part of those for whom the answer to the question, "Is money inherently different?" is unambiguously "yes."

Genie Short
Kenneth J. Robinson
Federal Reserve Bank of Dallas[6]

Public Policy Toward Corporate Takeovers
Murray L. Weidenbaum and Kenneth W. Chilton, eds.
New Brunswick, N.J.: Transaction Books, 1988, 176 pp.

Corporate takeovers is one of those topics that some people can get very excited about. In fact, the more people seem to know about takeovers, the more excited, or even exercised, they seem to get, regardless of which side they are on. There are few of what we might call balanced views on the topic. This is what makes Murray Weidenbaum and Kenneth Chilton's book an especially important contribution: It is thoughtful and fair, both in the discussion of the issues and in its policy recommendations. Though essentially pro-takeover, Weidenbaum and Chilton bravely face the facts that raise doubts about where the wealth gains in takeovers come from. This is a useful book for any nontechnician who is interested in the topic—from economists who work outside the field of corporate governance, to policy makers, to concerned citizens who wish to be better informed.

Weidenbaum and Chilton give everyone a day in court. Representing the most pro-takeover contingent is T. Boone Pickens, who makes his living by searching out and bidding for undervalued firms. At the other extreme, but inherently more scientific, are David Ravenscraft and Frederic Scherer, whose work on the earnings of firms merged through takeovers represents solid evidence that sheds doubt on the source and nature of the increased value that results from takeovers.

The book begins by reviewing the economics literature on takeovers, including some helpful background on the functioning of the stock market generally. The single most important and oft-cited fact is that the stockholders of the target firms in successful tender offers make, on average, more than a 30 percent return on the deal. The bidder firm stockholders, however, have average returns from the deal that are very close to zero.

Where do these profits come from? One's answer to this question will usually determine one's opinion on the value of takeovers. There are several hypotheses.

First, the profits may arise from efficiency gains resulting from improved management by the new owner/managers. This argument will often include discussions of how financial restructurings result in incentives that elicit better performance from managers. For example, if the new owners own

[6]The views expressed in this review should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

more stock in the company than the previous owners did, their interests are more closely aligned with those of the stockholders.

Second, the shareholders' profits may be someone else's loss. There are a number of potential sources. The most likely is other taxpayers. In many takeovers, and also in leveraged buyouts, a substantial amount of debt is issued and used to buy equity. Interest on corporate debt is deductible on a corporate tax return and consequently is taxed only at the individual level. Thus, interest on debt is taxed only once, whereas the shareholders' earnings are taxed twice—once at the corporate level and again when the earnings are paid out as dividends. If a firm has not fully exploited the tax advantages of debt, income taxes can be lowered and share value increased by issuing more debt. The shareholders' gain is a loss for the rest of the taxpayers.

When a large amount of new debt is issued, the holders of both firms' previously issued debt may suffer. If the new debt increases the likelihood of bankruptcy and weakens the claim of the old debtholders on the firms' assets, the value of the old debt falls. The magnitude of this loss appears to be small, but the potential for exploitation is there. Yet another set of losers may be unionized employees, or employees whose "excess" pension fund monies are used to pay for the takeover. So there are at least three groups from whom resources may be redistributed during a takeover—other taxpayers, existing creditors, and employees.

If behavior is any indication, it appears that those who stand to lose the most from a takeover are the managers of the target firm. They are the ones who spend the shareholders' money fighting the tender offer, lobbying for state laws to make takeovers more difficult, and changing their own corporate charters to block takeovers. This in itself is circumstantial evidence that the first hypothesis—efficiency gains from improved incentives—may be right. These managers are supposed to be working for the shareholders and taking the shareholders' interests to heart. While some management resistance to a tender offer can be justified as an effort to bid up the price, ultimately incumbent managers should accede to the offer and allow the shareholders to collect their 30 percent gains. Managers who kill a tender offer, regardless of the source of its value, are not serving their shareholders.

Finally, the increase in share price may result from simply replacing pessimistic equityholders with debtholders. If shareholders have an array of opinions about the future fortunes of the firm, it is the least optimistic who will sell when the price rises. The shareholders who are left are, by definition, those who believe the stock is worth even more than the tender offer price. It may not matter that reams of research indicate there is no publicly available information to support such beliefs. Not everyone is convinced by such research.

If the source of wealth gain is either redistribution or the displacement of pessimistic shareholders, then there is no reason to expect earnings to rise after the merger. But if efficiency gains are the source of the increased value, those gains ought to be manifested somewhere down the road in increased earnings for the merged firm. The best written paper in the volume is the one by Ravenscraft and Scherer. After adjusting for all necessary factors, these authors make the case that no increase in earnings materialize. Since the biggest adjustment made by Ravenscraft and Scherer to the income statement data of merged firms involves interest on new debt, their work suggests that the largest redistribution is indeed from the taxpayers to the equityholders. No other research on takeovers has been able to identify another source for redistribution—neither from bondholders nor from employees—that has anywhere near the potential increase in value as that resulting from increased debt. Along with the high post-merger divorce rate of 40 percent, this evidence is troublesome even for the supporters of takeovers.

Another source of concern is the increased levels of corporate debt that accompany most takeovers. With so many firms carrying heavier debt burdens, the economy is arguably more vulnerable. In a recession more firms will be threatened with bankruptcy, and bankruptcy is a costly process. But as many individuals commenting on this issue point out, the straightforward solution to this potential problem is not to limit takeovers. Rather, the tax law should be changed to eliminate its bias for debt financing, not just for takeovers, but for all transactions.

Another major issue in takeovers is the means that incumbent managers use to thwart takeover attempts. Even the names for these ploys summon visions of illegal warfare—shark repellants, poison pills, greenmail, and the dreaded supermajority charter amendment. These are the issues that inflame the likes of T. Boone Pickens and his United Shareholders of America.

Weidenbaum himself writes about these matters, again with admirable reserve. As he believes we need little in the way of legislation to inhibit takeovers, he also believes that corporate constitutions will right themselves to protect shareholders, and in some cases Weidenbaum argues, they already have. In conclusion, Wiedenbaum would rather trust the market than the legislature to make the appropriate modifications.

The reader who wishes to understand the issues in corporate takeovers from the point of view of both sides in the controversy would do very well to acquire and read the Weidenbaum and Chilton book.

Susan E. Woodward
U. S. Department of Housing and Urban Development