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# Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense

Ronald J. Gilson\*

Responding to my comments in the *Stanford Law Review*,<sup>1</sup> and to those of Lucian Bebchuk in the *Harvard Law Review*,<sup>2</sup> Professors Easterbrook and Fischel have reiterated their preference for a rule of pure passivity by target management in response to a tender offer. Unlike my more limited rule barring defensive tactics designed to prevent the offer but not barring the facilitation of competitive bids, Easterbrook and Fischel would prohibit both.<sup>3</sup> Because their response to the points that Bebchuk and I raised goes beyond their initial treatment of the subject, it is appropriate that I respond here by extending the arguments I originally presented.

As originally put, Easterbrook and Fischel argued that auctioneering was undesirable because of the sunk costs in information incurred by the original bidder. If a competitive bid was successful, the unsuccessful first bidder would be unable to recover these costs; the risk of this occurrence would reduce the incentive to invest in information in the first place. Therefore, monitoring would decrease and

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\* Associate Professor of Law, Stanford University. I am grateful to Professors Frank H. Easterbrook and Daniel R. Fischel for the dialogue reflected in this exchange. I look forward to the opportunity to disagree with each of them on small parts of major positions in the future. I am also grateful to Lucian Bebchuk, Bernard Black, Henry Hansmann, Thomas Jackson, Roberta Romano, and participants in the University of Pennsylvania Transaction Costs Economics Workshop for helpful comments on an earlier draft of this article.

1. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 868-75 (1981) [hereinafter cited as Gilson, *A Structural Approach*].

2. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) [hereinafter cited as Bebchuk, *The Case for Facilitating Competing Tender Offers*]. Bebchuk expands his position in this exchange. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter cited as Bebchuk, *A Reply and Extension*].

3. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Auctions and Sunk Costs*]. They first stated their position in Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175-80 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role of a Target's Management*].

agency costs would increase.<sup>4</sup>

I responded by noting that a first bidder could hedge its risk of lost information costs by buying a block of the target's stock that could be sold at a profit to a subsequent higher bidder.<sup>5</sup> I also argued that any loss from a reduction in monitoring would be offset by the increased efficiency that would result from allocating "target assets to their most efficient user."<sup>6</sup> Professors Easterbrook and Fischel now concede the existence of a hedge, but argue that the hedge is imperfect. In their view, even if first bidders both recover their sunk costs and earn a return on the investment, the increase in takeover prices associated with competitive bidding will nonetheless reduce the return on investment in information below what would have been earned in the absence of competitive bidding, with the same undesirable results: a reduction in monitoring and an increase in agency costs. In part I of this article, I argue that competitive bidding may *increase* rather than decrease the return on investment in information. If this is correct, then the choice between the two rules turns on their efficiency at resource allocation and on their susceptibility to abuse, points which I consider in parts II and III respectively.

Before turning to a more detailed examination of the matters on which Professors Easterbrook and Fischel and I disagree, it is important to emphasize the far more important area of agreement. Taken together, our respective articles demonstrate that there is no coherent justification for allowing target management to engage in defensive tactics that may deprive shareholders of the opportunity to tender their shares. Corporate managers must face up to the fact that such conduct benefits only themselves. State courts must recognize that the legal rules that facilitate this conduct, under the guise of deference to business judgment, do no more than sanction corporate treason.

## I. SUNK COSTS AND PROPERTY RIGHTS

As Professors Easterbrook and Fischel now put the matter, auctions are undesirable if they result in "any reduction in the return

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4. For a discussion of the monitoring function of tender offers, see Gilson, *A Structural Approach*, *supra* note 1, at 841-45; Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 3, at 1168-74.

5. Gilson, *A Structural Approach*, *supra* note 1, at 871.

6. *Id.* at 872.

from search."<sup>7</sup> The reduced return leads to reduced investment in search: This reduces the number of tender offers and, ultimately, reduces the beneficial impact on agency costs which we all ascribe to tender offers. Later in this article, I will argue that any reduction in these benefits may be offset by the increased allocational efficiency resulting from competitive bidding. But for now, I want to focus on a broader claim that I suggested, but did not emphasize, in my earlier article:<sup>8</sup> Not only can a first bidder recoup sunk costs if he loses an auction, but it may well be that, for certain kinds of information producers, auctions actually *increase* the return on investment in search. If this is correct, the argument against competitive bidding becomes substantially more difficult.

To understand the potential that competitive bidding has for increasing the return on investment in search, it is necessary to decompose a first bidder's investment in a takeover and examine the return associated with each portion of that investment. One portion of a bidder's investment is search costs, incurred to identify a target whose value can be increased by displacing inefficient management or through some form of synergy. The second portion is the amount paid to secure control and implement the strategy necessary to take advantage of the identified opportunity.

For purposes of illustration, assume that a potential bidder has invested \$2.5 million searching for a profitable acquisition and has discovered a target with one million shares outstanding whose stock is trading at \$50 per share but would be worth \$120 per share if new management could be installed, corporate policies modified, and some synergistic benefits gained. The potential bidder believes that, in the absence of competitive bidding, a successful tender offer could be made for \$100 a share.

Consider two strategies to exploit the investment in information. In the first, the traditional approach, the same entity that invests in information also invests in implementation: The acquiring company purchases 10% of the target's stock at \$50 per share prior to the need to make public disclosure and then follows with a successful tender offer at the assumed price. Its total investment in information and implementation is \$97.5 million (\$2.5 million for information costs, \$5 million for the pre-disclosure acquisition, and \$90 million for the 90% of the target's stock which is acquired in the tender offer).<sup>9</sup> Its

7. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 4 (emphasis in original).

8. See Gilson, *A Structural Approach*, *supra* note 1, at 871-72 & nn.186-87.

9. I intend the amount representing investment in information to reflect all information

return on the entire investment is \$120 million—the target's presumed post-acquisition value—for a capital gain of \$22.5 million or a return of approximately 23%.

The second strategy seeks to capitalize only on the value of the information and leaves the implementation to others. In a first variant of this approach, the information producer also takes a 10% stock position but then, instead of making the tender offer itself, passes the information along to another company who successfully completes the offer at \$100 a share. In this variant, the information producer makes a total investment of \$7.5 million (\$2.5 million for information and \$5 million on its recently acquired stock), receives a total return of \$10 million for a capital gain of \$2.5 million or a return of 33⅓%, some 10% higher than if it had also undertaken implementation. In a second variant, instead of simply passing the information along to a favored bidder, the information producer makes it public, presumably causing competitive bidding. As the auction drives up the premium, both the return on the information producer's stock position and, thus, the return on the investment in information increases: As the price approaches \$120 per share, the return approaches 60%. The effect is to further increase the disparity between the return from information production and the return garnered from both producing and implementing the information.

This analysis suggests that a successful acquisition requires two different sets of attributes: one involving information production skills and not very much capital, the other involving the operating skills required for implementing the takeover and substantially more capital. I see no reason to expect that both sets will always be present in a single entity. And if, as this analysis suggests, specialization does occur, information producers would prefer a rule allowing target management to facilitate competitive bidding, since competitive bidding would increase the return on their investment in information.

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costs, including management time involved in the search. The figure representing investment in implementation, however, reflects only the cost of purchasing the remaining shares. It does not include transaction costs associated with the tender offer, nor the cost of implementing the strategy designed to increase the target's value after the successful offer, an amount the management literature considers substantial. Implementation costs include capital investment in the target, *see, e.g.*, M. SALTER & W. WEINHOLD, *DIVERSIFICATION THROUGH ACQUISITION: STRATEGIES FOR CREATING ECONOMIC VALUE* 208-13 (1979) (analyzing Rockwell International's purchase of Admiral Corporation), as well as management time needed to integrate the new business into the acquiring corporation, *see id.* at 193. To the extent that these costs are significant, the example in the text overstates the percentage return on implementation. Thus, the example understates the amount by which the return on investment in information exceeds the return on implementation.

Implementers, on the other hand, would prefer a rule of pure passivity since that rule, by making competitive bidding less likely, would reduce takeover prices and enable implementers to secure higher returns by capturing some of the value associated with information production.<sup>10</sup> In short, implementers, not information producers, are

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10. As Easterbrook and Fischel suggest, as between one who produces only information and one who implements as well, the comparative advantage in return and, correspondingly, the incentive to invest in search depends on the price at which the acquisition can be completed. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 18-19. The higher the price paid, the greater the advantage to the pure information producer because the higher price raises the return on the information producer's 10% investment in the target's stock. A higher price also increases the price that the integrated acquirer would have to pay to acquire the remaining 90% of the target stock, thereby reducing its return more than proportionately. Thus, if in my example the buyer could acquire the remaining 90% of the target's stock at an average price of less than \$73 a share, the return to an integrated acquirer would exceed that to a pure information producer. If an integrated acquirer could systematically make acquisitions below this figure, designing a system to promote the interests of integrated acquirers would result in greater aggregate expenditures on search.

But three considerations suggest that it is doubtful that the integrated acquirer would be able to purchase the remaining stock at a sufficiently low price for it to have greater incentives to invest in search than would the pure information producer. First, the potential advantage to the integrated acquirer depends on the extent to which the very act of making the offer results in an increase in the price of the target stock. It is true that a specific security represents only a right to a future income stream with a particular risk-return relationship, for which there are many substitutes, and this means that increased demand for the security should not by itself result in a price increase. But the offer itself may convey sufficient new information concerning the target that the price will rise to reflect this new information rather than because of supply and demand characteristics. See Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972). That there is substantial information value associated with a bid is suggested by the fact that even *unsuccessful* tender offers result in substantial abnormal returns to target shareholders, in some cases exceeding the returns they would have earned had the offer been successful. See Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980); Dodd & Ruback, *Tender Offers and Stockholder Returns: An empirical analysis*, 5 J. FIN. ECON. 351 (1977). To the extent that pre-bid leaks of information are unavoidable, see note 13 *infra*, the price of the stock will rise to reflect this information value, reducing the return to the integrated acquirer regardless of the likelihood of an auction.

Second, because implementation involves risk, it would not be surprising if integrated acquirers earned a higher return (unadjusted for risk) than pure information producers. Although the return to an independent information producer depends only on the accuracy of the information, the return to an integrated acquirer depends both on the quality of the information produced and on the acquirer's ability to implement the post-offer strategy necessary to achieve the envisioned gains. Because of the additional risk associated with implementation, integrated acquirers may well require a higher return (unadjusted for risk) per unit of search than specialized information producers.

Finally, and most importantly, the numerical example in the text does not, as Easterbrook and Fischel point out, include gains from specialization. See Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 20. Adding these to the analysis, however, increases the information producer's advantage over the integrated acquirer. Suppose that the principal advantage to specialization in information producing is that the specialist can produce more accurate information, rather than that the information will be less costly. Although cost

made worse off by competitive bidding. But that should not result in less than the appropriate number of takeovers, since the implementers will always capture the entire value of their investment in implementation.<sup>11</sup>

Easterbrook and Fischel take issue with my argument at this point by correctly pointing out that another alternative is available to the specialized information producer: Rather than initiating an auction by giving the information away, the producer could, if no competitive bidding were allowed, sell the information to an implementer for a price reflecting some part of the \$20 million gain that would otherwise have been available to the implementer upon completing the takeover for the \$100 million no-auction price.<sup>12</sup> Applying their point to my example, so long as the payment for the information exceeds \$2 million, the information producer's gain from selling it without an auction exceeds the increased value that an auction would give the information producer's target shares.<sup>13</sup>

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savings from specialization are also plausible, the more important point is that the information has a higher probability of being correct. Cf. C. HOLLOWAY, *DECISION MAKING UNDER UNCERTAINTY: MODELS AND CHOICES* 348-50 (1979) (discussing value of increased certainty and use of experts to obtain it). In the context of the example, the information producer can more accurately predict whether there is an opportunity for increasing the target's value by takeover.

Now suppose that the integrated acquirer assigns a 50/50 likelihood that its information concerning the acquisition opportunity is correct. In that situation, the opportunity has a negative expected value of \$12.5 million to the integrated acquirer: a 50% likelihood of a profit of \$22.5 million if the information proves correct, and a 50% likelihood of a \$47.5 million loss (cost of \$97.5 million, post-acquisition value of \$50 million) if the information proves incorrect and the target is in fact worth no more than its pre-offer value. Further suppose that the pure information producer can identify the existence of the acquisition opportunity with certainty. In that situation, given the uncertainty associated with its information, the price at which an integrated acquirer could purchase the remaining 90% of the target would have to drop to approximately \$60 per share before the acquisition would even be a break-even proposition. But even at a price of \$120 per share, it would have a positive expected value for an acquirer with the benefit of the specialized producer's information. The fact that specialized information producers can thus produce more valuable information results in greater returns on their investment in search and, as a result, more search.

11. This example is intended to be illustrative rather than conclusive, though I believe that the numbers are reasonable. It is important to note, however, that the comparison in the text is between *rates* of return rather than *absolute* returns. In order for the comparison to be fair, the assumption must be true that capital not invested in the takeover, when only the investment in information is pursued, can be invested in the search for other targets with an expected return that is also higher than the return on implementation. Otherwise, an average return incorporating the available alternative investments would be a more accurate comparison. Put differently, it assumes that the competitive return from investment in information is higher than from investment in implementation.

12. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 19.

13. In the example, the information producer holds 100,000 shares of the target stock.

Evaluation of the sale alternative puts the issue in a somewhat different context. Assuming that a specialized information producer earns a higher return on its investment in information than an integrated acquirer, the question becomes how the information producer can best exploit its advantage—by selling the information to an implementer or by fomenting competitive bidding. In both alternatives the problem confronting the information producer is verification; whichever is pursued, in order for the information producer to secure any return on its investment in search, it must convince potential acquirers that its information is of a quality that warrants investment of up to \$120 million. An information producer's preference between the two alternatives, then, turns on a transaction cost analysis of available solutions to the verification problem.

Consider first the sale alternative.<sup>14</sup> Information producers can

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Since the auction can only increase the acquisition price from \$100 per share to \$120 per share, the maximum benefit from the auction is  $\$20 \times 100,000$  or \$2,000,000.

It should be stressed, however, that the problem of leakage, *see* note 10 *supra*, still remains. And just as leakage strengthens the position of the pure information producer as opposed to the integrated acquirer, it also reduces the ability of the purchaser of the information to secure all of the benefits of its purchase, thus diminishing, to the pure information producer, the attractiveness of the sale alternative, compared to the competitive bidding alternative. That there is substantial leakage in tender offers is suggested by the results of studies tracking abnormal returns to target companies in the period prior to public announcement of the transaction. For example, Keown and Pinkerton, in *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981), reported positive abnormal returns to target companies beginning 25 trading days prior to public announcement, representing approximately half the total abnormal returns resulting from the transaction. Substantial increases in trading volume accompanied these abnormal returns:

It was found that 79, 60, and 64 percent of the acquired firms exhibited higher volume one, two, and three weeks prior to the announcement date than they had three months earlier with the weekly average volume over this three week period 247, 112, and 102 percent higher than it was three months earlier. Such a pattern of volume is, of course, what one would expect to find prior to a public merger announcement if inside information had leaked out.

*Id.* at 863 (emphasis in original). A professional in a major solicitation firm explains the leakage phenomenon as follows:

You start with a handful of people, but when you get close to doing something the circle expands pretty quickly . . . . You have to bring in directors, two or three firms of lawyers, investment bankers, public relations people, and financial printers, and everybody's got a secretary. If the deal is a big one, you might need a syndicate of banks to finance it. Every time you let in another person, the chance of a leak increases geometrically.

Klein, *Merger Leaks Abound, Causing Many Stocks To Rise Before the Fact*, Wall St. J., July 12, 1978, at 1, col. 6.

14. For a discussion of the substantial transaction costs associated with sales of information, *see* Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J.L. & ECON. 291, 304 (1977) and Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561, 565, 572 (1971).



respond to the verification problem by strategies—characterizable either as bonding or signalling—designed to ensure the authenticity of the information to the buyer. For example, one would expect information producers who hope to sell information to make substantial investments in reputation, thereby both signaling that their product is of a quality to warrant repeat purchases and putting their investment in reputation at risk should the information prove to be inaccurate.<sup>15</sup> One might also expect the information producer to allow payment for the information to be conditioned on the success of the transaction and, in order to avoid creating a conflict of interest that could dilute the signal sent by investment in reputation, to voluntarily limit speculation in the identified target.<sup>16</sup>

The pattern described, of course, is that of the major investment banking houses.<sup>17</sup> Having already made the investment in reputa-

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15. One commentator, in discussing market responses to authentication problems, gives the example of the diamond trade. Since diamond buying takes place without inspection or appraisal by buyers,

De Beers has had to establish such a reputation that prospective buyers can be confident that the ultimate value of the [diamonds] exceeds [their] price. . . . The incentive for De Beers to engage in this peculiar form of trade seems to be that buyers are now in a position to spend on the actual purchase of diamonds the amount they otherwise might have spent on collecting information.

Barzel, *supra* note 14, at 304; see also Hirshleifer & Riley, *The Analytics of Uncertainty and Information—An Expository Survey*, 17 J. ECON. LIT. 1375, 1406 (1979). My analysis is consistent with the more general observation that in markets where product quality is difficult to determine ex ante but not ex post, repeat sales are anticipated, and consumers have easy access to ex post information, competition takes the form of investments in firm specific capital, like brand names and advertising, that act as barriers to entry. Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 626-33 (1981); see also Barzel, *Measurement Cost and the Organization of Markets*, 25 J.L. & ECON. 27 (1982).

16. Easterbrook and Fischel point out that problems of information verification also can be solved by vertical integration. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 19. See generally O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTI-TRUST IMPLICATIONS* 82-105 (1975). They suggest that combining the information and implementation functions avoids any problems specialization might create. The viability of vertical integration, however, involves more than economizing on transaction costs. It is also critical that the firm have an internal or external market for the function to be integrated that is sufficient to exhaust scale economies. See M. PORTER, *COMPETITIVE STRATEGY* 300-28 (1980). Indeed, Williamson begins his discussion of vertical integration by assuming that each stage of production "exhausts scale economies." O. WILLIAMSON, *supra*, at 82. While I am not aware of any study of efficient scale in the merger and acquisition business, the success of the investment banking community in this area suggests that it is too large for vertical integration to be a readily available option for most acquiring companies.

17. This analysis also explains the seemingly very high fees charged by the merger and acquisition departments of investment banking firms. While the fees might seem high in relation to the actual hours expended in the implementation stage—actually formulating the terms of the offer and accomplishing the transaction—they may not seem so high when considered as payment for information of assured quality.

tion, the transaction costs associated with selling their information are comparatively small. Further, their expectation of a continuing relationship with the information buyer through provision of fungible investment banking services following the acquisition serves to make a portion of the banker's total fee for the information contingent not only on the successful acquisition of the target, but also on the ultimate accuracy of the information concerning the opportunity: If the information proves inaccurate, the buyer will terminate the continuing services, and fees, of the investment banker.<sup>18</sup> It is thus hardly surprising that investment bankers follow a sale alternative.<sup>19</sup>

But the sale alternative is not the only strategy open to information producers. Indeed, for producers without either a preexisting investment in reputation or the capital and time to adopt the verification techniques used by investment bankers, this strategy may not even be available. For them, disclosure of their information in order to promote competitive bidding may be the only verification mechanism available and, therefore, the only way to appropriate the return on their investment in information. First, the bidding process itself acts as a verification technique.<sup>20</sup> Second, it can also be used to cause the producer's information to be verified by the best possible source: the target. An information producer might adopt the strategy of announcing, together with its information and its stock position, that it intended to cause the target to be acquired by someone. This would

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18. In contrast to the bonding and signaling strategies, which are essentially screening techniques, this is closer to a hostage strategy, whereby one party to an exchange reduces its incentives to behave opportunistically—in our case by misrepresenting the accuracy of information—by putting the other party in a position to respond if opportunism turns out to have occurred. See O. Williamson, *Credible Commitments: Using Hostages to Support Exchange* (draft, Sept. 1982). It is important to note that this is a very expensive verification technique because it is available only to a diversified information producer who, like an investment bank, can offer post-acquisition services to the buyer.

19. As such, it is also not surprising that investment bankers are generally credited with devising the lock-up (for example, granting the first bidder an option to purchase the target's most attractive asset) and split-price (paying a higher price for shares tendered during the pro-ration period) strategies used in the recent U.S. Steel/Marathon and Marshall Field/Batus transactions. Both of these devices are designed to reduce the likelihood of competitive bidding. As sellers of information, investment bankers do not gain from auctions.

That investment bankers actually view themselves as information sellers is suggested by a recent *Wall Street Journal* advertisement placed by a major banker—Blyth Eastman Paine Webber. The advertisement stressed that in many instances Blyth “not only negotiated the acquisition, but initiated it as well—that is, we established the company's value, developed the strategy, and suggested the eventual buyer or seller. In fact, we initiated more mergers and acquisitions last year than any other investment banker, and are initiating and completing such transactions at an even higher rate this year.” *Wall St. J.*, Oct. 7, 1982, at 49.

20. See text accompanying note 23 *infra*.

create an incentive for target management to select the ultimate acquirer—to seek a white knight. In this case, verification of the producer's information is provided by the target through its attempts to prove to those potential acquirers that it approaches the existence of the very opportunity the information producer has disclosed.

Institutional arrangements reflect this pattern as well. For example, Carl Icahn does not sell his information; he profits by reselling target stock to implementers. And his position on the benefits of auctions is also clear. When Marshall Field gave Batus lock-up options intended to prevent competitive bidding, Icahn attempted to invalidate them.<sup>21</sup>

In short, the impact of auctions on incentives to produce information is at the very least mixed. Some producers will benefit from auctions, others will not, and the balance will depend on transaction costs and other factors associated with actual practices—about which we know far too little. But it is clear that theory alone, unadorned by evaluation of transaction costs, does not preordain either the direction or the magnitude of the impact.<sup>22</sup>

Another consideration also suggests that competitive bidding has a more complicated impact on incentives for search and takeover than Easterbrook and Fischel acknowledge. An initial bid does signal some of the first bidder's information; but competing bids also disclose information. Frequently a white knight overbids because the target has given it information, not available to the first bidder, that demonstrates that the target is worth more than the initial bid. Now consider the strategy that a potential first bidder should adopt when

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21. *See* *Marshall Field & Co. v. Icahn*, No. 82 Civ. 0755 (PNL), slip op. (S.D.N.Y. Mar. 26, 1982).

22. Specialization in information production—both as between implementers and information producers and as between different types of producers—should also have a beneficial impact on the amount of search, wholly apart from either the comparative returns on search and implementation or the comparative returns on the sale and competitive bidding alternatives. If a return on search can be earned only by those with the capital to implement, or with the capital also to invest in reputation and other verification techniques necessary to sell the information produced, substantial entry barriers to the search industry are created. Specialization and the allowance of competitive bidding remove these barriers and will lead to increased investment in search so long as the return on search that is obtainable by taking a speculative position is attractive in comparison to the return available on other available investments. This would be true even if the return on search is less than the return to implementers, or than the return to information producers with the capital investment necessary for sale. Thus, competitive bidding may increase the overall investment in search because the resulting increase in return to the potentially more numerous specialized information producers draws new entrants into the search industry. This influx will outweigh the reduction in search by non-specialized producers or investment bankers that is caused by decreases in their total return.

it discovers information which discloses, subject to some uncertainty, that a target is worth twice its market price. If the information is correct, the first bidder would be willing to pay a significant premium; but the initial bid will not fully reflect this premium. If the information is incorrect, the target is worth no more than the present market value, and this uncertainty will be reflected in the initial bid. In this setting the white knight's bid reduces the first bidder's uncertainty and, hence, should cause the first bidder to be willing to pay more for the target than it would have in the absence of a second bid. Thus, while a second bid increases the takeover price and therefore reduces the first bidder's *absolute* return, it may not reduce its *risk-adjusted* return. One could well imagine a strategy of bidding well under the expected value of the target with the intention not of seeking a bargain, but rather of withdrawing the offer in the absence of a second bid.<sup>23</sup>

If either or both of these points are correct, Easterbrook and Fischel's argument that competitive bidding necessarily reduces the return on investment in information becomes much more difficult.<sup>24</sup> Even if competitive bidding reduces the return in some cases, it may increase it in others, leaving the overall effect indeterminate. And

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23. This phenomenon simply reflects an integrated acquirer using a market response, the competitive bidding process, to solve the problem of verifying information, here by recourse to the cheapest verifier—target management itself. A rule of pure passivity bars access to this source of risk reduction by preventing target management from seeking competitive bids.

24. To the extent that Bebchuk favors auctions as a means of diminishing the incentives to search for takeovers that result in no social gains, he may prefer Easterbrook and Fischel's position on this point. See Bebchuk, *The Case for Facilitating Competing Tender Offers*, *supra* note 2, at 1032–33; Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 3–7. As is clear from my initial article, Gilson, *A Structural Approach*, *supra* note 1, and subsequent writing, Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982), I agree with Easterbrook and Fischel that, overall, tender offers result in real gains.

I am skeptical, however, of the conclusion that data provides “compelling evidence that there are real gains involved in almost all offers.” Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 11. The data referred to does not distinguish between types of acquisitions and it is clear that pure diversification acquisitions cannot result in real gains. See, e.g., R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 657–66 (1981). To be sure, the current divestiture movement, see Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 14 n.30; note 31 *infra*, is evidence that the market eventually catches up, but the delay, perhaps due to the absence of hostile takeovers during most of the period covered by the studies, allows more room for transactions which principally benefit management. See note 30 *infra*. The data is thus consistent with the presence of some transactions which do not reflect real gains but which are outweighed by those that do. The issue then becomes the overall efficiency of the market for corporate control, a point which looms larger with respect to the allocational issue. See text accompanying notes 26–31 *infra*.

even if there were a net reduction in the return on investment in search, it would be considerably smaller than Easterbrook and Fischel expect. Thus, the issue of which rule—competitive bidding or pure passivity—leads to greater allocational efficiency becomes more important. Indeed, if competitive bidding does result in a net increase in the total investment in search by all types of information producers, those favoring a rule of pure passivity would have to show that a series of sales would be a *more* efficient allocational mechanism than an auction, a position Easterbrook and Fischel seem prepared to advance.<sup>25</sup>

## II. ALLOCATIONAL EFFICIENCY

There is agreement that tender offers serve an allocational role, and that competitive pricing generally facilitates the shifting of assets to their most productive users. What separates Easterbrook and Fischel's position from mine is their claim that a series of independent sales can cause assets to be shifted to their most productive users as efficiently as competitive bidding in connection with a single sale.<sup>26</sup> I disagree. While resolution of this issue turns on a comparative analysis of transaction costs, which would require a good deal more effort than has been undertaken by either Easterbrook and Fischel or myself, it is critical to note that a rule allowing target management to solicit competitive bids cannot be less efficient than a rule requiring managerial passivity. If would-be second bidders have a choice between entering a competitive bid or acquiring the target later from the first bidder, they will presumably choose the cheaper method. Therefore, the fact that many competing bids are made is powerful empirical evidence that a rule of passivity is inefficient.<sup>27</sup> Indeed, unless we are certain that a series of sales is cheaper in *every* transaction, choice is preferable. My rule gives acquirers that choice.

Some considered speculation may suggest why competitive bidding is likely to be more efficient than a series of sales. Let me start with two important elements of transaction costs in the acquisition setting: information costs necessary to identify the opportunity; and mechanical costs—for example, lawyers', accountants', and invest-

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25. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 15 ("The allocational benefits of auctions thus seem to be small if not negative.").

26. *Id.* at 14.

27. Notice, also, that both the relative disincentive to implement the acquisition and the efficiency gain from competitive bidding increase with the number of competitive bids. Thus, the greater the increase in agency costs caused by numerous bidders, the greater the offsetting increase in allocational efficiency.

ment bankers' fees—necessary to effect the transaction and cope with regulatory or other barriers (including defensive tactics by the target). I suspect that information costs are greater in a series of sales, simply because the wheel must be reinvented each time. In fact, the cost of reinvention may actually rise: While public information about the business is readily available from regulatory filings and shareholder reports at the time of the initial transfer, by the time of a succeeding transfer this information may be buried in a mass of less useful data covering the combined company.

With respect to mechanical costs, I see no reason to think that they will be materially higher in an auction setting; indeed, there are economies of scale in getting it all over at once. The clearest example is the saving in management time. After each sale in a series of sales substantial investments of management time would be needed to integrate the acquired business, a task which the management literature takes quite seriously.<sup>28</sup>

Finally, let me consider a third category of transaction costs—agency costs. Easterbrook and Fischel, arguing that a series of sales would result in allocational efficiency, state that “[t]here is . . . little evidence to support the belief that managers systematically reject the opportunity to profit by selling plants and divisions,” any more than managers systematically reject the opportunity to profit by selling new products.<sup>29</sup> While there may be no hard evidence, there is good theory, recited in both their initial article and in my own, suggesting that managers may overinvest in both new products and new divisions. Managers, when given the opportunity, will maximize their own welfare at the expense of shareholders. If managers personally gain from maximizing the size of their enterprise, they may well choose to forgo the opportunity to sell a division even at a price reflecting capitalization of a higher income than the division yields under their direction.<sup>30</sup>

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28. See note 9 *supra*. Easterbrook and Fischel, in *Auctions and Sunk Costs*, *supra* note 3, at 6, recognize the value of management time, and counsel against overlooking it in computing sunk information costs, but ignore it as a cost in this context.

29. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 14–15.

30. There is some evidence of this phenomenon. Reduction of risk by diversification at the company level does not increase the value of the company because shareholders can diversify their own portfolios more cheaply. Diversification at the company level, however, is of substantial value to managers; because of their human capital investment and the impact of incentive compensation plans, they would find it difficult to adequately diversify at the individual level. Because managers are affected differently than shareholders by different kinds of acquisitions, the more control managers have, the more frequent will be those transactions which favor them. The available data, while sketchy, is consistent with this prediction, sug-

If allocational efficiency is to be achievable through a series of sales, this behavior must be constrained; agency theory demonstrates that to reject managerialism requires *imposing* limits on managers rather than relying on managerial altruism. If managers selfishly choose to forgo the profitable sale of a division, then resort to a tender offer—which we all acknowledge plays a central role in constraining management—is necessary. But the problem with achieving allocational efficiency by a series of sales is that tender offers face greater barriers when what is sought is a division, rather than an independent company of equivalent size. If management actively or passively resists the second sale in the series, the offer will not only be a hostile one, it will be a larger transaction than the original because the second round covers the combined corporation. This reduces the number of potential bidders, and hence reduces the likelihood that the assets will end up being used as efficiently as they would have been had they been initially acquired in an auction. While the problem may be ameliorated by the ability to resell unwanted assets after the transaction, a post-transaction sell-off would necessarily involve increased uncertainty, causing the problem to remain.<sup>31</sup>

Moreover, if any defensive tactics are pursued, moving assets to their most efficient users becomes far more expensive if done through a series of sales; costs that are incurred only once in the auction model must be repeatedly incurred in the series of transactions model. Because no prohibition is perfect, even if defensive tactics are prohibited, as Easterbrook, Fischel, and I all advise, they will nonetheless still exist to some extent.

### III. RULE EFFICIENCY

Easterbrook and Fischel finally argue that the rule I recommend—prohibiting defensive tactics but permitting management to solicit competitive bids—will allow defensive tactics to be undertaken under a guise of neutrality and, to that extent, will result in a

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gesting that management-controlled firms, far more frequently than shareholder-controlled firms, make conglomerate, as opposed to horizontal or vertical, acquisitions. Amihud & Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).

31. That is not to say that sell-offs of divisions will not occur. Indeed, approximately half the acquisitions in recent years were not of previously independent companies, but of businesses being divested by someone else. See M. SALTER & W. WEINHOLD, *supra* note 9, at 17. Rather, there will be a reduction in allocative efficiency at the margin, a problem which Easterbrook and Fischel recognize in the sunk cost context. See Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 7.

loss not incurred under a pure passivity rule.<sup>32</sup> I expect that such a loss, if it occurred at all, would be small.<sup>33</sup> Moreover, the potential for loss must be compared to the similar problems that would arise under a pure passivity rule.

As I pointed out in my original article, the tender offer process often opens with a bear-hug letter suggesting a friendly acquisition but implicitly threatening that if negotiations are refused a hostile tender offer will follow.<sup>34</sup> Easterbrook and Fischel leave unclear whether a pure passivity rule would allow target management to seek competitive offers after receipt of such a letter, or whether they could only seek offers where they initiate the first contact. Consider a continuum running from tentative discussions at one extreme to a hostile tender offer at the other. If the point beyond which a passivity rule prohibits target management from seeking alternatives is drawn early, then the advantages of a truly negotiated merger or sale of assets are lost;<sup>35</sup> target management must pursue other offers at once or lose that option for good. Alternatively, if the point is set late, then an acquirer has an incentive to move there immediately in order to prevent a competing bid, perhaps at the cost of giving up information that negotiations would have provided. Either way, the forced takeover displaces the activity—negotiated takeovers—that it was supposed to monitor.

In any event, under a pure passivity rule, one must draw *some* line specifying when an offer has gone “too” far to allow the solicitation of competitive bids. This exercise, however, has the same potential

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32. See Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 15.

33. It is hard to say whether the potential difficulty of distinguishing solicitation of competitive bids from prohibited defensive tactics actually would lead managers to try to disguise defensive tactics as neutral solicitation of competitive bids. Such a determination would require a more detailed analysis of the relation between the manner in which a rule is formulated and the amount of conduct the rule deters than is possible here. See Gilson, *A Structural Approach*, *supra* note 1, at 881–87. For present purposes it is enough to note that at least independent directors would have little incentive to engage in such subterfuge since the gain from the effort would go largely to management, while the risk, made more real by the clear prohibition of defensive tactics, would be shared by the independent directors. *Id.* at 884–85. This point aside, however, the Brunswick/Whittaker/American Home Products situation referred to in Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 3, at 15 n.33, is an unlikely candidate for such a masquerade. Both my rule and one of pure passivity would bar selling a substantial portion of the business as a defensive tactic designed to make the target less attractive to the hostile bidder. See *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982).

34. See Gilson, *A Structural Approach*, *supra* note 1, at 874–75.

35. See *id.* at 846–47, 868.



for creating uncertainty and unintended costs as Easterbrook and Fischel claim would be created by my more limited prohibition.

#### IV. CONCLUSION

I have argued that, on balance, allowing target management to solicit competing bids *may* increase rather than decrease return on investment in search, and that such a rule *will* increase allocative efficiency. But I have not *proved* that this rule is preferable, and Professors Easterbrook and Fischel acknowledge that they have not *proved* the superiority of a pure passivity rule. We are, rather, in the world of policymaking, where choices are characterized by uncertainty, and where we are comforted by such empirical evidence as is available and are aided by such theory as we can manage. The major benefit of this exchange has been to clarify the basis for our difference so that those who really are charged with policymaking can do so with a better sense of the competing considerations and the assumptions on which those considerations are based. Indeed, if the exchange has accomplished nothing else, it has identified the character of the research needed to resolve this difference. The research must focus on as yet unanswered empirical questions concerning transactional patterns and costs, questions which become critical when theory is superimposed on reality. At the same time, however, I think it is critical to reiterate again what we have proved: *Defensive tactics are unjustifiable*. The differences pursued in this exchange should not be allowed to obscure that central and far more important fact.<sup>36</sup>

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36. Bebchuk stresses that his disagreement with Easterbrook and Fischel over the issue of a required waiting period is more significant than one might assume from my emphasis on our consensus concerning prohibiting defensive tactics. See Bebchuk, *A Reply and Extension*, *supra* note 2, at 24–25 & n.8. Perhaps I pay too little heed to this problem, but I think not. I base my reduced concern in part on pragmatic grounds: The present Williams Act effectively provides a significant waiting period, 15 U.S.C. § 78(k) (1976), and, whatever the terms of our debate, repeal of that legislation seems unlikely. In part, however, I also base it on the more substantive belief that the prohibition of defensive tactics by target management really does reduce the importance of the waiting period.

A central theme of my writing in this area has been that evaluation of corporate regulation requires a structural approach: one that takes into account both the nonlegal constraints operating on the corporation and its constituents and the fact that a change in one part of the structure evokes a response from other parts that must be considered in evaluating the original change. See Gilson, *A Structural Approach*, *supra* note 1, at 831–51; Gilson, *supra* note 24, at 831–34. Thus, the importance of the waiting period issue has to be considered in the context of a setting in which defensive tactics are prohibited.

But what happens to management's incentives when defensive tactics are prohibited? The prohibition should convince the managers of a potential target that the company cannot remain independent if an offer is made at more than the market price, and this will affect how they will behave in the preoffer period when they perceive their company a likely target. If

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they cannot prevent a tender offer, then their incentives more closely parallel those of the shareholders: Get the best price (including management perquisites) possible. Thus, when managers believe that the company is worth more than market value, they have a substantial incentive, now undiluted by the option of continued independence, to sell the company in a fashion that allows them to share in the gain. This is not to say that management would not prefer to remain independent, but only that, when remaining independent has been made more difficult, if not impossible, by the prohibition of defensive tactics, management's second best solution may be to actively promote the sale of the company. Thus, active solicitation of a buyer before an offer is made would likely preempt a hostile tender offer, making negotiated transactions the principal means of acquisition. This is precisely the outcome I have argued is most desirable—making tender offers operate as monitoring mechanisms rather than as the primary activity. See Gilson, *A Structural Approach*, *supra* note 1, at 848–52; text accompanying note 35 *supra*. In this regard it is critical to recall that if agents were costlessly loyal there would be no need for tender offers; if we reduce the divergence in interests that necessitates monitoring in the first place, issues concerning the terms of the monitoring technique recede in importance.

This is the context in which the issue of a waiting period must be evaluated. To be sure, the rules that apply when a tender offer comes first—permitting target management to solicit competitive bids and assuring them enough time to do it—remain important; but, I think, less so than when the prohibition of defensive tactics has not tempered the conflict between the incentives of managers and shareholders. Put simply, if offered the choice of two boons by the regulatory genie—either prohibit defensive tactics *or* impose a waiting period—prohibition seems to me by far the better choice.