the two conflicting interests.

<sup>26</sup> This may furnish some proof for the notion that executive compensation is a function of size. If the cost of taking over control is a function of the number of shareholders, as it certainly is in the case of proxy fights, it is likely that managers may be able to claim larger compensation to the extent of the higher cost to outsiders of buying control.

sense at least, the premium is paid in the form of expenditures necessary to persuade shareholders to vote a certain way. But the merger has considerable cost advantages over the other two forms of take-over, not the least being the ability to use shares rather than cash as the purchasing medium.

The shareholders should ordinarily be willing to accept any offer of a tax-free exchange of new marketable shares worth more than their old shares. But the managers are in a position to claim almost the full market value of control, since they have it in their power to block the merger by voting against it.<sup>27</sup> When we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring.

Side payments are often not simple transactions at law because of the rule that directors and officers may not sell their positions shorn of the share interest necessary to insure a transfer of control.<sup>28</sup> The most obvious kind of side payment to managers is a position within the new structure either paying a salary or making them privy to valuable market information.<sup>29</sup> This arrangement, easily established with mergers, can look like normal business expediency, since the argument can always be made that the old management provides continuity and a link with the past experience of the corporation.

<sup>27</sup> The greater the shareholdings of management, the more likely they are to approve a merger offer with little or no side payment.

<sup>28</sup> *Essex Universal Corp. v. Yates* 305 F.2d (2d Cir., 1962).

<sup>29</sup> See, e.g., *Smith v. The Good Music Station*, 129 A.2d 242 (Del. Ch. 1957), and *Borak v. J. I. Case Co.*, 317 Fed. 2d 838, at 844 (7th Cir., 1963), *aff'd* 377 U.S. 426 (1964). There are no reported cases of differential numbers of shares being offered controlling and non-controlling shareholders in a merger. Such an arrangement may be illegal under state statutes, and it is not likely to receive the high-majority-share vote required for most mergers.

There is still another very important reason why mergers may be more desirable than proxy fights or take-over bids as a way of operating in the corporate-control market. This is a market in which reliable information about valuable opportunities will be extremely difficult to discover. For reasons already mentioned, the corporate insiders will generally have no incentive to advertise this kind of information. Blatant cases will, of course, be evident from casual observation of industrial affairs and the stock market.<sup>30</sup>

The great problem in the corporate-control market is finding reliable information about new opportunities. There have generally been a few individual operators in this market, and perhaps they have found the more obvious cases of bad management. But to guarantee effective competition in the market for corporate control, it seems clear that corporations must be allowed to function therein. Managers of a competing firm, unlike free-wheeling individual participants in the market for corporate control, almost automatically know a great deal of the kind of information crucial to a take-over decision. Careful analysis of cost conditions in their own firm and the market price of shares of other corporations in the same industry will provide information that can be relied upon with some degree of confidence.

Since, in a world of uncertainty, profitable transactions will be entered into

<sup>30</sup> The most obvious example is that of a corporation whose total assets in liquidation would be worth more than the aggregate market value of all of its shares. This situation can continue to exist only because no individual shareholder believes there is any way of claiming the premium, since the managers will take no step toward liquidation and there is no indication that the corporation will not continue to be badly run. Perhaps the classic case of this sort was the take-over by Louis Wolfson of the Capital Transit Corporation. For this and other examples see *Karr, op. cit.*, p. 150.

more often by those whose information is relatively more reliable,<sup>31</sup> it should not surprise us that mergers within the same industry have been a principal form of changing corporate control. Reliable information is often available to suppliers and customers as well. Thus many vertical mergers may be of the control take-over variety rather than of the "foreclosure of competitors" or scale-economies type. Undoubtedly many more mergers, both horizontal and vertical, would have occurred but for our antitrust laws. The managers of corporations have considerable incentive to exploit such opportunities for their corporation, just as they are motivated to find any good new investment opportunity. And there are both legal and practical barriers to the individuals' utilizing such opportunities for themselves.

#### CONCLUSIONS

Mergers seem in many instances to be the most efficient of the three devices for corporate take-overs. Consequently, they are of considerable importance for the protection of individual non-controlling shareholders and are desirable from a general welfare-economics point of view. Certainly they are more desirable than the increased number of bankruptcies that would undoubtedly ensue if this avenue of taking over control were totally closed.

This is not to suggest that the anti-trust norm of competition in the product market need be entirely sacrificed to the norm of competition in the market for corporate control. Rather it points up some of the serious problems with current antitrust doctrine. The market for

corporate control implies a number of important advantages which must be compared to those existing in present antitrust enforcement. Among the advantages of the former, as we have seen, are a lessening of wasteful bankruptcy proceedings, more efficient management of corporations, the protection afforded non-controlling corporate investors, increased mobility of capital, and generally a more efficient allocation of resources.

The greatest difficulty in assessing the proper role for the market for corporate control comes in the area of horizontal mergers, where, as previously indicated, this market may operate most effectively.<sup>32</sup> It may be that, so long as entry into an industry is kept open, there is no reason at all for rules against mergers, at least short of a monopolization charge under Section 2 of the Sherman Act. It is extremely unlikely, however, that Congress or the courts would ever adopt such a rule.

Far more likely is an *ad hoc* recognition of the importance of the market for corporate control in individual cases.<sup>33</sup> Courts or agencies might begin to look at such factors as the average life cycle of firms in the industry, the amount of total new investment in the industry, the condition of the acquired firms in terms of both financial and managerial strength, the number of bankruptcies in the industry, and the amount of proxy-fight and tender-bid activity. These fac-

<sup>32</sup> The case for a free market in corporate control as between supplier and customer firms seems quite strong, since the arguments in favor of present anti-merger policy are perhaps weakest there. See Robert Bork, "Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception," *University of Chicago Law Review*, XXII (1954), 157-201.

<sup>31</sup> Cf. H. B. Malmgren, "Information, Expectations, and the Theory of the Firm," *Quarterly Journal of Economics*, LXXIX (1961), 399-421; and George J. Stigler, "The Economics of Information," *Journal of Political Economy*, LXIX (1961), 213-25.

<sup>33</sup> This might be done either through the resurrection of the "business-purpose" doctrine or, in Clayton Act cases, by beefing up the "solely-for-investment" proviso. See n. 5 above.

tors would then have to be weighed on the scales with the more traditional approach in terms of number of firms in the industry, concentration ratios, size of the acquiring firm, and its acquisitions history. But no longer does the tendency to hold most mergers illegal per se seem justified.

One real problem will be in devising statistical methods for distinguishing mergers motivated by a quest for monopoly profit from those merely trying to establish more efficient management in poorly run companies. But if the theoretical aspects of these transactions are well enough understood, this should not be insuperable. There may be different effects on the prices of shares depending on the motive behind the merger. In the normal merger for acquisition of control, something will be paid by the acquiring company for the control opportunity. Since this factor does not figure largely in the market price of even badly run companies until the possibility of a takeover is known, the exchange ratio in the merger will appear to be too favorable to the acquired company, judged by the relative premerger announcement prices.

The price of the shares of the acquiring company in such a merger should then tend to decrease and those of the acquired company to increase upon the announcement of the merger. If, on the other hand, the merger is motivated by a quest for market power, or by economies of scale available to both corporations, then the price of stock of each company should increase on the announcement of the merger terms. The first of these two results conforms to what seems most frequently to occur when mergers are announced, though no data are presently available on this subject.<sup>34</sup> The study of the economics of the market for corporate control is still in its infancy.

<sup>34</sup> A study of the effect of mergers on stock prices has been completed by the staff of the Subcommittee on Anti-Trust and Monopoly of the Senate Judiciary Committee. That study was unavailable at the time of writing this article.

Another possible approach to proof in this area is to determine if actual changes in the management personnel ultimately follow the merger. In mergers for market power, there is little reason to believe that this will occur very quickly; whereas, if the position is in the nature of a side payment, as it would be if the merger was motivated more by the control potential, we might anticipate somewhat earlier efforts to "ease out" the old managers of the acquired company.