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10 Panel Discussion: Corporate Takeovers and Public Policy

Joseph A. Grundfest, Gregg Jarrell, Steven C. Salop, and Lawrence J. White

Remarks Joseph A. Grundfest

November of 1986 marked a turning point in the politics of the takeover debate. In the space of ten days, the Securities and Exchange Commission announced settlement of the Ivan Boesky insider trading case[1] and the Democrats gained control of the U.S. Senate. Either event alone would have altered the context of the takeover debate. The combination of the two in such a short period of time, however, added a sense of urgency to the legislative desire to "do something—do anything" about takeovers.

In these remarks I will first discuss the relationship between takeovers and insider trading and explain the illogic of the argument that hostile takeovers should be curbed in order to stop insider trading. I then criticize recently introduced antitakeover legislation that does nothing to prevent allegedly egregious defensive tactics, while at the same time imposing overbroad burdens on stock acquisitions that could adversely affect many transactions wholly unrelated to hostile takeovers.

The Link between Insider Trading and Takeovers

Many takeover critics have tried to link insider trading with hostile takeovers. They argue that hostile takeovers should be curbed so that insider trading can be stopped. This argument is, however, seriously misguided.

Insider trading occurs when someone misappropriates or, through breach of a duty, converts valuable nonpublic information about a pending transaction or disclosure.[2] Thus, insider trading can occur

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when a friendly merger is pending,[3] when a company has found a substantial mineral deposit,[4] or when unfavorable earnings have not as yet been announced.[5] Hostile takeovers are not uniquely susceptible to insider trading, nor do hostile takeovers cause insider trading in any meaningful sense—just as mineral finds, earnings reports, and friendly takeovers in and of themselves do not cause insider trading. Indeed, efforts to prohibit hostile takeovers in order to deter insider trading make as little sense as efforts to stop vote fraud by cancelling all elections, or efforts to stop bank robbery by shutting down all banks.

Unfortunately, the recently introduced antitakeover legislation falls prey to easy but illogical arguments that seek to prevent insider trading by stopping takeovers. For example, a statement accompanying S. 1323, the "Tender Offer Disclosure and Fairness Act," attacks the "market manipulating corporate raider" and cites trading by Dennis Levine, Martin Siegel, and Ivan Boesky as examples of the abuses engendered by "manipulative raids."[6] The problem with this attack on insider trading, which makes a great deal of sense as an introduction to a legislative definition of insider trading, is that it makes no sense as a rationale for legislation targeting takeover activity.[7]

Insider trading is not caused by hostile takeovers, nor is it uniquely associated with hostile takeovers. To make this point crystal clear, consider the Nestle-Carnation deal, a notorious example of insider trading that involved Messrs. Boesky and Siegel and netted Boesky profits of $28.3 million.[8] In the Carnation trade, Siegel was Carnation's investment banker and participated in extensive friendly negotiations that both Carnation and Nestle sought to keep secret.[9] There were no hostile bids involved, and no raiders were trying to impose their will on Carnation's management. Nonetheless, Siegel tipped Boesky about the friendly deal, and the transaction gave rise to a stunning volume of insider trading.

The Carnation trade demonstrates that friendly deals are every bit as susceptible to insider trading as hostile ones. In fact, a recent study by the Securities and Exchange Commission's Office of the Chief Economist found substantial evidence of stock price runups before the announcement of friendly transactions.[10] It also found that runups before friendly deals were more pronounced than runups before hostile transactions.[11] This finding suggests—but certainly does not establish—that insider trading may be more pronounced in friendly deals than in hostile deals. Friendly deals may be more susceptible to insider trading because more people on both sides of the negotiations are likely to know of the pending deal for a longer period of time. In contrast, a hostile bidder wants to avoid tipping a target that a bid is forthcoming. The hostile bidder is therefore likely to move faster with fewer people knowing of the bid, and is more likely to be able to maintain secrecy.

If friendly deals are more susceptible to insider trading, should Congress stop friendly deals in order to stop insider trading? Of course not. Similarly, Congress should not constrain hostile takeovers on the misguided rationale that those deals are particularly susceptible to insider trading.

In fact, even in cases where insider trading is discovered in connection with a hostile takeover, the trading does not necessarily emanate from the bidder's camp, nor does it necessarily occur with the bidder's approval. For example, the U.S. Attorney's Office has alleged that during Mesa's hostile bid for Unocal one of Unocal's investment bankers tipped Mr. Siegel about Unocal's planned defensive maneuvers.[12] Unocal's defensive tactic caused the value of its shares to decline, and Siegel caused his employer to buy put options that increased in value as a result of the Unocal price decrease. But to blame this insider trading on the raider's conduct is obviously wrong and makes about as much sense as blaming pass interference on the quarterback who throws the football.

Strong rules against theft of information in the form of insider trading are sound public policy, and I support vigorous efforts to protect corporations' and stockholders' property rights in confidential market information.[13] The link between hostile takeovers and insider trading, however, is largely a public relations device used by opponents of takeovers with little regard to the logic of their arguments. Insider trading cannot and should not serve as a rationale for imposing restraints on takeover activity. Insider trading and takeovers are two different issues that call for distinct analyses and distinct legislative approaches.

Takeover Legislation

On the legislative front the Senate Democrats' antitakeover proposals introduced in the first six months of 1987 have suffered from a disappointing gap between rhetoric and reality. The rhetoric speaks of a need to control both coercive bidder tactics and abusive defensive techniques without forgoing the benefits that result from an active takeover market. The legislative reality, however, is that some of these bills would do essentially nothing to control the allegedly abusive defensive techniques they claim to address. They would also impose substantial burdens on anyone seeking to acquire a significant stockholding position in a publicly traded corporation, even if the share acquisition was wholly unrelated to a hostile takeover.

Whatever the rhetoric the message of much of the legislative language is clear: The legislation is designed to stifle takeover activity with little regard to the costs imposed on a broad range of nontakeover transactions. The legislation also seeks to tilt the balance in takeover contests strongly in favor of the incumbent management because the bills contain no meaningful effort to control abusive defensive tactics. Accordingly, even if one is opposed to egregious and abusive takeover tactics and believes federal legislation is appropriate, it would be easy to oppose much of the legislation pending before the Senate in 1987.

Take the example of S. 1323, the "Tender Offer Disclosure and Fairness Act," sponsored by Senator William Proxmire and cosponsored by all eight Democrats on the Securities Subcommittee of the Banking Committee. The statement accompanying S. 1323 explains that "tender offers themselves should be neither encouraged nor discouraged by law; egregious defenses as well as coercive takeover tactics should be limited."[14] Bravo! As a guide for responsible takeover legislation, this formula could hardly be crafted in a more workable and evenhanded way.

Nevertheless, by oversight or calculation, somewhere between the fine rhetoric and the serious work of legislative drafting, something has gone wrong because the bill does essentially nothing to limit "egregious defenses"; restricts a broad range of market transactions that have nothing to do with "coercive takeover tactics"; and seeks to discourage by law the very transactions toward which the statement proclaims neutrality.

Toothless controls on "egregious defenses?"

The authors of the bill have identified greenmail, golden parachutes, and poison pills as defensive practices that they consider egregious. Assuming for the moment that these practices warrant federal regulation—a conclusion I do not embrace—it would make sense to draft legislation that effectively addresses the problems caused by such "egregious defenses." The proposed legislation is, however, toothless when it comes to regulating greenmail, golden parachutes, and poison pills. Indeed, the remarkably ineffective nature of the provisions intended to regulate these three practices unfortunately calls into question the willingness of the bill's authors to control takeover defenses that are purportedly egregious.

Greenmail. In particular, S. 1323 does not prohibit greenmail.[15] Instead, it attempts to control the price at which greenmail can be paid. It does so by establishing a maximum repurchase price equal to the average price over the 30 days preceding the greenmail transaction. This price control provision will be ineffective whenever the average price over a trailing 30-day period is greater than the prevailing market price because, under those circumstances, greenmail can be paid at a price higher than the price prevailing at the time of the repurchase.[16] Thus, the antigreenmail provision of S. 1323 may paradoxically lead to higher greenmail payments. Moreover, because some individuals may have an interest in creating a higher 30-day average price in order to support a larger greenmail payment, the danger exists that some individuals may attempt to manipulate stock prices to take advantage of such a greenmail price control rule. Under no circumstances would the rule prevent a large stockholder from selling his shares back to the corporation for a premium price unavailable to other, typically smaller stockholders.

The proposed legislation would therefore do little to deter greenmail. Instead, if enactment of the bill is construed as federal approval of transactions that comply with its toothless price control rule, passage of the legislation could actually increase the incidence of greenmail transactions. A similar pattern has, in the past, been observed in connection with the tax treatment of golden parachutes: Once Congress established a special tax applicable only to golden parachutes that more than trebled an executive's compensation,[17] a rule of thumb emerged that parachutes that no more than trebled compensation were acceptable.

Golden parachutes. The golden parachute provision in S. 1323 would prohibit a company from adopting a golden parachute only while a tender offer is pending.[18] But at least 198 of the *Fortune* 500 firms already have such plans in place,[19] and the legislation would do nothing to control these existing parachutes. The proposed legislation would also do nothing to deter corporations from adopting parachutes at any point in the future—provided the paperwork is signed before the tender offer begins. Thus, the bill would again be toothless, this time regarding the hundreds of parachutes that have already been strapped on in anticipation of takeover battles.

Poison pills. The poison pill provision of S. 1323 would prohibit only poison pills adopted while a tender offer is pending.[20] More than 400 publicly traded corporations have already adopted poison pills.[21] The pending legislation would not affect the existing pills and would do nothing to prevent the adoption of future poison pills before a tender offer is announced. Thus, this legislative proposal is toothless with respect to the hundreds of poison pill plans that have already been put in place.

Leading takeover counsel have advised clients to adopt poison pills now, so that they will be prepared in the event the bill becomes law.[22] Paradoxically, if companies accept this advice, the simple introduction of S. 1323 will have increased the number of "egregious" poison pills in place.

Antitakeover provisions. The provisions targeting "egregious defenses" are all bark and no bite. Are the provisions aimed at potential hostile bids equally inept? Hardly. The antibidder provisions are so broad and overinclusive that I have neither the time nor space to describe even a fraction of them. Instead, I will describe only one set of provisions with potential consequences that are particularly overbroad. If enacted, these provisions could radically change the structure of the entire stock market and influence thousands of transactions that have nothing to do with hostile takeovers.

S. 1323 would prohibit anyone from acquiring more than 15 percent of a company's shares unless the acquisition is made through a tender offer.[23] Combined with a provision in S. 1324 that prohibits partial tenders by requiring that tender offers for more than 20 percent of a company's shares be for all the company's shares,[24] the legislation would effectively prevent anyone from acquiring more than 20 percent of a company unless he tendered for the entire company.[25]

The consequences of this legislation could radically restructure large portions of the securities market that are unrelated to hostile takeovers. As an example of the reach of these provisions, consider the following illustrations of transactions that would be forbidden.

Suppose a large pharmaceutical company wants to acquire 30 percent of a smaller, biotechnology firm's shares in conjunction with a license or joint venture. The bidder will be prohibited from making that investment unless it tenders for all of the biotech company's shares. Thus, the legislation could force the smaller company out of existence as part of the price of obtaining equity capital.

Suppose a company's founder wants to bequeath his 60 percent holding to an only child. The founder could not do so unless the child tendered for the entire company.

If an investor wants to provide additional equity capital to a company in which she already owns 20 percent, she would be forbidden from doing so unless she offered to buy the entire firm. Indeed, any investor already holding a 20 percent position who simply wants to increase an existing position would be forbidden from doing so unless the investor makes a tender offer for the entire company.

Viewed from the seller's perspective, the situation is potentially even more far-reaching because any seller who owns 20 percent or more of a company's shares would be unable to dispose of those shares in a single block unless the purchaser agreed to conduct a tender offer for all the company's shares. The block would therefore have to be broken into smaller positions before it could be sold outside an any-or-all tender.

The reach of these provisions obviously stretches far beyond any rational concern over hostile takeovers. Because the legislation would seriously deter any share acquisition that creates a holding in excess of 20 percent, the legislation would, over time, cause the gradual extinction of stockholder positions above 20 percent. Strong minority shareholders are a valuable monitoring device in corporate governance, even if the minority shareholders never threaten a takeover or proxy contest. The gradual extinction of these minority positions could therefore change the balance of power between stockholders and managers in ways entirely unrelated to hostile takeovers.

In addition, it is no defense of the provisions to observe that the SEC could craft exemptions "consistent with the purposes and policy fairly intended" by the legislation.[26] It is a foolish bill, so overbroad that its authors would require an administrative agency to construct an armada of exemptions merely to allow garden-variety transactions to continue undeterred.

These constraints should be evaluated in conjunction with efforts to introduce an unworkable extension of the "conscious parallelism" doctrine from antitrust law to the takeover arena; impose on shareholders onerous disclosure requirements unrelated to takeover activity; and create sweeping extensions of private rights of action and theories of liability that invite for extensive litigation and strike suits. In this context it quickly becomes clear that the proposed legislation places far greater burdens on bidders, who may be doing nothing unfair or coercive, than on targeted companies responding to takeover attempts with allegedly "egregious" defenses.[27]

Is the Legislation Balanced?

By no stretch of the imagination does the proposed legislation live up to its promise neither to encourage nor discourage tender offers. Nor does the legislation live up to its promise to limit egregious defenses as well as coercive takeover tactics. Instead, the proposed legislation would seriously deter takeovers without regard to whether the takeover is fair and noncoercive; place impediments in the path of innocent transactions wholly unrelated to hostile deals; and do essentially nothing to deter "egregious defenses."

Obviously, even if one believes that something should be done about takeover activity, legislation of the sort supported by many Senate Democrats is not a reasonable approach to the takeover problem.

Notes

1. *SEC v. Boesky,* No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986).

2. Generally, there must be a purchase or sale of securities in breach of a fiduciary duty or a relationship of trust or confidence while in possession of material, nonpublic information about an issuer or the trading market for an issuer's securities. See, for example, *Dirks v. SEC,* 463 U.S. 646 (1983); *Chiarella*

v. United States, 445 U.S. 222 (1980); *United States v. Carpenter*, 612 F. Supp. 827 (S.D.N.Y. 1985), *aff'd* 701 F.2d 1024 (2d Cir. 1986), *cert. granted*, 55 U.S.L.W. 3424 (U.S. Dec. 15, 1986) (No. 86-422).

3. See, for example, *SEC v. Siegel*, 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987).

4. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert.denied*, 394 U.S. 976 (1969).

5. See, for example, *SEC v. DePalma*, 86 Civ. 3541 (D.D.C. Dec. 30, 1986); *SEC v. Wahl*, 86 Civ. 0568 (D. Neb. Aug. 20, 1986); *SEC v. Weksel et al.*, 86 Civ. 6063 (CSH) (S.D.N.Y. Aug. 6, 1986); *SEC v. Moorhead*, 85 Civ. 2007 (D. Colo. Dec. 2, 1985).

6. 133 Cong. Rec. S7594 (daily ed. June 4, 1987) (statement of Senator Proxmire).

7. Not all members of Congress make this error. As Congressman Markey, Chairman of the House Subcommittee on Telecommunications and Finance observed, the incidence of insider trading "does not, of course, mean that we should halt all corporate takeovers in order to root out the insider trading problem. But it does mean that those responsible for these transactions have not developed appropriate mechanisms to contain the flow of information relating to takeovers." Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, "Congressional Study Finds Persistent Run Ups in Target Company Stock, Indicating Possible Pervasive Insider Trading," at 2 (July 15, 1987) (news release quoting Representative Markey, Subcommittee Chairman).

8. *SEC v. Siegel*, 87 Civ. 0963 (Complaint, ¶ 23).

9. For a description of these negotiations and Nestle's interest in maintaining confidentiality, see *In re Carnation Corp.*, Exchange Act Release No. 22,214, 33 S.E.C. Dkt. 1025, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,801 (July 8, 1985).

10. Office of the Chief Economist, Securities and Exchange Commission, *Stock trading before the announcement of tender offers: Insider trading or market anticipation?* (Feb. 24, 1987).

11. "Friendly, negotiated takeovers have more pre-bid runup than hostile takeovers (47.1 percent versus 35.3 percent one day before the bid) when foothold acquisitions of the bidder are held constant at zero." Ibid at 3.

12. *United States v. Siegel*, 87 Cr. 118 (RJW) (filed Feb. 13, 1987) (Complaint).

13. J. Grundfest, *To catch a thief: Recent developments in insider trading and enforcement*, address to the National Investor Relations Institute, New York Chapter (June 20, 1986).

14. 133 Cong. Rec. S7594, 7596 (daily ed. June 4, 1987) (statement of Senator Proxmire).

15. S. 1323, 100th Cong. 1st sess. § 8 (1987) (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 78n).

16. This scenario can occur if there is an intervening bid that is withdrawn or if expectations of such a bid arise and then disappear.

17. *See* I.R.C. § 280G, Golden Parachute Payments (West Supp. 1987).

18. S. 1323, § 8 (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 78n).

19. V. Rosenbaum, Takeover defenses—Profiles of the *Fortune* 500 (Investor Responsibility Research Center, Jan. 1987).

20. S. 1323, § 8 (amending Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 79n).

21. S. Labaton, More potency for poison pills, *New York Times*, July 20, 1987, at D2, col. 1.

22. M. Lipton, The Proxmire bill and the pill, memorandum to clients of Wachtell, Lipton, Rosen & Katz, New York, NY (June 6, 1987).

23. S. 1323, § 7 (amending Section 14d of the Securities Exchange Act of 1934, 15 U.S.C. 78n[d]).

24. S. 1324, 100th Cong., 1st sess. § 9 (1987) (amending Section 14d of the Securities Exchange Act of 1934, 15 U.S.C.78n[d]).

25. There are two reasons I analyze these provisions in unison although they are not contained in the same bill. First, proponents of each provision are likely to believe they need the other one to make their provision "effective"; in other words, the mandatory tender offer provision will have a far stronger impact if combined with a mandatory "any or all" rule, and vice versa. Thus, the sentiment is there to combine these two provisions in a single piece of legislation, and they have earlier been considered as elements of a common bill. Second, the adverse consequences of each provision are most far-reaching if the two provisions are combined, and I wish to emphasize the perhaps unforeseen consequences of legislation that mandates tender offers for acquisitions above a certain size threshold while simultaneously prohibiting partial tender offers.

This is not to suggest that these provisions are harmless if uncoupled. To the contrary, the mandatory tender offer provision of S. 1323 and the mandatory "any or all" provision of S. 1324 are objectionable standing on their own. The mandatory tender offer provision would substantially increase the cost of acquiring more than 15 percent of a publicly traded corporation's shares, and it could also substantially and unnecessarily increase the incidence of partial tender offers by investors seeking to establish large equity positions. In addition, the provision would prohibit many large block transactions because the purchaser would have to tender for the large block and, pursuant to SEC rules, would have to accept tendered shares on a pro rata basis from all stockholders, not just the seller of the block. All this would occur without adding any meaningful efficiency or investor protection to the market.

The mandatory "any or all" provision of S. 1324 would prohibit partial tenders and either inefficiently deter valuable partial acquisitions that facilitate technology sharing, venture capital investments, and legitimate "toehold" investments made by investors who want a careful look at a company before deciding to acquire full control; or inefficiently provide an incentive for investors to purchase substantial blocks in transactions that are carefully structured so as to fall outside the SEC's tender offer rules. This latter consequence could stimulate the very "street sweeping" activity that Congress and the SEC seek to deter (that is, efforts to cause the rapid accumulation of blocks that can be "swept up" on the "street" through large, negotiated, private transactions).

26. S. 1323 § 7(b)(3), (amending Section 14d of the Securities Exchange Act of 1934, 15 U.S.C. 78n[d]).

27. See Statement of Charles C. Cox, acting chairman of the Securities and Exchange Commission, before the Senate Committee on Banking, Housing, and Urban Affairs, concerning Corporate Takeover Legislation (June 23, 1987).

Remarks Gregg Jarrell

John Shad, the outgoing chairman of the Securities and Exchange Commission, and his enforcement chief, Gary Lynch, have engineered a remarkable crackdown on insider trading on Wall Street. Dennis Levine pleaded guilty and agreed to pay a $12 million penalty; Ivan Boesky turned over $100 million and continues to cooperate with the SEC's investigation; and several other major Wall Street figures have since been arrested. Recently, John Shad promised several more major indictments would be forthcoming in the near future. These earth-shattering scandals have precipitated numerous Congressional hearings on insider trading and other abuses stemming from the record mergers and acquisitions activity of recent years. It seems these cases will provide the political momentum necessary for antitakeover lobbyists to accomplish what the Reagan administration has thwarted until now: major new legislation designed to deter hostile takeover attempts.

The new legislative proposals contain major changes in tender offer rules, such as increasing the "cooling off" period for offers from the existing rule of 20 business days to 60 business days. This proposal vividly exposes that the true legislative motivation is to chill takeovers, not to reduce the incidence of insider trading. After all, does anyone seriously believe that tripling the minimum offer period to three months will reduce the opportunities for insider trading?

Before the Wall Street scandals, which can be dated with the 14 November 1986 announcement of Boesky's settlement, the intensive lobbying efforts by big business to achieve legislation conferring "veto power" over hostile offers had yielded few results. These lobbyists (including the Business Roundtable and other spokespersons for top management of large public firms) have been alarmed by the changes in the takeover market that have made America's once untouchable, large public firms vulnerable to hostile takeover bids. These changes include the pro-merger attitude taken by President Reagan's antitrust enforcers; the 1982 Supreme Court ruling striking down first-generation state antitakeover laws; the deregulation of oil and gas, transportation, securities and banking, and other industries; and the neutral stance toward takeover combatants taken by the SEC under Reagan. These developments together have fueled a surge in merger and acquisition activity, and financial innovations have made hostile bids for large firms quite feasible for those willing to pay the requisite premiums over market price.

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Although state courts have provided some rulings favorable to the antitakeover forces—such as the Unocal decision upholding the exclusionary self-tender offer and the Household decision upholding management's unilateral adoption of the poison pill defense without obtaining shareholder voting approval—these decisions have been qualified to limit their usefulness as devices for deterrence. The SEC recently passed a rule making exclusionary tender offers illegal, and the Delaware supreme court, while legalizing poison pills, prescribed strict standards to prevent pills from being used to entrench incumbent managements.

But the Wall Street scandals, together with the Democrats' takeover of Congress in 1986 and the corrosive effects of the Iran-contra scandal on the resolve of the Reagan administration, create a recipe for regulatory reform. It is truly open season on corporate raiders. Even Boone Pickens, through his United Shareholders Association, has adopted an "if you can't beat them join them" attitude and proposed a long list of regulatory initiatives, although they are decidedly less hostile to takeover specialists than the Congressional version. Although these new laws will prove costly to the mass of individual shareholders and mutual fund holders, the narrow but powerful political interests of top corporate management and various lobbyists will be the primary voices helping to craft the new laws.

Remarks

Steven C. Salop

I have been charged with discussing the implications for competition policy of the papers in this volume, in particular, their implications for antitrust policy governing mergers and acquisitions. I will briefly set out the regulatory environment governing mergers and acquisitions and then discuss the possible influence of the findings in this volume on merger policy.

Merger policy in the United States is carried out mainly by the Department of Justice (DOJ) and Federal Trade Commission (FTC). Under the Hart-Scott-Rodino Pre-Merger Notification Act of 1976, all proposed acquisitions of assets valued in excess of \$15 million by an acquiring firm with assets or sales in excess of \$100 million must be reported to the agencies. A merger cannot be consummated until one of the agencies has evaluated its likely effects on competition. If the agency finds a problem of competition, the merging parties can either withdraw the proposal, negotiate a method of alleviating the agency's

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concern (for example, by selling off a plant or an entire division), or litigate the issue. Very few cases are litigated. Over the years 1982–86 the FTC and DOJ brought enforcement actions against only 56 of the more than 7,700 mergers reported.[1]

Mergers are evaluated under Section 7 of the Clayton Act. A merger is illegal if it "substantially decreases competition or tends to create a monopoly." Three concepts of competition may be relevant for merger policy.

First, to economists, this language concerns market power, the ability of firms in a market to restrain output and thereby raise price above the competitive level, as defined by marginal cost. Mergers, especially mergers among competitors, may reduce competition in this regard by facilitating the exercise of market power.

Second, to economists, competition may concern the production efficiency of firms in the economy. Mergers and acquisitions, whether by competitors or by firms in separate markets, may help the merging firms reduce costs.

Third, to some noneconomists (possibly including the Congressmen who drafted and amended Section 7), competition concerns more than economists' definition of market power. Competition also concerns the social and political implications of concentration of assets or production among the largest firms in the economy as well as the ability of small businesses to remain viable in the economy. According to this concept of competition, acquisitions by large corporations can increase aggregate concentration, as measured by the share of assets held by the 200 or 500 largest corporations.[2]

These three concepts of competition have different implications for merger policy. The first definition would suggest that merger policy should focus primarily on "horizontal" mergers (mergers among competitors), and to a lesser extent on "vertical" mergers (mergers between suppliers and customers), where the former raise credible allegations of anticompetitive exclusion. In contrast to the third definition, this view of competition would not be concerned at all with "conglomerate" mergers (mergers among firms that are neither actual nor potential competitors and that do not stand in a vertical relationship to each other). The third definition also may conflict with the second, as in the case of an acquisition by a large competitor. Whereas the second definition would applaud such a merger, this acquisition also may reduce the ability of smaller, less efficient firms to compete, thereby offending the third definition.[3]

The current antitrust authorities focus on the first and second definitions of competition. They are not at all concerned with aggregate concentration. All conglomerate mergers are permitted. Merger policy is concerned only with market power and, as a result, focuses almost exclusively on horizontal mergers. Throughout the Reagan administration years only one or two vertical mergers have been blocked. Cost savings and other increases in production efficiency flowing from mergers now are viewed as reasons to allow the mergers, not the opposite. Formally, these arguments serve as defenses to allegations that a merger will increase market power.

This view of efficiency benefits is stated in the 1984 Department of Justice Merger Guidelines, the bible of merger enforcement, as follows:

> Although they sometimes harm competition, mergers generally play an important role in a free enterprise economy. They can penalize ineffective management and facilitate the efficient flow of investment capital and the redeployment of existing productive assets. While challenging competitively harmful mergers, the Department seeks to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or competitively neutral.

The Guidelines relate this statement to efficiency as follows:

> Some mergers that the Department otherwise might challenge may be necessary to achieve significant efficiencies. If the parties . . . establish . . . that a merger will achieve such efficiencies, the Department will consider those efficiencies in deciding whether to challenge the merger.

This view of antitrust is important in understanding the relevance for antitrust policy of the papers in this volume. First, the papers will be relevant only if they concern horizontal or vertical mergers. These mergers are a fairly small fraction of the mergers reported each year to the antitrust enforcement agencies. Second, their main relevance will be to gauge either the likely increase in market power or the magnitude of cost savings and other efficiencies that could be expected from the representative mergers and to characterize more precisely the determinants of these variables for any particular merger.

The impact of mergers on market power is not a particular concern of the papers in this volume. Several of the papers do, however, focus on the potential efficiency benefits of mergers. The Hall paper on research and development and the Brown and Medoff paper on labor both study potential efficiency effects. By gauging the likely (average) efficiency benefits of the average merger, these papers can be of assistance to policy makers engaged in balancing efficiency concerns against likely increases in market power.

Unfortunately, these two papers, at least in their present form, have little direct application to antitrust policy. First, because antitrust was not their focus, they do not distinguish between mergers among competitors and other kinds of mergers. We therefore cannot tell whether the effects uncovered would apply to horizontal mergers. Second, because the sample of horizontal mergers is so small, efficiency effects for this subsample may be statistically insignificant.

Other papers that examined the motives for merger may have more significant implications for antitrust policy, even in their present form. As stated above, antitrust policy presumes that mergers generally are either neutral or motivated by concerns for efficiency. Several of the papers raised questions about this presumption.

For example, the Guidelines quoted above suggest that mergers create efficiency benefits by penalizing ineffective management. In principle, the enforcement thresholds governing market power were set to trade off these benefits optimally against market power concerns. If it were shown that mergers do not have significant managerial control benefits, it would follow that the optimal enforcement thresholds should be tightened.

In this regard, the Shleifer and Summers paper has important implications for merger enforcement. The authors show that the fact that firms are acquired at a premium over current stock market value should *not* create a presumption that the acquisition increases efficiency or social wealth. Instead, the premium may reflect nothing more than the opportunistic transfer of quasi-rents to the acquirer. In acquisitions in which this transfer is significant, there is no efficiency justification for tolerating even small increases in the likelihood of market power.

Shleifer and Summers also raise questions whether antitrust authorities should view attempts to block mergers by incumbent managers and rivals as good signals that the acquisition actually would enhance efficiency and competition. Rivals may legitimately fear that the acquisition would raise their own labor costs by creating a fear in their existing workers that they also will breach their implicit contracts. Incumbent managers may be protecting these contracts in order to minimize long-run costs, not to protect their own jobs.

The Auerbach and Reishus paper raises similar questions with respect to the tax benefits of mergers. The private benefits from reducing taxes exceed the social benefits or may have no social benefits at all. Thus, mergers motivated by tax savings do not create efficiencies that justify increases in market power. This paper finds that tax considerations generally are unimportant, in the sense that they do not explain which mergers take place. Unfortunately, this is not the main issue for antitrust policy. There seldom is a choice of merger partners.

For antitrust analysis, the more salient question would be the effect of tax considerations on the aggregate level of merger activity. This issue is addressed by the Golbe and White paper. Here the authors find no effects from the different tax regimes. To the extent that this finding suggests tax considerations are unimportant, acquisition premiums are more likely to reflect efficiency (or market power) benefits.

In short, the papers in this volume were not geared to antitrust policy considerations and, therefore, have few direct implications. Perhaps the authors might focus in their next round of research on the issues of concern to competition policy planners.

Notes

1. See *Antitrust and Trade Regulation Reporter,* vol. 52, 5 March 1987, 452. Private parties (customers, suppliers, or competitors) and states also can sue to block a proposed merger. Because of the federal government's primary role in the process, however, private and state litigation has generally had little significance. But this is changing now that the government has so relaxed its merger enforcement. More cases are being brought, often successfully.
2. For trends in aggregate concentration, see the Golbe and White paper in this volume.
3. For example, in the *Brown Shoe* case (370 U.S. 294 (1962)), the Supreme Court treated the potential efficiency benefits of the merger as a rationale for blocking it.

Remarks Lawrence J. White

In this brief set of remarks I will offer two public policy perspectives on the merger and acquisition process: first, that of a former chief economist of the Antitrust Division of the U.S. Department of Justice who was one of the authors of the division's 1982 Merger Guidelines; and, second, that of a current member of the Federal Home Loan Bank Board, which regulates most of the nation's savings and loan associations and savings banks and faces an era of turbulence and change in financial services markets.[1]

Antitrust Policy

Antitrust policy on mergers rests for its legal foundation on Section 7 of the Clayton Act. That act instructs the Department of Justice and the Federal Trade Commission to halt those mergers "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[2] It is worth noting that the Clayton Act makes no mention of size or of aggregate concentration across the entire economy.

In 1982 the Antitrust Division issued a set of "Merger Guidelines" that were designed to formalize the paradigm and procedures the division would follow in deciding whether to challenge a merger and also to provide this information to private antitrust attorneys, so that they

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could better guide and advise their clients. These Guidelines represented a complete revamping of an earlier (1968) set of merger guidelines. In 1984 the division modified the Guidelines modestly. (Unless otherwise indicated, the discussion below will refer to the 1982 version.)

The conceptual basis underlying the Guidelines is a concern that mergers may create or enhance market power. At the heart of the Guidelines is the belief, in the tradition of Chamberlin (1933), Fellner (1949), and Stigler (1964), that oligopolists in markets where entry is not easy are likely to behave in a noncompetitive fashion.

The Guidelines first provide a paradigm for defining a relevant market for the purposes of judging a given merger.[3] Since the purpose of the antitrust merger limitation is to prevent the significant creation of or increase in market power, markets are defined in terms of the ability of firms, if they act in concert, to exercise significant market power. In essence, the Guidelines define a market as the smallest group of sellers—defined across both product space and geographic space—that, if they acted in concert (that is, as a monopolist), could profitably raise prices by a "small but significant" amount for a "nontransitory" period of time.[4] The Guidelines use a 5 percent increase over a one-year period as the crucial parameters in this paradigm.

Having delineated the market, the Guidelines then ask if any paired set of the merger partners' products are in the same market. If not, the merger immediately passes muster and is unlikely to be challenged.[5] If one or more pairs of products are in the market, however, further examination is needed.

The next focus of the Guidelines is the level of seller concentration in the delineated market. The Guidelines use the Herfindahl-Hirschman index (HHI), according to which each seller's percentage of market share is squared and summed. (The HHI of an atomistic market would approach zero; that of a pure monopolist would be 10,000.) Two HHI cutoff points are specified: If a market's postmerger HHI is below 1,000, a merger will ordinarily not be challenged; if the HHI is above 1,800 (and the increase in the HHI that results from the merger is 100 points or greater), the merger will usually be challenged, unless there are extenuating circumstances, such as easy entry (discussed below). If the HHI falls between these two cutoffs, further investigation is warranted, and a challenge may be forthcoming. (For readers who are more comfortable with the four-firm concentration ratio as a measure of seller concentration, it is worth noting that an HHI level of 1,000 corresponds empirically to a CR4 of approximately 50 percent; an HHI of 1,800 corresponds to a CR4 of approximately 70 percent.)

Because conditions of easy entry would undermine the ability of even an apparent monopolist to act noncompetitively, the Guidelines' primary attention to seller concentration may seem somewhat backward in focus. The reason for this primacy, however, is that levels of seller concentration are easily quantified, whereas entry conditions are not easily quantified. The HHI levels do indicate some clear dividing lines (after the market boundaries have been delineated) and thereby provide some "safe harbors" and "clearly treacherous" zones. Still, in their preference for quantification, the Guidelines may be likened somewhat to the drunk who loses his keys in the middle of the road but then spends most of his time searching on the sidewalk under the street lamp "because the light is better there."

After discussing seller concentration, the Guidelines turn to conditions of entry. A high likelihood of significant entry into the market within two years (in response to a 5 percent price increase) is the crucial test for whether entry conditions are easy and hence for whether mergers between firms in markets with high levels of seller concentration will not be challenged. Unfortunately, no further quantification or precision is offered.

The Guidelines then move on to other market conditions, such as the uniformity of product, level of buyer concentration, and history of prior antitrust violations, that may yield some inferences as to the likelihood of noncompetitive behavior after merger. These conditions should be important in decisions whether to challenge mergers in markets with seller concentrations in the "further examination" range (that is, with an HHI of 1,000–1,800). Again, these are considerations that are solidly within the tradition of oligopoly theory. But, again, the discussion of these elements offers no quantification or greater precision.

Finally, the Guidelines address the question whether the promised economies of scale or other benefits of a merger should count as an offset to the possible creation or enhancement of market power. The 1982 Guidelines took a highly skeptical stance toward these promises; the 1984 Guidelines indicate a greater willingness to accept economies of scale as an offset.

These, then, are the major features of the current set of Merger Guidelines. How have they been used?

Assessments of antitrust policy implementation frequently cite the number of cases brought (the number of mergers challenged) as an indicator of stringency or leniency. This type of measure is largely inappropriate, for two reasons. First, a case is likely to be brought only when each of the litigating parties is sufficiently optimistic about its own chances of success, or about the stakes involved, so as to overcome the expected costs of litigation.[6] Another way of expressing this point is that the "location" of a legal standard (in terms of leniency or stringency) is much less important for the volume of litigation than is the clarity or fuzziness of that standard and the differences of opinion among the litigants that may thereby arise. Second, in circumstances in which a potentially offending merger can be "cured" by one of the merger partners' spinning off a branch plant or a product division to a third party buyer, this cure might be arranged through presuit or postsuit (but prejudgment) negotiations. The difference in method might be more one of litigation style by antitrust enforcers than of substance, but the difference in suits brought could be sizable.

Accordingly, judgments about implementation must instead rest on much more difficult assessments of the nature of those mergers that go unchallenged and of where the border of challenge appears to be. Nevertheless, my horseback judgment, along with that of virtually all other observers, is that merger policy has been more lenient during the Reagan administration than it was before and has become still more lenient in the administration's second term than it was in its first. This greater leniency is probably a product of the somewhat greater leniency that is built into the Guidelines themselves (as compared with the 1968 Guidelines) as well as the apparent tendency of the Reagan appointees to the Antitrust Division and the Federal Trade Commission increasingly to interpret them in a lenient fashion.[7] Even so, it is worth noting that antitrust policy on mergers has not been entirely dormant. In recent years the FTC has successfully challenged the proposed mergers of record producers Warner and Polygram and of soft drink producers Coca-Cola and Dr Pepper, and the DOJ challenged the form of merger initially proposed for the steel producers Republic and LTV. In addition, both agencies have challenged a number of mergers between smaller and lesser known companies and have either stopped them or cured them through appropriate spin-offs.

It has sometimes been claimed that one of the elements contributing to the merger boom of the 1980s has been the perceived leniency in antitrust policy. I am unaware of any quantitative support for this claim, and its validity seems highly dubious since most mergers do not appear to be among horizontal competitors and hence would not be challenged under almost any antitrust standard of competition. Moreover, it is worth invoking here Golbe and White's findings elsewhere in this volume. In their time-series analysis of merger activity, they use a dummy variable to distinguish the time periods before and after January 1981. The authors conceived that variable as one that might measure the effects of the major tax changes of that year, but it might equally well capture the effects of the soon-to-follow changes in antitrust policy. Regardless of interpretation, however, the coefficient on that variable is consistently nonsignificant in a number of alternative model specifications. Perceived antitrust leniency does not appear to be a significant cause of the merger wave of the 1980s.

Mergers in the Banking and Thrift Industries

The commercial banking and thrift (savings and loan and savings bank) industries have been, and are likely to continue to be, ones containing significant numbers of mergers in the 1980s. The reasons for the merger wave in these industries are fairly straightforward: the changed national economic environment in general of the late 1970s and early 1980s; the more specific economic declines of the 1980s in regions of the country that are highly dependent on energy, agriculture, or natural resources; changes in telecommunications and information-processing technologies and innovations in financial services markets, such as the development of the secondary mortgage markets and the general trend toward "securitization" of assets that were previously thought to be unique and nontradable; and the deregulation of depository institutions that has occurred in the 1980s. All four of these reasons are specific examples of the changed economic circumstances hypotheses advanced by Golbe and White in their paper in this volume. I will treat each of the contributing reasons for the merger wave in turn.

General economic conditions. The relatively high inflation rates experienced by the U.S. economy in the late 1970s and early 1980s meant relatively high, and rising, nominal interest rates. For a thrift industry that was accustomed to borrowing short (passbook savings accounts) and lending long (30-year fixed-rate home mortgages), the rise in nominal interest rates was disastrous. Caught with a portfolio of long-lived mortgages that had been made in earlier years at lower interest rates, but forced to pay higher rates on deposits to prevent those deposits from fleeing elsewhere, the thrifts were in a severe bind. The overall industry experienced losses in 1981 and 1982, and hundreds of money-losing thrifts were merged out of existence: With their mortgage portfolios largely "under water," they provided tempting purchase targets for the stronger thrifts (or outside purchasers) that had the staying power and were willing to bet on an eventual decline in nominal interest rates.

Specific regional declines. The economic declines of the 1980s in regions that are highly dependent on energy, agriculture, or natural resources have meant hard times for many of the financial institutions that lent money to businesses located in these areas. Significant numbers of banks and thrifts, not all of them actually located in these areas, have become insolvent from poor loans and investments in these regions, with mergers (frequently with financial assistance from the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation) usually following. It is ironic that a number of thrifts, experiencing losses from the interest rate squeezes, saw investments in the sunbelt region as the means of bailing themselves out—with unfortunate consequences.

Technological change and innovation. Improved telecommunications and data processing have made it easier to operate financial services networks over large geographic areas. And the development of very thick secondary mortgage markets have brought new investors (for example, pension funds and insurance companies) into mortgage funding and encouraged the expansion of mortgage bankers that originate and sell mortgages in the secondary markets rather than holding them in a portfolio funded by deposits. These changed opportunities have certainly encouraged some of the mergers in the banking and thrift industries.

Deregulation. In response to the plight of the thrifts in the late 1970s and early 1980s and in partial response to the changed circumstances of financial markets generally, the Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982.[8] These acts called for the phasing-out of the Federal Reserve's Regulation Q (which had mandated the interest rate ceilings that banks and thrifts could pay on most of their deposits); authorized all thrifts to offer consumers interest-bearing checking accounts (negotiated order of withdrawal, or NOW, accounts); authorized banks and thrifts to offer adjustable rate mortgages; expanded the authority of thrifts to engage in lending and investment outside of home mortgages, including consumer, commercial, and agricultural loans and direct equity investments; and eased restrictions on banks' and thrifts' ability to purchase other depository institutions across state lines, if the purchased institutions were in financial difficulties. Simultaneously, some states (notably California, Texas, and Florida) were expanding the investment powers of thrifts; and more recently, many states have entered into regional or reciprocal compacts that have permitted interstate purchases and branching of banks and thrifts. Again, these changes have contributed to the merger wave in these industries.

Summary. It seems clear that, at least for the next few years, these changed and still-changing conditions will mean a continuing high level of mergers. The thrift industry has shrunk from almost 4,800 institutions (as members of the Federal Home Loan Bank System) in 1970 to approximately 3,500 today. As of this writing, the FSLIC has a problem list of approximately 400 insolvent thrifts that are unlikely to survive by themselves. Merger, in one form or another, is the likely outcome for most of them. And increased opportunities for interstate purchases and branching will likely mean the merger of many more. This will be true for the approximately 14,000 commercial banks as well.

In sum, flux and changing opportunities are likely to continue in the financial services markets, at least for the next few years. And these conditions will surely be conducive to a continuing wave of mergers in this sector.

Notes

1. Further discussion of merger policy and procedures can be found in White (1985) and Salop et al. (1987).

2. As noted earlier in this panel discussion, the DOJ and the FTC share responsibility for enforcing the Clayton Act. The division of responsibility for investigating potential cases is largely arbitrary, with historical expertise in the industrial or commercial area as the major guiding principle. The DOJ, though, does have sole responsibility for reviewing mergers in most regulated areas, such as transportation and financial services.

3. In my opinion this was the major conceptual advance achieved by the 1982 Guidelines.

4. It is worth noting that the market definition paradigm focuses primarily on a group of sellers, since it is sellers that may exercise market power. If a group could practice price discrimination toward one group of buyers—say, buyers in one geographic region—then the paradigm calls for a focus on those buyers as well.

5. If one of the merger partners is a likely entrant into one or more of the product markets of the other, where entry is difficult and potential entrants are scarce, a challenge to the merger might still be forthcoming.

6. For further discussion of this point see Salop and White (1986).

7. Although the FTC is not formally bound by the Guidelines, informal agency practice has been to follow their broad outlines.

8. Further discussion of the regulation and deregulation of depository institutions can be found in White (1986).

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