Corporate takeovers became a prominent feature of the American business landscape during the seventies and eighties. A hostile takeover usually involves a public tender offer—a public offer of a specific price, usually at a substantial premium over the prevailing market price, good for a limited period, for a substantial percentage of the target firm's stock. Unlike a merger, which requires the approval of the target firm's board of directors as well as voting approval of the stockholders, a tender offer can provide voting control to the bidding firm without the approval of the target's management and directors.

Because it allows bidders to seek control directly from shareholders—by going "over the heads" of target management—the tender offer is the most powerful weapon available to the hostile bidder. Indeed, just the threat of a hostile tender offer can often bring a recalcitrant target management to the bargaining table, especially if the bidder already owns a substantial block of the target's stock (called a foothold block) and can demonstrably afford to finance a hostile offer for control. Although hostile bidders still need a formal merger to gain total control of the target's assets, this is easily accomplished once the bidder has purchased a majority of voting stock.

Hostile tender offers have been around for decades, but they were rare and generally involved small target firms until the midseventies. Then came the highly controversial multibillion-dollar hostile takeovers of very recognizable public companies. By the late eighties there were dozens of multi-billion-dollar takeovers and their cousins, leveraged buyouts (LBOs). The largest acquisition ever was the $25 billion buyout of RJR Nabisco by Kolberg Kravis and Roberts in 1989. [Editor's note: this was written in 1992.]

Leveraged buyouts of small companies had also been common for decades, but in the eighties LBOs of large public companies became common. An LBO is a going-private transaction involving a tender offer for all of a firm's common stock, financed mostly by debt, made by a group usually involving some members of incumbent management. LBOs and leveraged cash-outs (first cousins of LBOs in which the target firm remains public because a small part of the compensation to selling shareholders is stock in the new, highly leveraged enterprise) rose to popularity for large public firms in the late eighties as a reaction to the hostile takeover activity. In essence the LBO was a way for management of a vulnerable public company to beat the hostile bidder to the punch, allowing management to buy out public shareholders at a premium and engage in the value-enhancing asset redeployments that otherwise would attract takeover entrepreneurs.

The vulnerability arises from a large "value gap"—which is the difference between a company's value as a going concern under the policies of incumbent management and the expected higher value of the stock, factoring in the value of redeploying the target's assets. Incumbent managements learned to tap the vast financial muscle of Wall Street in the late eighties and to engage in these control transactions to avoid being the victims of hostile attack. Indeed, many of the large leveraged restructurings were taken in direct defense after a hostile bid had been made.

Both economic and regulatory factors combined to spur the explosion in large takeovers and, in turn, large LBOs. The three regulatory factors were the Reagan administration's relatively laissez-faire policies on antitrust and securities laws, which allowed mergers the government would have challenged in earlier years; the 1982 Supreme Court decision striking down state antitakeover laws (which were resurrected
with great effectiveness in the late eighties); and deregulation of many industries, which prompted restructurings and mergers. The main economic factor was the development of the original-issue high-yield debt instrument. The so-called "junk bond" innovation, pioneered by Michael Milken of Drexel Burnham, provided many hostile bidders and LBO firms with the enormous amounts of capital needed to finance multi-billion-dollar deals.

Managers of target companies in takeover battles have access to a variety of defensive tactics, many invented during the turbulent eighties. These defensive measures have always been controversial because they necessarily pose a conflict of interest for management. A top manager's own narrow interest is to save his job, which he often loses after a takeover. His legal obligation is to get a good deal for shareholders, which often means allowing the takeover. Not surprisingly, some managers go with self-interest.

The array of takeover defenses includes charter amendments that require supermajorities (i.e., votes of 70 percent or even 80 percent of shareholders) to approve a merger; dual-class restructurings that, by creating two classes of stock, concentrate voting control with management; litigation against the hostile suitor (usually alleging violations of antitrust and securities laws); and purchasing the hostile bidder's foothold stock at a premium to end the takeover threat (so-called green-mail payments). Although these particular defenses often are effective at delaying the hostile bidder, they rarely are enough to keep a target company independent. The two modern-day defensive weapons that can be "show-stoppers" are the poison pill and the state takeover laws.

The term "poison pill" describes a family of "shareholder rights" that are triggered by an event such as a hostile tender offer or the accumulation of voting stock above a designated threshold (usually 15 percent of outstanding stock) by an unfriendly buyer. When triggered, poison pills provide target shareholders (other than the hostile bidder) with rights to purchase additional shares or to sell shares to the target on very attractive terms. These rights impose severe economic penalties on the hostile acquirer and usually also dilute the voting power of the acquirer's existing stake in the firm.

Although poison pills are considered to be absolute deterrents to a hostile takeover, they can almost always be cheaply and quickly altered or removed by target management if they have not been irrevocably triggered. Therefore, they almost always are the subject of strenuous state-court litigation in takeover battles, and their practical effectiveness as an absolute deterrent has been decided in court more often than not. Today, the majority of large public companies are armed with poison pills of one type or another. State courts have allowed target managers to use pills to buy time (up to several months) to search for better third-party offers or develop value-creating corporate restructurings.

In the late eighties the Supreme Court upheld the constitutionality of state takeover laws, the most important being Delaware's merger moratorium law. This law prohibits a hostile acquirer from formally merging with the target for at least three years after buying a controlling interest. Widely regarded as a major deterrent, the Delaware law has an exception if the hostile bidder can acquire more than 85 percent of the target's stock, excluding shares held by inside managers and by certain kinds of employee stock-ownership plans. Since the law passed, Delaware-incorporated companies (which account for the majority of medium-size and large public companies in the United States) have engaged in various kinds of transactions to "lock up" more than 15 percent of stock in friendly hands, rendering these companies "bullet-proof" under Delaware law.

State antitakeover laws and the poison pill have dramatically reduced the scope for hostile tender offers in the U.S. market. Both defensive barriers can be overcome only by getting the target board of directors to approve the takeover. Therefore, hostile takeover activity has been moved directly into the boardroom, through the increasing use of proxy fights in conjunction with tender offers that are conditional on the bidder gaining control of the board or approval from the incumbent board. This hybrid proxy/tender offer approach is considerably more expensive,
time-consuming, and risky than the hostile tender offer of the eighties. Consequently, hostile takeover activity has declined sharply, and the campaigns that have been waged were long, drawn-out proxy battles.

Was all this takeover and LBO activity good for the economy? The issue stirs strong emotions on both sides, but I believe the evidence shows that takeovers and buyouts are a good thing. Many published studies have documented the effects of tender offers and mergers on stock prices. The consensus is that these transactions confer large stock-price gains on target shareholders, averaging about 30 to 50 percent over preoffer prices during the eighties. The evidence on returns to bidders, however, is mixed. During the period from 1960 to 1980, the average stock-price gain to bidding firms was 3 to 5 percent. But during the eighties the returns to bidders began to erode, and some studies conclude that bidder firms suffered modest stock-price declines, on average, during the late eighties.

The principal reason for this erosion is the increased competition for targets. This increase in competition resulted from the target’s greater effectiveness at dealing with the initial suitor and at getting rival bids, including bids from the targets’ own management. The winning bidders in these auction contests of the late eighties frequently paid top dollar and saw their stock prices decline when the market learned that they had “won.”

Nonetheless, the huge gains to target shareholders mean that takeovers and so-called highly leveraged transactions (HLTs) have created large net economic gains. Indeed, Harvard’s Michael Jensen estimates that over the fourteen-year period from 1976 to 1990, the $1.8 trillion of tender offers, mergers, divestitures, and LBOs created over $650 billion in value for selling-firm shareholders. Moreover, this estimate does not include the additional large gains made by companies that restructured out of fear of being taken over.

Although this estimate excludes the gains and losses to shareholders of bidding firms, the empirical studies that find net losses for bidders also show that these losses—at 1 to 3 percent of the stock price—are minuscule compared with the enormous gains to target shareholders. These academic studies show clearly, on the basis of share prices, that hostile takeovers and highly leveraged transactions created huge increases in the values of companies. Moreover, several follow-up studies have shown that these stock-price gains are generally reliable predictors of real operating improvements and of increased corporate efficiency.

Critics of takeovers often complain that these share-price gains ignore the economic losses that takeovers and LBOs impose on other groups connected with the target firms. This intense debate has centered on the potential harm to corporate “stakeholders” other than shareholders, such as bondholders, employees, customers, suppliers, local communities, and taxpayers. Many takeovers in the airline industry, for example, have involved conflict between acquiring-firm management and the unionized labor of the target firm. These conflicts contributed to the popular view, shared by some economists, that shareholder premiums from takeovers come largely at the expense of labor’s wages and benefits. But the empirical research has failed to show any reliable association between takeover activity and the income of workers. According to Joshua Rosett’s recent study of over five thousand union contracts in over a thousand listed companies from 1973 to 1987, less than 2 percent of the premiums to shareholders can be attributed to wage reductions in the first six years following takeovers. In hostile takeovers the data show an increase in union wages in years following the control changes.

Another frequent complaint is that the constant threat of hostile takeovers forces nearly all corporate managers to stress short-term policies at the expense of more valuable long-term plans, thereby impairing the economic health and competitive vigor of their companies and the nation. Although rhetorically stirring, this theory has been studied thoroughly by economists and has received no empirical support. For example, the research shows no connection between takeover activity and public companies’ expenditures on research and development. Studies also show that share prices generally respond
positively to long-term investments by corporations. Also unsupported is
the charge that losses to bondholders finance the shareholder gains
from takeovers. Although some shareholder gains have come at the
expense of bondholders, banks, and other creditors who financed these
deals, Michael Jensen estimates that the aggregate amount of these
losses between 1976 and 1990 is not likely to exceed $50 billion, a
small fraction of the $650 billion gain to target shareholders.

There is some empirical basis for the idea that reducing taxes was at
least a partial motive for takeovers, and especially LBOs. Some
researchers estimate that for the typical leveraged buyout, tax savings
(from deducting higher interest payments) accounted for about 15
percent of the premiums paid to sellers. Still, most mergers and tender
offers were not motivated by tax savings. Also, Jensen has found that,
contrary to popular assertion, LBOs have actually increased total tax
payments to the U.S. Treasury. That is because selling shareholders
pay taxes on their gains. All in all, the evidence shows that tax savings
account for only a small fraction, at most, of the huge gains to target
shareholders and other selling firms.

In sum, although some individuals (incumbent management, for
example) and some other groups obviously lose in any takeover, the
empirical studies offer little or no support for the notion that the huge
gains to shareholders reflect similarly large losses to other related
parties. These zero-sum theories cannot begin to explain the large
shareholder returns. The bottom line is that, on average, takeovers
reflect wealth-enhancing and socially valuable redeployments of
corporate resources.

Although several of these late-eighties LBOs and leveraged cash-outs
ran into financial difficulties when the U.S. economy suffered a
recession in the early eighties, there is much evidence that the LBO
phenomenon also has been beneficial for our economy. Economists
have found that the "free cash-flow" theory (developed by Michael
Jensen) helps them to understand much of this activity. This theory
postulates that high leverage can be a powerful disciplining device
because it forces top management to undertake value-enhancing
strategic changes. Companies with ample cash flow but few potentially
profitable investment projects should pay out the excess cash to
shareholders to maximize shareholder value.

According to this theory managements that fail to pay out excess cash,
instead investing it in diversifying acquisitions or in low pay-off projects,
will cause the stock price of their companies to be below their optimal
value, creating a value gap. LBOs and other leveraged recapitalizations
force managements to sell unprofitable divisions, avoid low pay-off
investments, eliminate wasteful corporate expenses and diversifying
acquisitions, and boost operating efficiency in order to meet the interest
charges on the high level of debt. These forced efficiencies eliminate
the value gap and create net economic gains for shareholders.

Although this is a severe solution that exposes the firm to financial
distress in the few years after the LBO, the evidence is that the LBOs
and leveraged restructurings of the eighties created large net gains for
shareholders.

In short, the U.S. market for corporate control witnessed unprecedented
activity and change during the eighties as the largest public companies
became frequent targets of hostile takeovers. Corporate managers
reacted to this activity by lobbying hard for legal restrictions on the so-
called raiders, and by restructuring and refocusing their companies
while increasing debt levels and shareholder payouts.

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Further Reading

Regulations of Cash Tender Offers." Journal of Law and Economics 23, no. 2


Leveraged means largely financed by borrowed capital. After the takeover, the raider sells subsidiaries of the company in order to pay back the bondholders. Bonds issued to pay for takeovers are usually called junk bonds because they are risky: it may not be possible to sell the subsidiaries at a profit. But, because of the risk, these bonds pay a high interest rate, so some investors are happy to buy them. Sometimes a company’s own managers want to buy the company, and re-organize it. This is a management buyout or MBO. If the buyout is financed by issuing preference shares and convertibles, A leveraged buyout is the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Leveraged recapitalizations replace most of a company's equity with debt, often as a takeover defense. more. Leveraged Loan Definition. A leveraged loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt and/or a poor credit history. more. Highly Leveraged Transaction - HLT.