
Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Averting a Kamikaze Regulatory Campaign

TO THE EDITOR:

Gregg Jarrell's article in the Summer 1992 issue of *Regulation*, "The 1980s Takeover Boom and Government Regulation," offers a remarkably revisionist history of the decline and fall of the hostile takeover. We undertake to set the record straight, particularly in light of Jarrell's ad hominem attack. ("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 [that is, Jarrell] might have appeared to be subtle at the time, but in the longer run they have turned out to be extremely important.") Time for a strong dose of reality.

The dominant view in the academic literature is that corporate managers successfully prevailed upon state legislatures to restrict takeover activity. In addition, the state courts upheld various antitakeover devices that could be implemented by corporate managers despite strong shareholder opposition. Most notably, the courts interpreted state law as allowing a corporation to adopt, without shareholder approval, a "poison pill" that rendered it financially impractical for a bidder to take over the company against the wishes of the target's management. The credit

crunch of the early 1990s, stimulated in large part by federal banking legislation that undercut the high yield bond market and by regulatory initiatives designed to curb "highly leveraged transactions," provided the *coup de grace* by eliminating much of the financing that had been used in hostile takeover transactions.

As a result, the volume of hostile takeover transactions plummeted from twenty-seven deals worth \$38.5 billion in 1988 to two deals worth only \$77.4 million in 1991. Not a single hostile bidder initiated a successful transaction in all of 1992.

Jarrell understands the key role that state legislatures and courts played in the demise of the hostile takeover. According to Jarrell, however, the world would now look quite different had the Securities and Exchange Commission only followed his advice when he served there as chief economist. Jarrell would have had the commission adopt rules prohibiting greenmail and other management defensive strategies and requiring that a shareholder vote be held to adopt a poison pill provision. In addition, he would have had the federal courts declare state antitakeover statutes unconstitutional. Indeed, Jarrell goes so far as to criticize Judge Frank Easterbrook of the Seventh Circuit Court of Appeals, no slouch when it comes to free market thinking, for upholding Wisconsin's antitakeover statute.

The trouble with the alternative strategy that Jarrell claims the commission should have followed is that it is a prescription for lawless agency action, heedless of the bounds placed upon the SEC both by the terms of its delegation from Congress and by the United States Constitution. As is clear from the D.C. Circuit's decision in *Business Roundtable v. SEC*, the commission has no jurisdiction to mandate shareholder votes on any matter. The commission can require disclosure in connection with shareholder votes that are mandated by state law.

It can condition certain forms of regulatory grace upon shareholder ratification of a board of directors' decision. But only the state of incorporation has the authority to require a shareholder vote as a condition of corporate action.

Jarrell's suggestion that the commission should have prohibited greenmail payments suffers from the same flaw. The commission may require extensive disclosure in connection with greenmail payments. The authority actually to prohibit such payments, however, lies only with the states and is clearly a matter beyond the SEC's jurisdiction.

Jarrell's criticism of Judge Easterbrook's decision upholding Wisconsin's antitakeover legislation is equally ill-informed. We are a nation of laws adopted by elected representatives through a deliberative, legislative process. We are not a nation in which the law is dictated by any economist's—or court's—vision of Nirvana. It is therefore hardly surprising that a judge sworn to uphold the Constitution and obliged faithfully to interpret the law might sometimes have to uphold the constitutionality of an unwise measure. Indeed, when Judge Easterbrook upheld Wisconsin's antitakeover statute in *Amanda Acquisition Corp. v. Universal Foods Corp.*, he did so with the observation that "[i]f our views of the wisdom of state law mattered, Wisconsin's takeover statute would not survive."

Similarly, when the Supreme Court upheld Indiana's antitakeover statute, Justice Antonin Scalia joined in the judgment, observing that he "does not share the Court's apparent high estimation of the beneficence of the state [antitakeover law] at issue" and that "a law can be both economic folly and constitutional" (*CTS Corp. v. Dynamics Corp. of America*).

Jarrell apparently does not grasp the distinction between that which is permitted by law and that which may be economically imprudent. It is thus with ill grace that he criticizes judges who both understand and perhaps agree with his economic agenda but also understand and honor the lawful allocation of authority between the states and the federal government.

Accordingly, had the SEC "heeded the advice of its financial economists" as Jarrell insists it should have, the commission would have

rushed headlong into a series of regulatory initiatives that would quickly and properly have been overturned by the courts as exceeding its authority. Indeed, on the one occasion when the commission followed Jarrell's strategic wisdom and sought to prohibit certain dual-class recapitalizations, partially on the ground that differential voting rights could make many corporations "takeover proof," its regulations were struck down for exceeding its authority (*Business Roundtable v. SEC*). Yet, oblivious to the legal realities, Jarrell now criticizes the agency for not having embarked upon a kamikaze regulatory campaign simply to prove its fealty to Jarrell's interpretation of free market principles.

More fundamentally, however, Jarrell's critique raises questions about the operation of a federalist system in which the states may have powerful incentives to adopt policies that promote local interests over the greater national good. The relationship between federalism and state corporation law has provoked a substantial strategic and scholarly debate. There is, however, precious little reason to believe that Jarrell's proposed federal preemption of all matters related to takeover law—which is far outside the terms of that

debate—would have improved upon the world we face today, imperfect as it may be.

At the most pragmatic level, there is not the slightest reason to believe that if Congress actively usurped the state's corporate law jurisdiction, it would then legislate in accordance with Jarrell's free market philosophy. To the contrary, as Jarrell's own analysis demonstrates, every congressional initiative in the takeover arena (principally the Williams Act and its amendments) has been designed to restrict the market for corporate control.

From a broader policy perspective, it is also highly questionable whether the public interest would be served if we were to abandon principles of federalism and thus to give Congress a monopoly on regulation of corporate self-governance rather than to leave that responsibility to the fifty state governments. As an economist, Jarrell is well aware of the benefits of competition. Those benefits can also be found in the market for legislation and regulation, where competition can provide diversity, innovation, and experimentation. To imagine that a federal monopoly on corporate governance in general or on takeover regulation in particular would lead to a *laissez*

faire policy is to take leave of one's senses, to forget all one might know of our history, and to ignore all that an economist should know about public choice.

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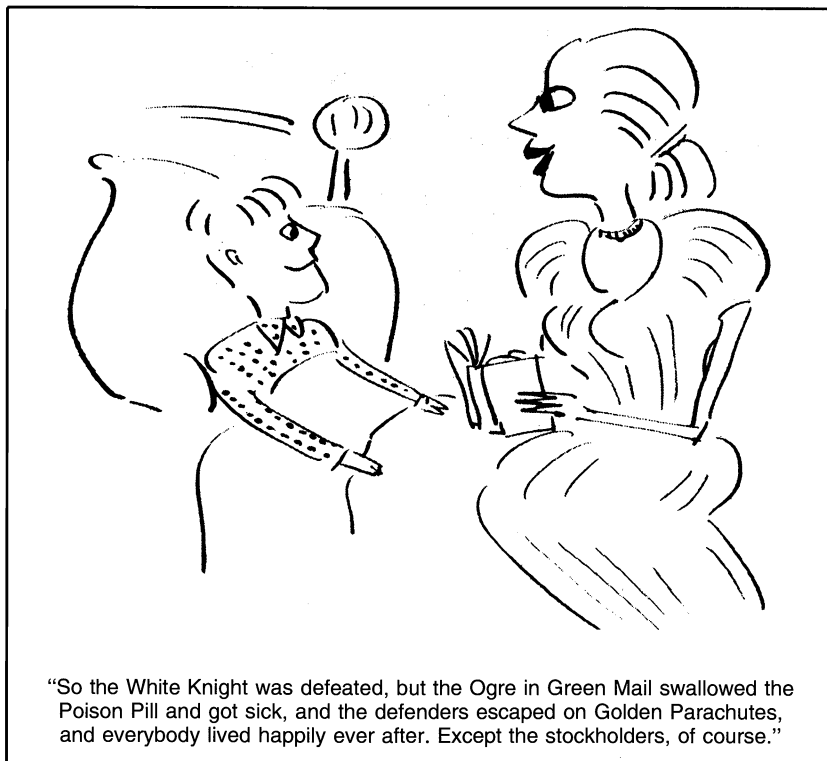
Douglas H. Ginsburg
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United States Court of Appeals
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Reviewing the Evidence on Air Bags

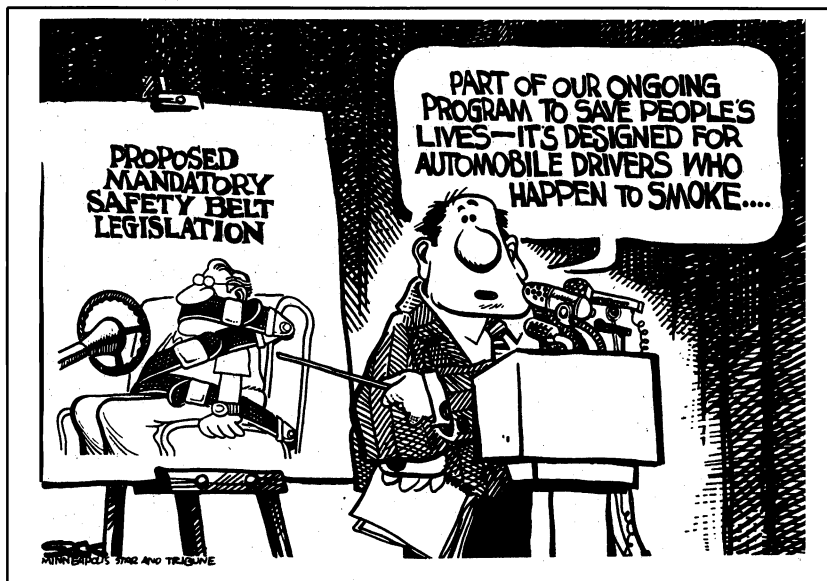
TO THE EDITOR:

In the Summer 1992 issue of *Regulation* George Hoffer and Edward Millner wrote a current addressing the question, "Are Drivers' Behavioral Changes Negating the Efficacy of Mandated Safety Regulations?" In answering the question, the authors turned to insurance claims data to assess the effectiveness of air bags in reducing motor vehicle crash injury, arguing that, "barring any behavioral changes, occupants of cars equipped with safety appliances [air bags] should have lower relative insurance claims than occupants of vehicles not so equipped."

Unfortunately for your readers, the Hoffer and Millner current misuses data from the Highway Loss Data Institute, erroneously implies that air bags have not reduced occupant injury in motor vehicle crashes, and ignores much of the published literature that directly addresses their question of risk compensation in response to safety regulation. The insurance data analyzed by the authors are inadequate to address the question of injury reduction with air bags. Several evaluations confirming the injury-reducing and life-saving benefits of air bags have been published, and substantial empirical evidence directly contradicts the hypothesis of significant behavioral risk-taking in response to safety regulations, such as air bags. The Hoffer and Millner article reflects a lack of scholarship in the treatment of data as well as in the failure to review the relevant literature regarding both



"So the White Knight was defeated, but the Ogre in Green Mail swallowed the Poison Pill and got sick, and the defenders escaped on Golden Parachutes, and everybody lived happily ever after. Except the stockholders, of course."



the significant public health problem of motor vehicle crash injury and the titillating, but largely irrelevant, hypothesis of risk compensation.

The Analysis. Hoffer and Millner's evaluation of the risk compensation hypothesis compared injury and property damage claims information for twenty-one car models before and after they were equipped with air bags; the information was obtained from Highway Loss Data Institute Insurance Injury Reports. However, as the institute notes in those reports, the presence of an air bag cannot be expected to have a large effect on injury claim frequencies. Air bags are designed to save lives and reduce serious injuries in relatively severe frontal collisions. They will not eliminate all injuries, especially the less serious and more common ones, in crashes not severe enough for the air bag to deploy. In those crashes that are severe enough to involve air bag deployment, at least some minor injuries that result in insurance claims may still occur. In addition, most cars with air bags have only driver-side air bags, and the institute's injury claim frequencies are based on injuries to all vehicle occupants regardless of seating position. For those reasons, simple analyses of insurance injury claims frequency data cannot reveal whether air bags have reduced the incidence of serious injury in motor vehicle crashes.

Air Bag Effectiveness. Not only do Hoffer and Millner misuse the Highway Loss Data Institute's data in analyzing the effects of air bags on

injury, but they completely ignore published documents that confirm unequivocally the effectiveness of air bags. A special institute study of injury claims in severe frontal crashes, where air bags are expected to have their primary benefit, found a 25 to 29 percent reduction in severe injury claims for 1990 model cars equipped with air bags relative to cars equipped with automatic belts. A second study by the Insurance Institute for Highway Safety found that driver deaths in air-bag-equipped cars were down 19 percent relative to similar cars equipped only with manual belts (additional data have since increased this estimate to 20 percent). Recently, the U.S. Department of Transportation released its evaluation of the federal standard requiring automatic restraints in all new cars and concluded that cars equipped with air bags were experiencing 11 to 17 percent fewer driver fatalities. Hoffer and Millner's implication that air bags have not reduced injuries from motor vehicle crashes is not only based on a misuse of the Highway Loss Data Institute's data but is clearly contradicted in published reports.

Evidence for (against!) Risk Compensation. Because there is no evidence that air bags have been ineffective, there is no reason to look for changes in driver behavior that might be negating air bag effectiveness. That is no surprise. Application of the risk compensation hypothesis to automobile safety innovations like air bag protection requires a belief that people have a certain tolerance for risk and that their level of

risk is regulated by a homeostatic mechanism. By that argument, if forced to "consume" more safety than they would voluntarily, people will balance the safety increase by taking more risks. That strong version of the risk compensation hypothesis has long since been discredited; one investigator concluded after substantial review of the history of highway safety that "risk homeostasis theory should be rejected because there is no convincing evidence supporting it and much evidence refuting it."

Evidence from earlier research indicates that offsetting, risky behavior has been documented only in response to safety changes that affect the handling or performance characteristics of the car that provide some direct feedback to the driver (for example, studded snow tires). Air bags simply do not affect the performance characteristics of the vehicle. They provide even less feedback to drivers than do seat belts, and evaluations of seat belt use laws have provided direct refutation of risk compensation. The Insurance Institute for Highway Safety studied driver behavior related to risk, such as speed and following distance, before and after belt use became mandatory in Newfoundland, Canada, and in the United Kingdom. The results of those studies revealed no evidence of any increase in driver risk-taking, even after a year's experience with mandatory belt use (in the United Kingdom). Belt use is a much more obvious form of increased occupant protection, and, if risk compensation were a real possibility, one would expect it to occur more readily with mandated belt use than with the introduction of less obtrusive protection like air bags.

Hoffer and Millner's observation that property damage collision claims have increased for air-bag-equipped cars is also a misrepresentation of insurance claims data. The authors' statement that "for eighteen of the cars, the relative collision (physical damage only) claim frequency increased relative to their performance when the autos were belt-equipped" is incorrect. For the twenty-one included in the comparisons, ten had higher collision claim frequencies, nine had lower collision claim frequencies, and two were unchanged from the previous year. The authors' statement apparently reflects confusion between collision

claim frequency and the average collision loss payment per insured vehicle year, a measure that includes both claim frequency and the average loss payment per insured vehicle year. The latter measure did increase as claimed by the authors, but it is not surprising that the newer vehicles equipped with air bags have somewhat higher collision average loss payments. That increase does not suggest an increase in collisions from riskier driving; in fact, as indicated, the data actually indicate no change in the incidence of collisions for air-bag-equipped cars.

The Hoffer and Millner current gives the wrong answer to a spurious question. There is no theoretical or empirical reason to expect that increases in risky behavior are offsetting the documented effectiveness of air bags. Questions affecting the lives of millions of people deserve better formulation and a genuinely scientific approach to their answers.

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What Is Driving Behavioral Change?

HOFFER and MILLNER reply:

We believe that Drs. Lund and Hazelbaker misinterpret our results. First, let us emphasize that if all other things were equal, we would choose an air-bag-equipped vehicle over a nonequipped one. We do not dispute that if all other things are equal, air bags lower the extent of occupant injuries in an accident. Nowhere in our original article did we make or imply statements to the contrary. What we did report is that sixteen of twenty-one domestic and foreign

model car lines with air bags as standard equipment through the 1990 model year, and for which Highway Loss Data Institute reported results in September 1991, incurred worse frequency claims filed under personal injury coverage in the year the air bags became standard compared with the previous year. That result was significant well within the 5 percent level and was not contested by Lund and Hazelbaker. While we do not argue with their contention that the extent of injuries may have decreased, under no circumstances would a significant increase in relative accident frequency be expected unless some other factors are at work.

We also reported that eighteen of those twenty-one vehicles had worsened their average loss payment per insured vehicle over the same time period since incorporating air bags. The probability that those events could have occurred at random was less than 1 percent. We noted that the worsening of collision results could be expected due to the estimated \$1,000 expense of replacing the bag system once it has been deployed. Had the latter not occurred, our findings under the personal injury coverage would have been questionable. Lund and Hazelbaker pointed out correctly that we referred to the frequency of loss rather than the average loss in our initial presentation of those statistics. We apologize for any confusion our poor phrasiology may have caused.

We forwarded three hypotheses to explain our findings. Based on Highway Loss Data Institute findings that seat belt usage is comparable in air-bag- and non-air-bag-equipped vehicles, we discarded the obvious hypothesis that occupants of air-bag-equipped vehicles, feeling safer, reduce their use of seat belts.

The second hypothesis that we forwarded was supportive of Professor Sam Peltzman's work of over a decade ago. In several academic pieces Peltzman presented evidence that while mandated safety devices may have prevented the deaths of some vehicle occupants and associated insurance losses, those savings were accompanied by increased losses from nonoccupant deaths and a higher frequency of nonfatal accidents. We discussed at length that

the literature is almost totally non-supportive of the Peltzman hypothesis and even quoted Crandall and Graham's summary of the literature that any driver behavioral changes are swamped by the engineering effects of safety hardware. Nonetheless, our results are consistent with Peltzman's hypothesis—specifically, that both the frequency of insurance claims under personal injury protection and the average collision loss payment increased for air-bag-equipped cars relative to when they were last equipped only with seat belts.

Our third hypothesis was that the findings really reflect a market demand for safety appliances. Automotive buyers who perceive themselves at risk for whatever reason—type of driving, annual mileage, driving location, personal habits—seek out the vehicles that they perceive to be safer. During the observation period, air bags were widely touted as an effective safety device; therefore, "at risk" drivers may have purchased cars equipped with air bags in greater proportion than the general population. With more at risk drivers in air-bag-equipped vehicles, our findings may reflect the short-run change in the risk attributes between drivers of air-bag- and non-air-bag-equipped cars.

To conclude, we do not argue with Drs. Lund and Hazelbaker's review of the literature or discussion on the effectiveness of air bags. We certainly do not want to be interpreted as saying that air bags make cars less safe. Nonetheless, there is evidence that something is happening in the real world—either drivers or buyers are making behavioral changes in response to the availability of air-bag-equipped motor vehicles. Additional research is needed in this area to clarify exactly what is happening.

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