The 1980s Takeover Boom and Government Regulation

Gregg A. Jarrell

The mergers and acquisitions boom of the 1980s is now officially over, and the liberal press is having a field day scolding everyone they hold responsible for the decade of greed. Even free-market economists are criticized for their role in encouraging the Reagan administration to allow such a fiasco. Popular books and articles routinely assert that the excesses of the 1980s caused many of our current economic problems. The hugely expensive failures of the S&Ls, the sharp rise in bankruptcy filings by large companies, and the restructurings by many overleveraged and uncompetitive firms have been blamed on the overheated market for junk bonds and the hostile takeover activity in the late 1980s. Even the recent recession was attributed in large measure to the excessive debt taken on by firms and individuals in the go-go 1980s.

Recent studies disprove many of those assertions. Especially misunderstood remains the role of junk bonds. Glenn Yago and others show that junk bonds could not have been a significant factor in the S&L crisis because they accounted for only a trifling fraction of the thrifts' investment portfolios. Bad real estate loans and perverse regulatory policies were probably the real culprits. The recent recovery of the junk bond market bolsters those who argue that its collapse was due to regulatory overkill. Likewise, the credit crunch that helped trigger the recession and the sudden inability of the banks to serve their highly leveraged clients during the business downturn were directly related to overly political regulatory decisions. More broadly, recent research by Robert Comment and me indicates that the 1980s trend toward reduced corporate diversification created substantial economic benefits.

Despite the blows to conventional wisdom emerging from economic research, greedy popular writers writing about greed continue to get their facts wrong. A recent account of the Securities and Exchange Commission's activities during the 1980s, David Vise and Steve Coles's *Eagle on the Street*, concludes that the Chicago School economists and their free-market ideology are primarily responsible for the excesses on Wall Street. The authors assert that the policies of Chairman John Shad, the ex-Wall Street executive nominated by Ronald Reagan in 1980, reflected primarily the

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economic advice of several Chicago-trained economists, including Charles Cox (the chief economist from 1982 to 1983, a commissioner from 1983 to 1989, and the acting chairman in 1987) and me (the chief economist from 1984 to 1987). That advice, they claim, fostered the laissez faire regulatory environment that allowed numerous hostile takeovers, forced widespread defensive restructurings, and generally caused the "leveraging up" of American businesses.

Vise and Coles argue that if the free-market economists had stayed away from the SEC, things would have turned out better. The takeover boom would have been nipped in the bud. Therefore, junk-bond takeover financing would not have arisen. And the S&Ls would not have destroyed themselves by investing in junk bonds. Indeed, inside trading would not have corrupted so many without the lure of takeover-induced price runups. Corporate America would not have been forced to leverage up its balance sheets and close plants without the pressure from corporate raiders. Although the economy, absent the takeover boom, might have been less robust in the 1980s, they argue, the absence of the debt and financial crises caused by the takeover binge would have saved us from the inevitable postbinge recession. Damn those Chicago economists!

Of course, the depiction of the "decade of greed" in *Eagle on the Street* is not unique. Indeed, *Den of Thieves* by James Stewart is a more skillful distortion of the times. But *Eagle* attempts to chronicle the influence of Chicago economists and other Reagan-era policymakers on the regulatory responses and nonresponses to those events. Here I reexamine the major regulatory policies and debates concerning takeovers and mergers to assess the charges against free-market economists. I find the notion that the SEC economists had any important effect on takeover policy to be unsupported. On the contrary, takeover policy at the federal and state levels never reflected the central positions held by Reagan-era SEC economists and their financial-economist allies in academia. Instead, it was shaped by states-rights conservatives within the Reagan administration, who persuaded Shad and others that corporate governance issues were best left to the states. Once the SEC adopted the "federalist" policy of deference to state legislatures, the agency was relegated to its current inconsequential role in regulating mergers and takeovers. Meanwhile, the antitakeover forces quickly implemented their complete menu of takeover barriers with the cooperation of parochial state lawmakers. Despite its economists' urging for an open market for corporate control, the SEC quite simply allowed itself to be outflanked.

The Conflict between the Conservatives and the SEC Economists

The policy debate between the conservatives and the SEC financial economists was not rooted in fundamental differences over normative, first-best policy prescriptions for takeover policy. Indeed, both sides proclaimed allegiance to free-market principles. The first-best approach to takeover regulation, all might have agreed, would have been to repeal the 1968 Williams Act—the federal "disclosure and delay" rules administered by the SEC—since it was not justified by promarket economic analysis. Also acceptable to both sides was the basic system of state corporation law, with the role of the federal regulators kept to a minimum. There was a generally held faith that the state laws of incorporation had worked well and that federal corporation law would be a mistake. That faith was predicated on the notion that to compete for firms to incorporate in their jurisdictions, states would offer an efficient menu of enabling statutes and efficient court systems that would provide great net economic benefits. Such competition would be absent if the federal government entered the business of chartering companies, and so free-market economists and legal scholars typically favored state regulation.

Takeover policy at the federal and state levels was shaped by states-rights conservatives within the Reagan administration who contended that corporate governance issues were best left to the states. Once the SEC adopted the "federalist" policy of deference to state legislatures, the agency was relegated to its current inconsequential role in regulating mergers and acquisitions, while antitakeover forces implemented their complete menu of takeover barriers.

The notion that competition among states worked well has always been a contentious issue, even among free-market advocates. Obviously, the states have certain parochial interests that competition would not eliminate, the pursuit of which would destroy national wealth. But the constitutional prohibition against interfering with interstate commerce should make the system of state competition a fairly reliable one for producing economically efficient regulations, the conservatives reasoned.

Perhaps no issue has tested the theory of "efficient laws through state competition" more severely than takeover laws. During the 1980s the very real policy decisions under debate forced supporters of federalism to decide how solid their belief in state competition really was. The SEC economists reasoned that the Williams Act was essentially a set of rules restraining bidders, and that a second-best policy solution required some authority to devise a corresponding set of rules restraining targets. Otherwise, inefficient obstacles would burden the market for corporate control and thereby reduce national wealth significantly in the long run. They concluded that preempting state authority with an active SEC policy restricting target behavior was the preferred second-best solution.

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The SEC economists were generally trained in business schools as financial economists, with little or no study of the law or political-economic theory. They naively approached corporate governance issues by applying theories of agency cost and efficient markets. To protect a free market for corporate control, the financial economists generally opposed defensive tactics by targets. Perhaps reflecting their naivete, they were apparently happy to allow an aggressive, interventionist SEC to regulate against abusive defensive tactics, such as poison pills and exclusionary self-tender offers. Financial economists at the SEC and in academia accorded great weight to stock-price studies in reaching their judgments on the economic merit of any particular offensive or defensive tactic. Once a tactic had been labelled as either pro- or antitakeover, the economists urged the federal government to act decisively, either to clear the way if protakeover or to prohibit its use if defensive. Since state regulators appeared to be pathologically opposed to takeovers, the financial economists found themselves pinning their hopes for sensible takeover policy on an aggressive, active, promarket SEC.

Meanwhile, conservative policymakers within the Office of Management and Budget and the Council of Economic Advisers continued to urge a minimal federal role in regulating the affairs of corporations, even in the presence of the Williams Act. Therefore, they left it to the states, primarily Delaware, to police target defensive behavior—their second-best solution. The economic policy advisers of OMB and the council were economists and legal scholars with decidedly noninterventionist leanings. Those conservatives, especially the lawyers, seemed to view the takeover regulation movement as part of a pervasive attempt by federal regulators to usurp traditional state jurisdiction over large parts of corporate law. After all, many of the legal scholars earned their stripes by arguing against liberal proposals (supported by the SEC) to adopt a federal incorporation law that would largely replace the current system of state corporate law.

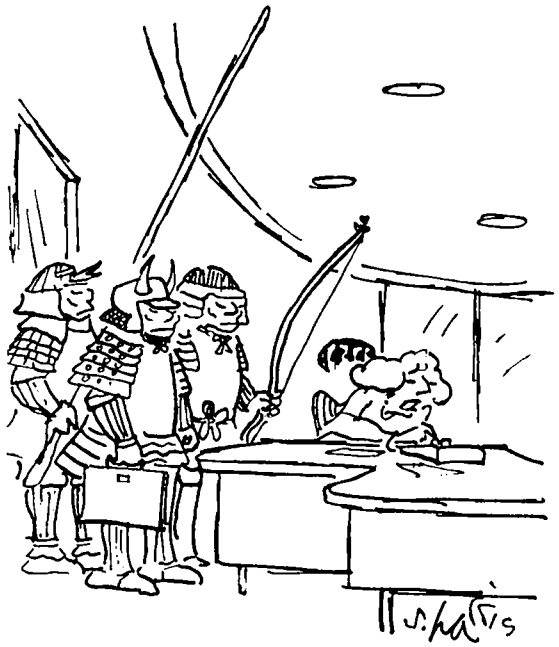
They were accordingly concerned about how the SEC would use any newfound authority in the future under Democratic administrations (or even under moderate Republican administrations). Much more so than the SEC free-market economists, the conservatives looked past the immediate arguments concerning whether a particular tactic increased or decreased the trading value of companies. Although the Shad SEC appeared likely to use its authority in ways consistent with free-market ideology, the conservatives reasoned that history clearly showed that the SEC simply could not be trusted in the long run. During the Shad years, the conservative policymakers outside the SEC exerted the dominant influence in shaping the federal regulatory response to takeover activity.

This, then, is a brief overview of the complex debate. What follows is an attempt to review the debate in more detail to understand the political-economic forces that seem to have brought us what I regard as a highly undesirable and economically inefficient set of takeover regulations.

The Origins of SEC Regulations of Tender Offers

Until the early 1960s, tender offers were infrequent and usually negotiated rather than hostile. Later on in the 1960s, overtly hostile bids became headline material over the still strong objections of many Wall Street practitioners. Those unregulated tender offers were dubbed "Saturday night specials" because they were open for only brief periods and offered premiums (modest by modern standards) on a first-tendered, first-served basis. During the late 1960s a series of congressional hearings gave rise to a political coalition including management groups that were threatened by hostile offers, conservative elements of the Wall Street community, and federal regulators who were concerned that certain classes of shareholders were being disadvantaged in hostile control contests. Those hearings resulted in the passage of the Williams Act in 1968, which imposed comprehensive disclosure and delay rules on all cash-only tender offers. In 1970, after the market saw a sudden shift away from all-cash transactions toward security-exchange offers that were covered only by the traditional 1933 Securities Act disclosure requirements, Congress passed the Williams Act Amendments to include all kinds of tender offers under the new rules.

The Williams Act's advertised purpose of investor protection was apparently reflected in its detailed disclosure rules, which provided target shareholders with greater time and information to make a rational tendering decision. Specifically, the act regulates three major areas of corporate control activity. First, section 13(d) requires large (originally over 10 percent, now 5 percent) purchasers of a public firm's stock to disclose within ten days their identity, their stock holdings, their financing arrangements, and their intention with respect to seeking control, influencing strategy, or passively holding. Additional disclosures are required in the event of either changes in holdings or intent. Second, the act regulates tender offers directly, by requiring a minimum offer period (originally ten calendar days, now twenty business days with an automatic ten-day extension in the event of a competing tender offer), withdrawal rights, and strict rules for prorating oversubscribed partial and two-tier offers. The disclosure rules also cover target management's public responses to third-party tender offers, and certain disclosure and delay rules govern self-tender offers that firms make for their own stock. Finally, the act also contains broad antifraud provisions that give target managements explicit standing to sue for injunctive relief from perceived ill-effects of false or misleading disclosures. The 1970



"An investment group from Tokyo is here. To me it looks like a hostile takeover bid."

A series of congressional hearings in the late 1960s gave rise to a political coalition of management groups threatened by hostile offers, conservative elements of the Wall Street community, and federal regulators concerned that certain classes of shareholders were being disadvantaged in hostile control contests. Those hearings led to passage of the Williams Act.

amendments significantly expanded the SEC's power to make new rules under section 14(e) to prevent fraudulent and manipulative activities.

The purported intent of the Williams Act was to provide a balanced set of rules designed to protect shareholders from abusive bidder tactics. It was reasoned that effective and nonmanipulative disclosures, coupled with greater time for deliberation and a guarantee of fair participation, would remove the tactical advantages that had previously allowed bidders to "stampede" shareholders into accepting possibly less than optimal offers. Indeed, the act was more neutral than many advocates wished it to be. It was certainly less onerous for bidders than the first-generation state takeover laws that had blanketed the country by 1980 and required prebid disclosure of bidders and subjected offers to possibly lengthy hearings for "merit" approval by state regulators.

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Nevertheless, the Williams Act came under criticism by free-market economists for being unfavorable to bidders. Although a decade passed before empirical results on the effects of the act began to appear, the findings were particularly striking. The act clearly caused tender offer premiums to increase and the returns to successful bidders to fall. In short, the disclosure and delay rules shifted a significant proportion of the gains in shareholder wealth created by tender offers from bidders to targets. The evidence raised concern among some economists that the act's rules unfairly expropriated the value of bidders' takeover-related information and handed it to passive target shareholders. That conflicted with free-market principles, according to which bidders should be allowed strong property rights in the economic value of their information about corporate control.

Moreover, the tender offer rules clearly benefitted target managements by providing them with legal standing and time to litigate, select alternative bidders, and otherwise frustrate hostile bidders. Although much of that activity also benefitted target shareholders through higher premiums, the incidence of target managements' use of abusive, value-destroying defenses rose dramatically with the passage of the act. Those concerns ultimately led to a dissenting opinion by the two economists serving on the 1983 SEC Advisory Panel, Frank Easterbrook (at that time a noted University of Chicago legal scholar with a strong economic approach to the law) and me. Our dissent urged a significant repeal of many of the Williams Act's disclosure and delay rules to allow bidders greater property-rights protection over their takeover-related information. Our dissent effectively defined the free-market position on takeovers that the SEC economists later followed. Financial market policymakers largely rejected both the 1983 Easterbrook-Jarrell dissent and the SEC financial economists' specific advice in 1986.

The political-economic analysis of the Williams Act does not end with recognizing that target managements and shareholders of many of the target firms are beneficiaries of the act. The act spawned drawn-out, litigious, multiple-bidder contests by giving takeover targets and potential rival bidders sufficient time and "free" information about the hostile attackers' ideas to mount effective challenges. The contests of the late 1970s and 1980s are direct products of the act's disclosure and delay rules. The immense activity created a large community of takeover advisors on Wall Street. Naturally, that Wall Street community of MBAs, corporate lawyers, and accountants is among the SEC's most powerful constituency groups. The Williams Act has become to them what the Sherman and Clayton Acts have been to the antitrust bar and microeconomists. The interests of that constituency were clear: Wall Street benefitted by disclosure and delay regulations that boosted the demand for their services without excessively stifling takeover activity in the first place. Wall Street's interests diverged from those of target management groups and labor, however, on the issue of state antitakeover laws, because those laws were tough enough to stifle most takeover activity and thus reduce the demand for Wall Street services.

The Rise and Fall of First-Generation State Takeover Laws

From the perspective of embattled target managements and organized labor, the Williams Act did not go far enough in erecting barriers to unwanted takeover attempts. Managements under siege sought protection from state and federal courts, while broader management coalitions sought further restrictive regulation from state legislatures. By the end of 1976 thirty-six states had passed statutes that were usually much tougher on aspiring acquirers than the original Williams Act. Generally, those laws required more stringent disclosures by the bidder well in advance of the tender offer—usually ten to thirty days before the announcement. Further, they required longer minimum offer periods and more liberal withdrawal rights than did the original Williams Act. But the most important defensive provisions were their administrative procedures, by which state regulators could significantly delay or even prohibit hostile tender offers. That amounted to de facto merit regulation of hostile tender offers. The state laws empowered state securities commissioners to seek an injunction against any offer believed unlawful, made violations a criminal offense, and provided for compensatory damages for shareholders.

The late 1970s and early 1980s are replete with examples of protracted takeover battles, with target managements' making full use of both Williams Act and state law defenses. Many of those cases saw court sanctions ending hostile bids, with large damages to target shareholders in the form of foregone premiums. In other cases court-imposed delays carried clear economic costs with no obvious shareholder benefits. Meanwhile, the SEC lobbied hard against the spread of state statutes. The commission argued that state laws at best were duplicative of the SEC's rules and at worst were so protective of targets as to harm shareholders. The scorched-earth defenses employed by many besieged target managements gave the SEC's complaints the ring of truth. In 1982 the Supreme Court in the pivotal case of *Edgar* v. *Mite* agreed with the SEC and struck down virtually all of the first-generation state laws as unconstitutional.

Justice White's majority opinion appeared to embrace a sweeping free-market philosophy in assessing the market for tender offers. White asserted that the offending Illinois law distorted the "reallocation of economic resources to the highest-valued use, a process which can improve efficiency and competition." The majority held that the Illinois act violated both the commerce clause, because the law's jurisdictional rules were overly inclusive, and the supremacy clause, because the law regulated tender-offer conditions in a manner excessively duplicative of the Williams Act and thus infringed on federal prerogatives. Although that famous decision wiped out the existing panoply of state regulations over tender offers, it also showed future drafters possible ways to craft new state laws that would survive constitutional challenges. It would take five or six years, but the new state laws would effectively end hostile takeovers and usurp tender offer regulation from the SEC for good.

The Debate over Reforming Federal Tender Offer Rules

By the mid-1980s several forces, including sweeping industry deregulation, innovations in the financing of large-scale acquisitions, and a marked relaxation of antitrust merger restrictions, jointly stimulated the greatest boom in mergers and acquisitions activity in U.S. history. With state laws dead and the disclosure and delay provisions of the SEC insufficiently onerous to help besieged target managements, the strategic advisers to defending targets invented new, nonregulatory defensive weapons: the Pac-Man defense, the poison pill, the golden parachute, greenmail buyouts, and crown-jewel lockups.

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At that time the debate about takeover regulations at the SEC was influenced by at least three interest groups. Against takeovers was the somewhat odd coalition of organizations representing top corporate management, liberal politicians,

organized labor, and representatives of local community interests. They pushed for takeover restrictions in every available arena, including state and federal courts, state legislatures, the SEC, the Federal Reserve Board, the Federal Trade Commission, and Congress. Opposing the antitakeover interests were the free-market advocates, who pushed for rules to promote an unfettered market for unsolicited tender offers. They included an equally strange assortment of financial economists at the SEC and other federal agencies as well as from academia, shareholder activists who specialized in needling large corporations, and corporate takeover entrepreneurs and their Wall Street advisors. But the most influential group in shaping the SEC's responses to proposals for new takeover regulations was also the least visible to the public. Following Reagan's 1980 victory, many influential scholars who had been urging deregulation and promarket reform of governmental processes joined the administration to implement their ideas. Those conservative policymakers formed several expert "regulatory shops" in the Office of Management and Budget, the Council of Economic Advisers, the Federal Trade Commission, and the Justice Department's Antitrust Division. From their powerful positions, they actively advised and influenced appointed regulators on policy in a bold attempt to coordinate regulatory policy and to ensure that each agency's traditional constituencies did not frustrate the administration's goals.

Top corporate management, liberal politicians, organized labor, and local community interests pushed for federal and state takeover restrictions. Free-market advocates including SEC financial economists pushed for rules to promote an unfettered market for unsolicited tender offers. Conservative Reagan administration policymakers argued against further federal regulation of the market for corporate control.

The administration's policy on regulation of the market for corporate control was spelled out in chapter 6 of the 1985 *Economic Report of the President.* Authored by Joseph Grundfest, who was then at the Council of Economic Advisers and shortly thereafter was appointed as an SEC commissioner, the policy argued aggressively that the market for corporate control should not be further regulated at the federal level. Supported by a comprehensive review of the dozens of financial-economic studies on takeovers and defensive tactics, that chapter became the blueprint for the SEC's regulatory policies over the next few years. As an SEC commissioner, Grundfest joined with OMB's Douglas Ginsburg to become the strongest influence on shaping Chairman Shad's takeover policies. The differences in the positions between the Grundfest-Ginsburg conservatives and the SEC financial economists might have appeared to be subtle at the time, but in the longer run they have turned out to be extremely important.

The Debates over Greenmail and Poison Pills

The debate in 1984 over the practice of greenmail was my first exposure to those two different approaches. Greenmail offended many free-market economists because it allowed target managements to pay premium prices to a particular shareholder without extending the offer to other shareholders. The SEC economists studied greenmail and documented that it caused large stock-price declines on two counts: the nonparticipating shareholders effectively financed the buyout, and the buyout usually eliminated the prospect of a premium bid. Therefore, the financial economists condemned greenmail and branded as "entrenched" the target managements that paid it without first obtaining shareholder approval. The economists also eagerly supported SEC proposals to force greenmail to be approved by shareholder vote.

The administration policymakers disagreed. They argued that it was not the place of federal regulators to dictate which particular issues should be subject to corporate votes. Although the conservative advocates agreed that greenmail appeared to harm shareholders, they reasoned that concerned shareholders could persuade management to put before them charter amendments that, if passed, would require a vote before greenmail could be paid. Moreover, they noted that disgruntled shareholders who had been harmed by managements' paying greenmail could use existing proxy machinery to register their discontent. Chairman Shad agreed with the conservatives' position, and the SEC did not ban greenmail.

A similar division occurred regarding poison pills, devices that reduce the target's value in the event of takeover. Professor Michael Jensen, then of the University of Rochester and Harvard University and a leader of the free-market financial economists, was the economic expert witness in the famous poison pill case involving Household International. Jensen argued that poison pills dramatically reduced the alienability of common stock and, therefore, should be subject to shareholder voting approval before being adopted. The SEC submitted a friend-of-the-court brief arguing the same thing and referred to economic studies by the SEC's Office of the Chief Economist showing stock-price declines when pills were used.

The Delaware court rejected those arguments. It ruled that the business judgment rule protected pill adoptions by managers and directors and thus pill adoption did not require a shareholder vote. The Delaware court's decision was an embarrassing defeat for the SEC lawyers and economists. Did the SEC then move to regulate against poison pills? No. Although the financial economists joined forces with SEC staffers in urging the SEC to overrule Delaware and require a shareholder vote on poison pills, a sympathetic Chairman Shad decided that the issue was best left to the state courts. Once again takeover policy was being shaped not by financial economists or lawyers at the SEC but by the conservatives and Delaware.

The New State Laws and the End of Hostile Takeovers

The takeover regulation debates resulted in few new federal initiatives in accordance with the conservatives' preferences. In the end the state legislatures and courts were left with the task of modifying state corporation law in response to the demands of the mergers and acquisitions boom. The financial economists at the SEC, who urged that the SEC regulate target conduct as vigorously as the Williams Act regulated bidder conduct, were completely unsuccessful in shaping the new takeover policy. As the SEC stood aside, Delaware and other states ignored the economists' advice regarding poison pills and exclusionary defensive self-tender offers.

Delaware's courts ruled that poison pills could be adopted unilaterally by management, a decision that ushered in nearly universal poison-pill adoptions by virtually all large and medium-sized public corporations. Although the Delaware courts established strict legal standards of conduct for pill-protected target managers during hostile contests, the procedure ensured costly litigation and heavy involvement by the Delaware courts in all hostile contests involving Delaware targets. Moreover, targets protected by poison pills used the newfound delaying tactic more to engage in leveraged restructurings (that helped to preserve their jobs) than to maximize shareholder benefits. The explosion in the late 1980s of leveraged restructurings, in which target managers borrowed massive amounts of money and repurchased significant fractions of equity to defeat the hostile offer, would not have been possible without the legalization and widespread adoption of the poison pill.

The takeover regulation debates resulted in few new federal initiatives in accordance with the conservatives' preferences. State legislatures and courts were left with the task of modifying state corporation law. SEC financial economists were completely unsuccessful in shaping the new takeover policy.

Perhaps in response to the rash of leveraged restructurings, the Delaware courts began to signal litigants that they might legally accept a "just say no" takeover defense, if the target management could make a persuasive case that the hostile offer threatened "long-term" shareholder or company interests. The *Time-Paramount* decision did exactly that. It effectively legalized using the poison pill as an absolute defense against hostile tender offers. The courts ruled that Time's board of directors need not allow their shareholders to have access to Paramount's high-premium, all-cash hostile offer if the Time board reasonably decided that the "long-term" value of its business plan (essentially paying Warner a premium to merge with Time) was superior to the Paramount tender offer. The business judgment rule now protected target management who refused to redeem their pills to allow shareholders access to premium offers, so long as they and their advisors carefully crafted the proper "paper trail."

While the Delaware courts were approving powerful new defensive tactics, the state lawmakers were drafting two new types of antitakeover laws

designed to be less vulnerable to constitutional challenge. In 1987 the Supreme Court approved Ohio's control share acquisition law, which stripped away the voting rights to shares purchased through hostile tender offer or large, open-market transactions. Hostile acquirers have to win a special shareholder vote held about fifty days later to regain the power to vote the stock. The Supreme Court ruled that the law dealt with voting rights for corporate stock, traditionally an area solely regulated by the states. Further, the Court held that the law did not directly interfere or overlap with the disclosure and delay provisions of the federal rules and thus did not violate the supremacy clause. The court noted that, while Ohio's law might represent "economic folly," that does not make it unconstitutional.

Besides the control share acquisition law, the other more powerful innovation was the merger moratorium law. That law simply disallowed a hostile acquirer (who crossed a 15 percent stock ownership threshold without first receiving approval from the target's board of directors) from merging with the target for a period of three to five years, depending on the state. That law's force comes from denying the acquirer the ability to formally legally merge with the target, which is necessary in most situations to gain complete control over the target's assets and corporate policies.

While hostile takeovers are still technically possible to launch, they are virtually impossible to execute unless the bidder first obtains the approval of target management. In practice, that means that the hostile bidder has to make a high-premium, all-cash, fully financed tender offer combined with a proxy fight to attempt to put maximum pressure on the target board to negotiate.

Those two kinds of state takeover laws were widely adopted by the late 1980s, before Delaware had a state law. Delaware lawmakers appointed a special committee of mostly outside legal experts to consider how Delaware should handle the issue of state takeover laws. The committee decided that, although the control share acquisition law was approved by the Supreme Court and the merger moratorium law was not, the latter provided a more powerful deterrent against hostile takeovers and would be more popular with its vast constituency of top corporate managers. The Delaware legislature then adopted its version of the merger moratorium law, called section 203, that contained a novel 85 percent exclusion for certain hostile bidders to create the illusion of concern for the shareholder. That exclusion exempts a hostile acquirer from the fatal merger moratorium provisions if the acquirer can purchase over 85 percent of eligible shares in the same transaction that takes the acquirer over the 15 percent threshold. The exclusion creates the impression that the lawmakers did not want to block hostile offers that would be sufficiently popular with target shareholders, but it is illusory because target managers can easily form blocking positions that make it impossible for acquirers to use the exemption. Indeed, since passage of the law there have been no hostile acquirers that have used the 85 percent exclusion.

Shortly after passage of that law, the Delaware courts ruled that most employee stock ownership programs, even if they are set up in defense of a hostile offer, can be used by target managers to make their companies "bulletproof" under section 203. As a result of that ESOP ruling, and given the many other innovative means Delaware companies have used to form friendly stock blocks, the Delaware merger moratorium law effectively has no exclusion and is an outright obstacle to hostile tender offers.

But, is Delaware's law unconstitutional? Wisconsin has a similar merger moratorium law that was challenged in 1989 in litigation stemming from the attempted takeover of Wisconsin's Universal Foods Corporation. Judge Frank Easterbrook handled the appeal and ruled that the Wisconsin law dealt mainly with merger rules, which were traditionally a subject strictly reserved for state corporation law. Also, the law did not materially interfere with the SEC's other rules governing tender offers (except, of course, to practically eliminate tender offers), and so all merger moratorium laws are deemed to be constitutional. Et tu, Frank?

By 1990 the vast majority of states, including the dominant state of Delaware, had powerful laws that acted as nearly absolute deterrents to hostile takeovers. Moreover, Delaware targets could legally use the dreaded poison pill to defend

against most hostile tender offers. Technically speaking, hostile takeovers are still possible to launch. But they are virtually impossible to execute unless the bidder first obtains the approval of target management, so that the poison pill is redeemed and the state law is rendered inapplicable. In practice, that means that the hostile bidder has to make a high-premium, all-cash, fully financed tender offer combined with a proxy fight to attempt to put maximum pressure on the target board to negotiate. The bidder will have to incur long delays (several times the minimum offer period of the Williams Act), be entangled in extended litigation, win a bare-fisted proxy fight, and pay top dollar to prevail. That daunting prospect translates to unacceptably high financial and political risks for most bidders and virtually all third-party lenders. Thus, hostile tender offers, especially for larger companies, have been eliminated in recent years and may be extremely rare in the foreseeable future.

Conclusion

The rise to dominance of Delaware as our nation's regulator of takeovers and mergers should not please advocates of a free market for corporate control. One wonders whether it pleases the conservative policymakers of the Reagan administration who worked so hard and so successfully to limit the role of the SEC in directing takeover policy. The result of Delaware's domination has been court decisions and new antitakeover laws that have choked off all means by which bidders can make premium tender offers available to target shareholders without obtaining the approval of the target's management. The nearly absolute inability of hostile bidders to "go over the heads" of target managers and deal directly with target shareholders is the exact antithesis of a free, unfettered market for corporate control.

If the SEC had heeded the advice of its financial economists instead of federalism-minded conservatives, it is at least arguable that Delaware could have been prevented from dominating takeover rules. The SEC probably would have mandated a shareholder vote before adopting poison pills, which certainly would have dramatically restricted the spread of pills. It would also have forced target companies to rely on the Williams Act rules during takeover contests, which would have diminished the spread of defensive leveraged restructurings and put shareholders squarely in charge of the fate of besieged target managers. Such a free market would not have spawned greater financial leverage, because the evidence is clear that even before Drexel Burnham's collapse, the trend to higher leverage was reversing itself as leveraged buyout returns were declining.

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The theory of *Eagle on the Street*—that free-market economists allowed the takeover boom of the 1980s to damage our economy—is contrary to the evidence. Indeed, economists committed first and foremost to an open market for corporate control never had any significant influence over policy. If they had, tender offers would have been regulated by a reformed Williams Act, with ten-day minimum offer periods and 10 percent (not 5 percent) Schedule D thresholds. There would have been very few poison pills, and state laws governing takeovers in any direct or indirect way would have been declared unconstitutional intrusions of interstate commerce. Since I believe that most of the deleterious effects of the merger and acquisition boom of the 1980s can be directly traced to defensive actions by desperate target managers, I also believe that even the liberal press would have been more satisfied with the corporate landscape of the 1990s if only the alleged influence of free-market economists had actually been real.

Selected Reading

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