THE SECURITIES COMMISSION'S TAKEOVER PROPOSALS: A "LAW AND ECONOMICS" PERSPECTIVE

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I. INTRODUCTION

The Securities Commission is in the process of reviewing the law and practice of company takeovers. In 1983, the Commission proposed several changes in the current law and invited public comment.[1]

The proposals proved to be quite controversial. Extensive (and highly critical) submissions were received from the Treasury[2] and the Reserve Bank of New Zealand.[3] Both the Treasury and the Reserve Bank attacked the Commission's proposals as regulatory overkill which would penalize shareholders in the guise of protecting them.

A quite different perspective was presented in a recent article written by Christopher G.G. Hogg, an attorney associated with a New York law firm which specializes in takeovers.[4] Mr. Hogg approved of the Commission's proposals but stated that they were not regulatory enough.[5] He not only suggested that New Zealand adopt many of the features of United States law relating to tender offers, but also advocated the enactment of broad general anti-fraud and disclosure requirements, applicable to all publicly held companies, to be enforced both by the Commission and through private litigation.[6]

The purpose of this article is to examine the Commission's proposals from a "law and economics" perspective. I proceed from the premise that regulation should be imposed only when a market failure has created a problem, either of efficiency (wealth maximization) or of fairness (wealth distribution.) Further, since regulation itself affects both efficiency and distribution, the comparative costs and benefits of the proposed regulation should be considered, along with other available regulatory alternatives.[7]

I also proceed from the premise that takeovers are generally beneficial to shareholders and to the economy.[8] First, a successful takeover usually

[1] *Company Takeovers: A Review of the Law and Practice in New Zealand*, 5 October 1983. Volume I is entitled "Discussion and Proposals for Reform" and is hereinafter cited as "Commission Proposals."

[2] Regulation of Company Takeovers, Treasury Submission to the Securities Commission, November 1984, hereinafter cited as "Treasury Submission."

[3] Company Takeover Law in New Zealand: Securities Commission Proposals for Reform, A Submission by the Reserve Bank of New Zealand, June 1984, hereinafter cited as"Reserve Bank."

[4] Mr. Hogg is a member of the bars of both New Zealand and New York. He was also a student of mine at Cornell (and an excellent one, too) but the content of his article demonstrates that I had no influence on him at all.

[5] Hogg, "A Takeover Law for New Zealand — An American Perspective", 15 V.U.W. Law Rev. 101 (1985)

[6] *Ibid.* at 122.

[7] See generally Breyer, "Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform", 92 Harv. L. Rev 547 (1979)

[8] This premise is shared by several American legal scholars. See, e.g., Easterbrook & Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer", 94 Harv. L. Rev. 1161 (1981); Bebchuk, "The Case for Facilitating Competing Tender Offers", 95 Harv.

produces gains for both the bidder and the target company shareholders.[9] Second, the mere possibility that a takeover will occur provides an incentive for managers to manage well, since they know that potential bidders will be looking over their shoulders (a process generally referred to in the literature as "monitoring.")[10] Finally, takeovers benefit the economy generally by transferring assets to their highest-valuing (and therefore probably most efficient) users.[11]

Empirical evidence demonstrates that regulating takeover offers increases their cost. Regulation which mandates a delay in the offer, or increases the amount of disclosure, increases the amount of premium paid for the target's shares.[12] These increased costs reduce the number of offers,[13] with a

L. Rev. 1028 (1982); Carney, "Shareholder Coordination Costs, Shark Repellants, and Takeout Mergers: The Case Against Fiduciary Duties", 1983 A.B.F. Research J. 341; Gilson, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers", 33 Stan. L Rev. 819 (1981); and Dennis, "Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?", 31 Georgia L. Rev. 1 (1985). It is not, however, universally accepted. See, e.g. Coffee, "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance", 84 Colum. L. Rev. 1145 (1984) and the arguments against takeovers discussed therein.

[9] Studies in the United States show that both tendering and non-tendering target company shareholders, as well as bidders, gain from takeover offers. Target shareholders gain an average of 29.1%; bidder shareholders gain an average of 4%: Jensen & Ruback, "The Market for Corporate Control: The Scientific Evidence", 11 J. Financial Econ. 5, 10, 16 (1983). In New Zealand, the average gain to target company shareholders from 1968-71 was 28%; the average gain for the bidder and the target, taken as a unit, ranged from 2.2% to 7.3%, depending on the assumptions used about the comparative sizes of bidders and targets: Treasury Submission at 11, citing an unpublished study done by K.G. Cambie.

[10] See, e.g., Jensen & Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 J. Financial Econ. 305 (1976). "Agency costs" — the costs imposed by management's ability to shirk, consume on the job, or otherwise take more than they are entitled to while producing less than they ought to — are unavoidable when ownership is separated from control They can, however, be reduced by monitoring. Reducing agency costs increases the value of the shares. Thus, the monitoring performed by potential bidders benefits shareholders even if a bid is never actually made.

[11] Of course, a bidder may make a mistake. If it makes too many of them, however, another bidder waiting in the wings will take over the inefficient bidder and make a profit by selling off the mistakenly acquired assets to someone who can manage them better: Jensen, "Takeovers: Folklore and Science", Nov.-Dec. Harv. Bus. Rev. 109 (1984). Coffee, *supra* fn.8, argues that the bidder's management may be operating from motives of self-aggrandizement rather than from any expectation that the transfer of control will increase actual value. If managers are compensated based on the size of assets under management rather than profitability, or receive other utility gains from increased size, they may cause firms to make takeover bids which will not increase (and may decrease) the value of the bidder's shares. This "managerialist" or "empire building" hypothesis may accurately explain some takeover bids, but that does not mean that legal rules should be adopted which will deter tender offers. The net gains to bidders from tender offers are clear, and the market will penalize bidders who pay too much, either because of mistake or management self interest. The law can therefore ignore overpayments, because they are self-deterring. Easterbrook & Fischel discuss this point further in "Corporate Control Transactions", 91 Yale L J 698, 707 (1982).

[12] Advisory Comm. on Tender Offers, U.S. Sec. & Exchange Comm'n, Report and Recommendations (statement of Easterbrook & Jarrell)(hereinafter "Easterbrook & Jarrell"); see also Jarrell & Bradley, "The Economic Effects of Federal and State Regulation of Cash Tender Offers", 23 J.L. & Econ. 371, 389-90 (federal regulation of tender offers in U.S. increased premiums by 20% and state regulation increased premiums an additional 20%.) The Commission apparently believes that any action which increases the premium to target shareholders is a move toward a more competitive market: Commission Proposals at 34-35. In fact, it is a move in exactly the opposite direction: toward fewer participants in the market and fewer takeovers.

[13] The Treasury Submission includes a study of the effects of federal regulation on the number of takeovers in the United States. The data came from the SEC study, *supra* fn.12. The

corresponding reduction in monitoring and efficient resource allocation.[14]

The evidence also seems to indicate that regulation transfers wealth from investors in bidders to investors in targets.[15] If that transfer were accomplished without reducing the number of takeover offers, if it were cost free, and if shareholders held diversified portfolios which were evenly divided between bidders and targets, then it would be of little concern. Shareholders would simply be taking money from one pocket and putting it in another.

However, regulation does impose transaction costs and reduces the number of offers. Further, while shareholders can in fact diversify, and therefore to a certain extent are as likely to hold targets as bidders,[16] that ability to diversify cuts against regulation, not in favor of it. Because shareholders can diversify, and because they do not know in advance whether they will hold targets or bidders,[17] they will prefer a rule which maximizes the number of offers and the amount of monitoring. Accordingly, if shareholders were free to choose *ex ante* they would choose a rule which permitted bidders to realize the full value of the acquisition, since that would provide the maximum incentive to bid.[18]

Treasury study found that there is an apparent association between the passage of the Williams Act and a drop in takeover numbers of the order of 63%, with the lower limit at 43%: Treasury Submission at 30-34. The Treasury notes that other factors may also have been at work, but the data is consistent with the argument that takeover regulation reduces takeover activity.

[14] If a larger premium is required before a target can be taken over, inefficient management has acquired a shelter. The price of the stock will have to fall further before a takeover is profitable than it could safely fall in a world of easy takeovers.

[15] Jensen & Ruback, *supra* fn.9, at 29. Another possible interpretation of the data, however, is that those takeover bids that are still made would have been made at the same price, even without regulation. In that case, regulation simply truncates the distribution of takeovers, so that less profitable offers are not made. This truncation still adversely affects shareholder wealth, both by depriving shareholders of the premiums they would get from offers never made, and in reduced monitoring.

[16] Not all shareholders are diversified. An investor who does not believe the markets are efficient, for example, might rationally choose not to diversify, but even that investor would have no way of predicting in advance which stocks in his or her suboptimally diversified portfolio would be bidders, and which targets. Further, undiversified investors tend to pursue an active trading strategy, and might therefore be conceived of as "serially diversified." They are repeat players If they miss out on the tender offer lottery this time, they will make it up in the future -- and, to continue the gambling analogy, they will prefer a legal rule which maximizes the number of chances to win. There is one group of shareholders, however, for whom a target-to-bidder transfer may be seriously unfair. These shareholders have attempted to protect themselves against various kinds of risk by investing through institutions, such as insurance companies. One of the benefits of investing through institutions is that small investors can achieve substantial diversification However, that diversification is not perfect because institutions tend to weight their portfolios in favor of "blue chip" stocks. Institutional holdings in New Zealand seem to be concentrated in the larger companies: Farrar, "Ownership and Control of Listed Public Companies -- Revising the Concept of Control", forthcoming. Bidders are generally larger than targets, Treasury Submission at 11, so institutional portfolios may be more likely to contain bidders than targets. To the extent that small shareholders, the proverbial "widows and orphans," are the ones investing indirectly, through institutional investors, and to the extent institutions in turn invest only in larger "blue chip" companies, a rule which transfers wealth from (large) bidders to (small) targets is regressive, and therefore unfair. For a further discussion of the distributive effects of takeover regulation, see *infra* fn 30

[17] Bebchuk, *supra* fn.8, argues that shareholders may be able to tell in advance whether their portfolio is more likely to contain targets However, while there are certain characteristics (such as size) associated with "target-ness," as opposed to "bidder-ness," the association is not strong enough to be able to predict in advance which of the many companies with "target" characteristics will in fact be targets. Jensen & Ruback, *supra* fn.9, at 29.

[18] Easterbrook & Fischel, *supra* fn 11, at 698, 708-15. This point is discussed further in the

Thus, shareholders — all shareholders, whether in bidders, in targets, or in bystanders — are the losers if takeovers become more costly, more complicated, or more scarce.[19] It is with these premises in mind that both the current law and the Commission's proposals will be evaluated.

I will first briefly set forth the current law relating to takeovers and the economic effects of that law. I will then analyze the Commission's proposals. Finally, it is submitted that while some of the Commission's proposals might appropriately be adopted, taken as a whole they impose far too much regulation and may well do more harm than good. Indeed, it is further submitted that the current law imposes too much regulation for a healthy market and should be revised.

II. The Current Law

The law relating to takeovers in New Zealand resembles a patchwork quilt. It is tacked together from bits and pieces of the Companies Act 1955, the Companies Amendment Act 1963, the Commerce Act 1975, the Overseas Investment Act 1973, and the rules of the New Zealand Stock Exchange. Although the Commission refers to the current New Zealand takeover market as essentially "unregulated,"[20] taken as a whole those bits and pieces provide a fair amount of intervention which may deter takeovers.

The Companies Act 1955. The Companies Act 1955 does not directly govern takeovers, but it does contain four groups of provisions relating to transfers of control. First, the Act regulates the sale of office (although not of control *per se*) by incumbent directors.[21] Second, the Act prohibits a company from financing the purchase of its own shares.[22] Third, the Act provides a procedure for "mopping up" the remaining shares when a successful bidder has acquired at least 90% of the shares.[23] Finally, a "scheme of arrangement" may be used to amalgamate two companies with the approval of 75% of the shareholders.[24]

text accompanying notes 70 and 74.

[19] Easterbrook & Jarrell, *supra* fn.12, at 70

[20] Commission Proposals at 43.

[21] Sections 191-194. The sale of office is also forbidden in the United States. See, e.g. *Essex Universal Corporation v. Yates* 305 F.2d 572 (2d Cir. 1962).

[22] Section 62. The apparent purpose of the section is to prevent companies from doing indirectly (through providing financing) what they are not permitted to do directly (purchase their own shares) although there may be other reasons for the prohibition. For example, when Canada and the United Kingdom amended their respective companies laws to permit companies to purchase their own shares, they nevertheless (and without explanation) retained the prohibition on financing a purchase In the United States, companies are permitted to repurchase their own shares directly and are also permitted to finance their purchase. Indeed, "leveraged buy-outs" are quite common. For a discussion of section 62 and proposals for reform, see Russell, "Section 62 of the Companies Act", [1982] N.Z.L J. 194.

[23] The compulsory acquisition provisions of section 208 also give the remaining shareholders a "put" — that is, the right to demand to be bought out. A dissenting shareholder in either case may ask a court to refuse to allow the offer. For a thorough discussion of the law relating to mergers in New Zealand, see J. Farrar & M. Russell, *Company Law and Securities Regulation in New Zealand* 371-411 (1985).

[24] Sections 205-207. A scheme of arrangement is carried out under the supervision of the High Court which will seek to ensure that the transaction is fair and that the consent of the shareholders is given only after full disclosure: *Re C.M. Banks Ltd.* [1944] N.Z.L.R. 248. The requirements of court supervision and approval by three-quarters of the shares make amalgamation far more difficult that it is in most United States jurisdictions. There, a merger can be accomplished by the approval of the directors and a mere majority of the shares voting. Indeed, for some kinds of mergers (as, for example, when a large company is acquiring a very small one) the acquiring company's shareholders do not vote at all. See, e.g., Revised Model Business Corporation Act 11.03. In return for the greater ease with which a simple

The supermajority requirements for compulsory acquisition and amalgamation operate as a barrier to control transfers. It is possible, however, that shareholders are not harmed by this particular impediment.[25]

The Companies Amendment Act 1963. The Companies Amendment Act 1963 provides a procedure for making "takeover offers."[26] If the 1963 Act were actually applied to all takeover bids, it would present some formidable barriers to a successful offer. For example, the bidder must give the target at least two weeks advance notice of its intention to make an offer, along with an extensive statement of the particulars of the offer. As noted earlier, delay and advance information both favor the target at the expense of the bidder.[27]

Perhaps fortunately, however, the 1963 Act as written and construed makes compliance optional.[28] First, the Act exempts takeover offers made to not more than six members of the target company.[29] As the Commission points out, with the growth of institutional shareholdings in New Zealand, the acquisition of the six largest blocks would effectively transfer control of most listed companies.[30]

majority can accomplish a fundamental change, dissenting shareholders generally have the right to seek appraisal, forcing the company to pay fair value for their shares. A merger (particularly when one party is controlled by the other) is usually also subject to review in equity if a minority shareholder sues.

[25] One common antitakeover device (popularly known as a "shark repellent" or "porcupine provision") used by many American corporations is a supermajority provision inserted in the articles of incorporation. Two studies of companies employing such charter amendments showed that they had little effect on shareholder wealth: Jensen & Ruback, *supra* fn.9, at 34-35. While one would ordinarily expect to see a negative impact whenever management action makes a takeover less likely, it is possible that the very act of amending the charter conveys information to the market that the company is a likely takeover candidate. Of course, in New Zealand, because the supermajority provision is statutory, there is no opportunity for an amendment to produce a signalling effect. It is also possible that a supermajority provision has no negative impact because it makes it easier for management to negotiate a better price for the company (assuming management is inclined to do so, rather than simply opposing a transfer at any price.) On the other hand, a supermajority provision may have a negative impact on share prices if someone associated with management has enough shares effectively to block a takeover: Jensen, *supra* fn.11, at 117. For an example of the debate in the legal literature on "shark repellants" compare Carney, "Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties", 1983 Am. Bar Found. Research J. 341 with Gilson, "The Case Against Shark Repellent Amendments. Structural Limitations on the Enabling Concept", 34 Stan. L Rev. 775 (1982).

[26] The 1963 Act defines a "takeover offer" as "an offer in writing for the acquisition of shares in a takeover scheme," s.2, and a "takeover scheme" is in turn defined as"a scheme involving the making of offers for the acquisition of any shares in a company which, together with shares, if any, to which the offeror is already beneficially entitled, carry the right to exercise or to control the exercise of more than one-fifth of the voting power at any general meeting of the offeree company." *Ibid* For a general discussion of the 1963 Act, see Commission Proposals at 10-16. See also Farrar & Russell, *supra* fn.23, at 378-380 (1985).

[27] See text accompanying fn.12-15

[28] Farrar & Russell, *supra* fn.23, at 379.

[29] S.3.

[30] Commission Proposals at 11 The current law therefore apparently favors institutional shareholders by providing an incentive to a bidder to acquire control through them, thereby excluding the other shareholders from the premium. If, however, the bidder succeeds in increasing the value of the target (which is, after all, the reason for the acquisition) then the remaining shareholders will benefit as well. To the extent that institutions remain net winners, the law now favors the small investors who are institutional beneficiaries. If the government is handing out regulatory subsidies, "widows and orphans" may appropriately be preferred to the comparative plutocrats who manage their own investments. Cf. Banoff, "Regulatory Subsidies, Efficient Markets, and Shelf Registration. An Analysis of Rule 415", 70 Va. L. Rev. 135 (1984) (distributive effects of regulation should be recognized).

Second, the Act only applies to offers in writing. Verbal offers and open market purchases — even if made pursuant to a written notice of intention to "stand in the market" as a purchaser — do not fall within the Act.[31]

The Stock Exchange Rules. Since a bidder can avoid the rigours of the statute by purchasing on the market, the rules of the Stock Exchange assume major significance. The Exchange has adopted a "takeover code" which is intended as a guide for both bidders and targets. The rules apply to listed companies and to the brokers who assist them; violations may lead to a suspension of trading or even delisting for the company's shares, and to discipline for the broker.[32]

Briefly stated, the rules require disclosure of the terms of a bid to the target's shareholders and sufficient time for the shareholders to make a decision. Further, shareholders of the same class must be treated alike (which means that if the bid is increased all shareholders must receive the new price, and shares must be taken up pro rata if the bid is for less than all the stock). The rules also state that the target company management must not wrongfully oppose the offer, and inside trading is prohibited.[33]

Both the Commission and Mr. Hogg believe that the Exchange rules are not a satisfactory form of regulation because they lack effective sanctions.[34] However, the requirements of disclosure, a waiting period, and pro rata treatment all favor the target at the expense of the bidder, and thus deter beneficial takeover bids.[35] It is therefore probably a good thing that the language of the rules is vague and enforcement doubtful.

The Commerce Act 1975. Part III of the Commerce Act 1975, as amended, requires that anyone proposing to acquire more than 20% of a company's stock must obtain consent from the Examiner of Commercial Practices or from the Commerce Commission if (1) the bidder and the target are in certain specified industries[36] or (2) the aggregate value of the assets of the participants is $20,000,000 or more and the value of the smaller participant is $2,500,000 or more.[37]

As of 1985, 85% of the applications for consent were considered under the "fast track" system of review, where the proposal is referred to the Examiner for decision within 25 working days.[38] A "fast track" referral is made where the takeover proposal appears to the Chairman of the Commerce Commission

[31] Although there is some evidence that the Act was intended to require that all"takeover offers" be made in writing, this interpretation was rejected in *Multiplex Industries Ltd. v.Speer* [1966] N.Z L.R. 122. See also *Carter Holt Holdings Ltd. v. Fletcher Holdings Ltd.* [1980] 2 N.Z.L R. 80 (oral offers) and *Tatra Industries Ltd. v. Scott Group Ltd.* (1983) 1 N Z.C.L.C. 98, 648.

[32] The Exchange has the contractual power to enforce its own rules, since the listing agreement requires listed companies to observe those rules: *New Zealand Forest Products Ltd. v. New Zealand Stock Exchange* (1984) 2 N Z.C.L.C. 99, 159. As the Commission notes, however, delisting securities for a breach of the rules punishes the shareholders, not the management, and removes the securities from the market at precisely the time that a competitive market for the stock should be in operation. Commission Proposals at 25; see also Hogg, *supra* fn.5, at 105 and Farrar & Russell, *supra* fn.23, at 380.

[33] Rules 601-615.

[34] Commission Proposals at 25; Hogg, *supra* fn.5, at 105. Mr. Hogg also criticizes the "general and precatory" rather than "specific and mandatory" language of the rules. *Ibid.*

[35] See text accompanying notes 12-15.

[36] Section 68(1) covers beer and alcoholic beverages, foods, land transportation, and publishing. The Commerce Amendment Bill 1984 proposed the addition of flour milling and bread baking. The Commerce Bill 1985 would abolish the office of Examiner and restructure the Commission.

[37] The proposed bill would raise the thresholds. The required amount of aggregate value would become $50,000,000 and the value of the smallest participant would go up to $5,000,000.

[38] Farrar & Russell, *supra* fn 23, at 394.

not to have any significant effect upon competition. It is understood that the Examiner "will be conscious of the need to preserve confidentiality of sensitive information which in some cases may include the fact of the proposal itself."[39] Nevertheless, some leakage may be inevitable, and the process itself delays the offer. Any advance warning to the target, either directly or because of information leakage, particularly when accompanied by a delay in the offer, benefits targets at the expense of bidders.[40]

There are no doubt serious social costs involved in anticompetitive mergers.[41] The empirical evidence in the United States, however, demonstrates that the profitability of takeovers is not in fact attributable to the creation of monopoly market power.[42] It should also be recognized that the very requirement of advance notification may have anticompetitive effects on the market for corporate control — itself a competitive market among managers for the right to manage corporate assets.[43]

The Overseas Investment Act 1973. The Overseas Investment Act 1973, as amended, and the Regulations promulgated thereunder, control the activities of foreign companies[44] seeking to acquire the shares or assets of New Zealand companies.[45] The overseas bidder must obtain prior consent from the Overseas Investment Commission.

The Overseas Investment Commission evaluates the proposed acquisition to determine whether it is in New Zealand's economic interest to permit it to proceed. Most of the proposals are approved.[46] Once again, however, a statute intended to increase economic welfare may in fact be decreasing it.

A market operates best when it has large numbers of participants. The market for corporate control in New Zealand would be greatly expanded if foreign bidders could participate freely. To the extent that the requirement of advance notification and consent with its concommitant delay deters takeover offers, the statute is depriving New Zealand shareholders of the highest value for their shares, and — to the extent that takeovers transfer resources to more efficient users — is depriving consumers generally of more efficient production. In addition, shareholders are denied the benefits of monitoring which an increased pool of monitors would bring.

While one is sensitive to the national concerns involved in promoting New Zealand ownership of New Zealand assets, perhaps those concerns could

[39] *Ibid.*

[40] See text accompanying fn.12-15.

[41] Not everone agrees that industrial concentration is necessarily anti-competitive, however. See, e.g. Y. Brozen, *Mergers, Concentration and Public Policy* (1982).

[42] The evidence is summarized in Jensen & Ruback, *supra* fn.9, at 23-28. The evidence also indicates that antitrust opposition to an acquisition imposes serious costs on the target company shareholders (and may confer unearned benefits on rival producers) without any apparent benefit to competition. *Ibid.*

[43] This definition of the market for corporate control is used in Jensen & Ruback, *supra* fn.9, at 5-6 For a seminal discussion of the effects of the antitrust laws on the market for corporate control, see Manne, "Mergers and the Market for Corporate Control", 73 J. Pol. Econ. 110 (1965).

[44] Domestic companies in which a foreign person owns 25% or more of the voting stock are also regulated.

[45] The Act requires consent for any acquisition of assets worth more than $100,000 as well as any acquisition of shares which would give the bidder more than 25% of the voting power at any general meeting. For a general discussion of the Act as it relates to takeovers and mergers, see Farrar & Russell, *supra* fn.23, at 406-09.

[46] Farrar & Russell, *supra* fn.23, at 409.

be accommodated by restricting foreign investment only in certain key industries. The national interest is, after all, also served by a healthy market for corporate control.

III. The Commission's Proposals

The Commission has proposed for public discussion a takeover code which would apply to all offers for more than 20% of a company's stock. Such offers could proceed either by means of a written takeover offer to all shareholders or by "standing in the market."

Written Offers. If the bidder proceeds with a written takeover offer, the following requirements apply: (1) the bidder must pay all shareholders the same amount and kind of consideration for each share accepted; (2) the bidder must offer each shareholder the same price as the highest price paid by the bidder during the three months preceding the offer; (3) if the price is raised during the offer, the higher price must be given to everyone who has previously tendered; (4) if the offer is for less than all shares, and more shares are tendered than will be accepted, then acceptances must be pro rata; (5) lowering the price or calling off the offer would require the consent of the Commission; and (6) the offer cannot open until two weeks after it is made and must remain open for at least three weeks.[47] Additionally, the bidder must furnish substantial information about its financial arrangements, prior dealings in the target's shares, plans for the business, and intentions with regard to employees.

Standing in the Market. If the bidder chooses to "stand in the market," it must announce its intention to do so 14 days before the offer commences, and must remain in the market for three weeks. The offer must be unconditional, for cash only, and may not be for less than all the shares. The price provisions are the same as for written tender offers; the price may not be less than the highest price paid during the last three months and if the price is raised during the offer, all sellers should receive the new price.[48] The disclosure requirements are also basically the same as for written offers.[49]

The Theoretical Underpinnings. The Commission's proposals rest on three interrelated major premises: first, that equitable treatment of the small investor requires that shareholders be treated equally;[50] second, that the market for corporate control is not sufficiently competitive, so that bidders are not paying a high enough premium for control;[51] and third, that shares of potential targets are undervalued in the market because, while the stock market is well suited to the valuation of minority parcels, it does not accurately value companies with relatively high asset values,[52] nor does it factor in the possibility of a change in control.[53]

[47] Commission Proposals at 112-114.

[48] Commission Proposals at 114-115. It is difficult to reconcile the Commission's recommendation with respect to price increases with its statement that a separate contract is created by each acceptance, so that acceptances are not revocable. If the contract is formed on acceptance, then the consideration should be fixed as of that date. If the contract is not considered complete until the 21 days have expired (with or without a rise in the consideration) then it should not be complete for the offeror either. Otherwise, the contract lacks mutuality.

[49] *Ibid*

[50] Commission Proposals at 30. This is the familiar principle of pari passu.

[51] *Ibid.* at 31-35.

[52] "It seems that stock exchange prices reflect expectations of earnings or distributions rather than asset values, whereas those seeking control may give greater weighting to assets, especially where replacement costs exceed notional asset values derived from stock exchange prices." Commission Proposals at 32.

[53] Commission Proposals at 34.

I will deal first with the Commission's assertion that target shares are undervalued; then with its belief that the market for control is not competitive; and finally with the argument that equal treatment for shareholders is always in their best interests.

Target Undervaluation. The Commission's statements about the pricing of target company stock are really an assertion (albeit not explicit) that the market is not efficient. [54] In an efficient — or reasonably efficient — market, and in the absence of insider trading, the price of a stock represents the best available estimate of its true value. In such a market, all publicly available information is reflected in the share price, and new information, when disclosed, is impounded into price almost instantaneously and in an unbiased way.[55]

The assets of a listed company are usually public information, and market analysts can estimate the divergence of real asset value from book value.[56] Accordingly, if the asset value of the firm is not impounded into price, then the market must not be efficient.

Similarly, while the likelihood of a takeover in any given case may be difficult to predict,[57] an efficient market would take into account the possibility that non-controlling shares might be assembled into a control block at any time. That possibility would be discounted by the market's estimate of its probability, so that the value of non-control shares would reflect a constant, but varying, premium for potential control. The Commission, in contrast, states that the stock exchange provides an adequate mechanism for valuing minority shares but not for the "discontinuous" market for control — which again necessarily implies that the market is not efficient.

As Professor Coffee stated with regard to similar "market inefficiency" arguments in the United States, "[i]n effect, this view postulates that there

[54] The Reserve Bank treats this portion of the Commission's discussion as an argument that a market failure exists whenever the market price differs from the price that would exist in a perfectly competitive market. The Bank then rebuts that argument by pointing out that the stock market is not monopolistic, no public goods are in evidence, and any externalities are easily internalized (these being the usual sources of market failure.) The Bank notes that there is a difference between perfect competition and a reasonably efficient market, and that the real world imperfections which make perfect markets unattainable are unlikely to be remedied by regulation Reserve Bank at 6-8. I quite agree with the Bank that it is sufficient if a market is reasonably efficient, see, e.g., Grossman & Stiglitz, "On the Impossibility of Informationally Efficient Markets", 70 Am. Econ. Rev. 393 (1980) and Gilson & Kraakman, "The Mechanisms of Market Efficiency", 70 Va. L. Rev. 549 (1984). I do not, however, read the Commission's proposals as merely voicing a complaint that the stock market is only reasonably efficient Instead, it seems to me that the Commission is saying that the market cannot be relied upon to set even reasonably accurate prices, other than for "minority interests."

[55] This is the "semi-strong" form of the efficient capital market hypothesis. The "strong" form would add that even non-public information is impounded into price, and therefore that insiders cannot profitably trade on inside information. While there is ample empirical evidence supporting the "semi-strong," public information model, the available evidence contradicts the "strong," inside information model. The empirical evidence is discussed infra fn.57.

[56] Dennis, "Materiality and the Efficient Capital Market Model. A Recipe for the Total Mix", 25 Wm. & Mary L. Rev. 373, 394-95 (1984)

[57] There is ample evidence that the market cannot predict in advance which companies will be targets· Jensen & Ruback, *supra* fn.9, at 29. However, almost half of the abnormal returns associated with a merger or takeover occur prior to the announcement. It is possible that the pre-announcement price changes reflect inside trading and leaks, but it is equally plausible that the market is simply adjusting in an unbiased manner to public information (such as a divergence between asset value and replacement cost) that increases the probability of a takeover *Ibid.* at 14

are two distinct markets for corporate shares with only imperfect arbitrage between them: one market for corporate control and another for investment profit."[58] Yet, as Coffee goes on to point out, even if this "debatable" premise were accepted, shareholders would still be harmed by a policy of chilling takeovers.

First, if shares are chronically undervalued, there is no assurance that they will ever rise to their "intrinsic" value. Bids will still take place at an above-market price, and a premium over a depressed market is better than nothing.

Second, rational bidders will always seek the greatest available bargain. Even if the market consistently undervalues all shares, the best bargains will still be inefficiently managed firms.[59] An active market for corporate control would consequently still benefit shareholders by increasing their wealth when a bid is made, and by disciplining management even when no bid is made.

Even if the market were inefficient, therefore, an attempt to correct that "market failure" by regulating takeovers would not be in the best interests of shareholders. More to the point, however, there is a multitude of evidence that the market is efficient.[60] The value of a non-controlling parcel continuously reflects the value of a possible acquisition (and therefore contains, if not a control premium, at least a potential-control premium.)[61] The market also accurately factors in the relative asset values of listed companies.[62] The Commission's view that a "market failure" exists is simply not supported by the vast weight of the evidence.

There is, to be sure, some anomalous evidence that the market is not

[58] Coffee, *supra* fn.8 at 1171.

[59] If the market were biased toward undervaluation, it would still undervalue both efficient and inefficient firms equally. There would still be an intrinsic price differential between well managed firms and poorly managed firms. Thus, bidders will acquire efficient firms in preference to inefficient firms only if the undervaluation is perverse (because efficient firms are undervalued more often than inefficient firms) or the market so volatile that efficient firms routinely experience severe price swings that cause them to sell below inefficient firms. *Ibid.* at 1172-73. See also Dennis, *supra* fn.8, at 34.

[60] See E.J. Elton and M.J. Gruber, *Modern Portfolio Theory and Investment Analysis* (1984) and the 167 studies referenced in the bibliography. Several studies by Professor Emanuel show that the New Zealand share market is also efficient: Treasury Submission at 36

[61] See, e.g. Lease, McConnell, & Mikkelson, "The Market Value of Control in Publicly-Traded Corporations", 11 J. Fin. Econ. 439 (1983).

[62] Jensen, *supra* fn.11, at 113 (market prices incorporate all current information about future cash flows and the value of individual assets in an unbiased way). Indeed, the notion that there is some qualitative difference between earnings-based value and asset value ignores how asset value is determined Assets are worth what they will sell for. How does a company decide what to pay for an asset? By forecasting the earnings expected from the asset, choosing a discount rate which reflects the cost of capital to the firm for a project of that level of risk, and calculating the net present value of the investment: J.F. Weston & E.F. Brigham, *Managerial Finance* 267-75 (5th Ed. 1975). The process is exactly the same as for valuing shares, except that shares are valued as a perpetuity. Of course, one company may be willing to pay more for existing (or even replacement) assets than another, but only because it predicts that it can earn more (or at less risk) than competing purchasers. The Commission apparently believes that if target share prices are kept artificially high (by imposing a regulatory premium) then funds will be channeled into new plant and equipment: Commission Proposals at 40. This assumes that the decision to expand is made without reference to the cost of expansion. However, the decision to acquire used assets rather than build new capacity is also a capital budgeting decision. If a firm is prevented from purchasing existing assets, it will not necessarily invest in new plant or equipment; if "replacement cost" is too high, the firm will simply forgo expansion. It should also be noted that the Commission's view that its proposals will inflate the price of targets ignores the likelihood that increased regulation would depress share prices generally

efficient.[63] An anomaly is defined as "a deviation from the common rule, type, or form; someone or something abnormal, incongruous, or inconsistent."[64] Legislatures must often make decisions on the basis of facts of which they are only reasonably certain (and sometimes on less than that.) The evidence on market efficiency is clear and convincing; it should not be necessary to prove it beyond a reasonable doubt.

Competition for Control. The Commission believes that there is insufficient competition in the market for control. By competition, the Commission means competitive bidding once an offer is made.[65] According to the Commission, "market raids" or other pre-emptive tactics designed to ensure a quick (and successful) takeover will transfer control at a lower premium than an auction would produce.[66] Since this is a market in which there are relatively few buyers and the product is large and complex, some potential bidders need time to prepare before entering into competitive bidding.[67] The Commission therefore proposes to keep bids open for a relatively long period, and to require a good deal of disclosure, so that other potential bidders can determine whether to offer a higher price.

The Commission is correct in its assertion that the size of the premium will vary with the degree of rivalry among bidders. A successful auction produces a 17% gain for the target shareholders.[68] Auctions are also ordinarily the method by which assets are moved to their highest and best use.

On the other hand, auctions usually require an auctioneer. In the case of a target company, management will be conducting the auction, and may use the search for a competitor as a pretext for defeating all offers. While shareholders make substantial gains when the auction works, they lose all of the benefit they would have obtained from the single bid if their management simply drives off the offeror and no additional bidders materialize.[69]

The ability of subsequent bidders to "free ride" on the first bid may also make it less likely that the first bid will ever be made. The search for profitable targets is not costfree. Bidders are less likely to invest in information if they must give it away. Shareholders might prefer an auction once a bid has occurred, but "behind the veil of ignorance," before they know whether any bids will be made at all, they would prefer a rule that maximizes profits to the first bidder, thereby increasing the number of offers.[70]

[63] See, e.g. Jensen (ed.), "Some Anomalous Evidence Regardıng Market Efficiency", 6 J. Financıal Econ. 95 (1978)(symposium); "Symposium, Valuation Anomalies — Empırical", 39 J. Fin. 807 (1984). These anomalies (which may turn out not to be anomalous at all, when financial researchers finish shaking them out) are begınning to spawn a revisionist legal scholarship. See Gordon & Kornhauser, "Efficient Markets, Costly Information, and Securities Research", forthcomıng in N.Y.U, L. Rev., and Wang, "Some Arguments that the Stock Market ıs Not Efficient: or, Where Have All the Substituteurs Gone? Long Time Passing. Where Have All the Arbitrageurs Gone? Long Time Ago", forthcoming ın U.C. Davis L.Rev. These articles are "revisıonist" because they are written by authors with apparent sophisticatıon in economics, as opposed to another line of artıcles wrıtten by lawyers who simply reject any notion that targets might be inefficiently managed, and who assert that markets cannot be efficient because prıces are volatıle. For an example of this latter category, see Lowenstein, "Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation", 83 Colum. L. Rev. 249 (1983). See also of Easterbrook & Jarrell, *supra* fn.12, for a critique of Lowensteın.

[64] *The Random House Dictionary* (1980).

[65] Commıssion Proposals at 32.

[66] *Ibıd.*

[67] *Ibıd.* at 34.

[68] Easterbrook & Jarrell, *supra* fn.12, at 110.

[69] Jensen & Ruback, *supra* fn.9, at 14-16.

[70] Easterbrook & Fischel, "Auctıons and Sunk Costs in Tender Offers", 35 Stan. L. Rev. 1

Nevertheless, the Commission's position with respect to auctions is quite defensible. Reasonable economic minds (if that is not an oxymoron) differ on the issue.[71] There is, however, one important caveat: any attempt to defend against being taken over must be banned outright. Management may auction; it may not take action aimed at remaining independent. The aforementioned reasonable economists who differ on auctions are unanimous on that point.[72]

Equal Treatment. The Commission believes that it is unfair to treat shareholders unequally.[73] Obviously, no one is against fairness. The problem lies in the equation of unequal treatment with unfairness.

It is surely not unfair to allow one who produces a gain to keep it, even if it means that the producer becomes wealthier than non-producers. Indeed, a rule which takes away the profits from productive activity and gives those profits to non-producers might well be considered normatively unjust (assuming there is no great pre-existing wealth disparity to be remedied) as well as economically unsound. Thus, transferring wealth from bidders to targets would be unfair even if it were not also frequently regressive.[74]

Agreeing that unequal treatment as between bidder and target shareholders is appropriate does not necessarily mean, however, that whatever premium is paid for the transfer should not be equally shared among the target shareholders. If bidders were always indifferent as to how the premium is shared, a requirement of equal treatment would not affect the number of offers. If the number of offers were not affected, shareholders would prefer a rule of equal treatment.

On the other hand, if some beneficial transactions would not occur without unequal sharing, then shareholders would prefer a rule that maximizes the

(1982). See also Treasury Submission at 22; Reserve Bank at 12.

[71] Compare Easterbrook & Fischel, *supra* fn.69, and Jarrell, "The Wealth Effects of Litigation By Targets: Do Interests Diverge in a Merger", 28 J. L. & Econ. 151 (1985) with Bebchuk, "The Case for Facilitating Competing Tender Offers: A Reply and Extension", 35 Stan. L. Rev.23 (1982) and Gilson, "Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense", 35 Stan. L. Rev. 51 (1982). Coffee, *supra* fn.8 at 1175, concludes that"neither side can clearly prove its thesis on more than a provisional basis." Gilson and Bebchuck assert that auctions do not chill takeovers because the first bidder may recoup its investment in information by selling its shares — at a profit — to the winning bidder. One objection to that view is that United States law presents a significant impediment to such a strategy, because a bidder who has acquired more than 10% of a listed company's shares comes within Section 16(b) of the Securities Exchange Act of 1934. Section 16(b) (which applies only to officers, directors, and more than 10% shareholders) provides that any profit made on the purchase and resale of shares within a six month period must be repaid to the company. An exception has been judicially created for a frustrated bidder who is forced to exchange the target shares because of a defensive merger, but an unsuccessful bidder who sells the shares for cash may be required to disgorge the profits: *Texas Int'l Airlines v. National Airlines, Inc* 714 F.2d 533 (5th Cir. 1983), cert. denied 104 S. Ct. 1326 (1984). But see *Heublein, Inc. v. General Cinema Corp.* 722 F.2d 29 (2d Cir. 1983), cert. denied 104 S. Ct. 1416 (1984). Since New Zealand has no such provision, an unsuccessful bidder could more confidently expect to recoup its investment if the second bidder is seeking all the shares and if the offer is made to all shareholders, including the bidder.

[72] *Ibid.* Mr. Hogg, who does not otherwise share this perspective, agrees that defensive tactics should be regulated. Hogg, *supra* fn.5, at 120. A ban on defensive tactics must have teeth in it. Such tactics are prohibited by the City Code, which regulates take-overs in the United Kingdom, but they are regularly used anyway: Danziger, "Remedial Defensive Tactics Against Takeovers", 4 The Company Lawyer 3.

[73] "The underlying principle should be equality of opportunity for all shareholders to participate in the benefits of a contest for control as far as it is practicable to achieve this." Commission Proposals at 37 (emphasis in the original.)

[74] See *supra* notes 16, 30.

total number of beneficial transactions, so long as they are not made worse off as a result.[75] In short, they will prefer a rule that permits unequal treatment. The question, therefore, is whether some value-increasing transactions will not occur because the "control premium" must be equally shared.

There is ample reason to believe that some transactions will not take place if equal treatment is required. For example, a bidder may wish to acquire control by direct purchase from the owner of a substantial bloc of shares. If the owner is also a manager, he or she will not sell the shares without some compensation for the managerial perquisites being forgone. If the acquirer must pay the same price to non-managers, the deal will become too expensive and control will not be transferred.[76]

It is also perfectly appropriate to treat blocs owned by non-managers differently from smaller shareholdings. First, bloc assemblage facilitates control transfers. A bidder may acquire control more rapidly, and at a lower cost, by privately negotiated purchases from bloc owners. Second, bloc assemblage is good for shareholders even if no offer is made. The existence of a moderate-sized bloc produces an increase in the value of all the firm's shares, apparently because of the expected increase in monitoring by the bloc owner.[77] Third, pre-offer bloc acquisition by bidders will be essential if regulations are adopted which encourage auctions. The only way for a losing bidder to recoup its initial investment in target "search" is to sell out to the winner.[78] If regulation makes it more difficult or costly to acquire ade.[79]

If bloc owners cannot sell their shares at a higher price than is available to other shareholders, there will be little incentive to assemble blocs. Since bloc assemblage produces benefits for all shareholders, they would agree to permit unequal sharing of the gain.

Unequal sharing may also be necessary to encourage shareholders to cooperate in creating the gain. If all shareholders must be treated equally, it pays to be passive. A delayed acceptance or a non-acceptance would produce as much profit as a prompt acceptance. Yet if all shareholders delay, or do not accept at all, offers are deterred or defeated. All shareholders benefit from unequal sharing if it reduces the incentive to be passive.[80]

If all shareholders would prefer a rule which maximizes the number of value-increasing transactions, and if permitting unequal treatment is necessary to accomplish that result, then the Commission's insistence on "fairness" is not in the best interests of the very people the proposals were designed to protect.[81]

IV. Conclusion

An active market for corporate control is good for shareholders and for

[75] Easterbrook & Fischel, *supra* fn.11.

[76] Manne, *supra* fn.43, at 113.

[77] Dann & DeAngelo, "Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control", 11 J Financial Econ 275 (1983).

[78] See *supra* fn.71.

[79] Easterbrook & Jarrell, *supra* fn.12, at 93.

[80] *Ibid.* at 82, 97; Easterbrook & Fischel, *supra* fn.11, at 710

[81] To the extent that some shareholders prefer a rule of equal treatment, companies can amend their articles of association to require it. If "fair price amendments" produce gains, the competition for capital should lead all companies to adopt them: Easterbrook & Jarrell, *supra* fn.12, at 86; Treasury Submission at 25.

the economy. Any regulation which impairs that market will impose costs without necessarily providing any corresponding benefit.

The Commission has not demonstrated that a "market failure" exists which would justify more regulation. Indeed, the current law makes tender offers more difficult than is necessary to serve what are concededly important public policies such as prevention of monopolies and New Zealand ownership of key industries.

The Commission's view that auctions should be encouraged is not unreasonable if defensive tactics aimed at preserving the target's independence are banned. However, given the uncertainties as to the effect of auctions on the total number of takeovers, the Commission might usefully employ a presumption against regulation in the absence of a demonstrated need:

if it isn't broken, don't fix it.