CHAPTER 2

MERGERS AND TAKEOVERS: NATURE, CAUSES AND CONSEQUENCES - AN ANALYTICAL PERSPECTIVE

The chapter presents an overview of the available economic literature on certain key issues of the analysis of mergers and TOs that we have taken care of in this thesis. Since a very wide range of issues is dealt with in this study, it is neither appropriate nor very helpful to cover all the literature in a single chapter. We will therefore consider only the overall approach and methods here. A consideration of the more specific literature is relegated to the relevant chapters. This, it is hoped, will enable a comprehensive and coherent review of the evolution and development of the theories on merger and TO activities.

The chapter is organised as follows. Section 2.1 is a resume of the notion of merger and TO activities. Section 2.2 concentrates on an extensive survey of the existing literature on the theories that have been advanced to explain the possible causal factors behind amalgamation and acquisition activities, in the market for corporate control. In Section 2.3, we present the available theories regarding the potential effects of mergers and TOs in general and in terms of market concentration, in particular. Section 2.4 provides a broad contour of the general concept of CG including an analysis of the three well-defined brands of CG found in the developed industrial world, namely the Anglo-American (A-A), Japanese and German CG systems. Section 2.5 provides an overall summary to the chapter.

2.1 Concept of Merger and Takeover Activities – Some Competing Views

2.1.1 “Passive” versus “Active” Firms and Mergers and TOs

The traditional firm theory starting with Adam Smith and passing through Jevons, Edgeworth and Marshall viewed firm as a passive, profit-maximising, single product decision unit, which, given its immediate or perspective economic environment, sought via its decision on prices, advertising and capital commitments to maximise profits. A firm demonstrating “passive” behaviour accepts the existing cost and demand (market share) structures as given, and optimises its objective function. In other words, a passive firm reacts passively to the structural conditions faced in pursuit of its goal. However, a firm may also try to escape the constraints of its existing cost structure and demand share, i.e., modify market structure, reduce competitive pressures and expand and grow the business opportunities available, so as to attain its own objectives better. This may be designated the “active” behaviour
of firms (Hay and Morris (1992): 271, 496). There exists various ways in which the firm may use accumulated funds to carry out active behaviour.

- invest in new capacity through investment in plant and machinery
- put resources to process research and development (R&D)
- spend money on marketing its products and product R&D
- engage in corporate restructuring through mergers, TOs, etc.

The first two ways determine the development over time of the cost structure. The third influences consumer preferences, which is one determinant of demand conditions. In each case, the firm acquires and organises new resources. All the three ways refer to internal investment by the firm.

However, there exists a fourth possibility by which a firm may acquire resources already organised in the form of a firm or a part thereof, by merger or TO. Mergers and TOs are ways in which the size and number of firms — the other determinants of demand conditions — are modified. Mergers and TOs refer to external investment by a firm. By each of these ways thus, the firm can relax its demand and price-cost constraint, i.e., the market condition, so as to earn higher return, or reduce loss or prevent exit.

2.1.2 Alternative Perceptions of Mergers and TOs in terms of the Transactions Involved

TO and merger activity is an important part of the operation of a market economy, under which firms and parts of firms are exchanged so as to put assets to their most productive uses. One of the most significant phenomena of the contemporary industrial scene all over the world, is the expansion of some firms by the taking over of others or the coming together of two or more firms on a voluntary basis. The former of these two processes is normally referred to as a TO, while the latter is usually called a merger. However, since they both embrace the characteristic of external corporate expansion, it has become customary to refer to them by the generic title of “industrial mergers” (Howe (1978): 151).

On going through the literature on mergers, acquisitions/TOs, we may observe strains of contradiction regarding the definition of the concepts, as posed by the different economists on the subject. Whether this just reflects different perceptions of the same notion or whether the economists consciously differ among themselves to convey their own messages may provide an interesting area of research on such collusive activities.
According to Sawyer (1985), acquisition refers to cases where one firm purchases another firm from its shareholders and the control of the newly formed large firm lies with the acquiring firm. Merger, on the other hand, relates to cases where two or more companies come together to form a new joint company. The dividing line between acquisitions and mergers is not always clear-cut, and the form and substance of acquisition and a merger may differ a little. Thus, for example, it may appear that a merger has taken place with the formation of a new joint company on the basis of two previously independent firms, but the substance may be that one firm has acquired control over another. For example in 1989, the press announced that SmithKline Beckman, the US pharmaceutical company, had taken over the UK company Beecham for 4,509 million pounds. However, technically speaking, it was a “merger” because a new company, SmithKline Beecham was created which acquired the shares of the two constituent companies to form a new entity (Griffiths and Walls (1991)).

According to Griffiths and Wall (1991), merger takes place, with the mutual agreement of the managements of both companies, usually through an exchange of shares of the merging firms with shares of the new legal entity. Additional funds are not usually required for the act of merging, and the new venture often reflects the name of both the companies concerned. Here Griffiths and Walls basically speak of the notion of agreed mergers of Hay and Morris (1992).

Griffiths and Walls however consider acquisitions and TOs to be synonymous. According to them, a TO or acquisition occurs when the management of firm A makes a direct offer to the shareholders of firm B and acquires a controlling interest. Usually the price offered to firm B shareholders is substantially higher than the current share price on the stock market. In other words, a TO or an acquisition involves a direct transaction between the management of the acquiring firm and the stockholders of the acquired firm. TOs usually require additional funds to be raised by the acquiring firm (Firm A) for the acquisition of another firm (Firm B), and the identity of the acquired company is often subsumed within that of the purchaser. This is likely to be the case of Sawyer where it may appear that a merger has taken place with the formation of a new joint company (with the acquired firm having been subsumed in the acquiring firm) on the basis of two previously independent firms, but the substance may be that one firm has acquired control over another. Griffiths and Wall are of the view that sometimes the distinction between merger and TO is clear, as when an acquired company has put up a fight to prevent acquisitions, i.e. in the case of hostile TOs.

According to Waterson (1984: 184), in the case of a merger between two firms in the same industry (horizontal merger), there may be two alternative situations:

(a) the merged firm may continue to operate as two entirely separate divisions;
(b) the merged firm may become unified in more than a trivial sense.

Case (a) is presumably the one where, in line with the spirit of Sawyer, the coalescence is more of a TO in “substance” whereas the latter situation, is a merger in “form”.
Odagiri (1994: 111), on the basis of his experience in Japan, defines merger as a legal amalgamation of two or more companies to form a single company. According to him, an acquisition refers to the acquisition of control of another company without merging. It usually involves an acquisition of ownership, typically more than half of the shares. Odagiri's definition of acquisition thus involves two dimensions -- acquisition of ownership and that of control.

Odagiri then relaxes the tacit definition of acquisitions and mentions cases which are deviations from his definition of acquisition (in the sense of preserving both the dimensions intact), but which retain the spirit of corporate TOs by maintaining any one of the two characteristics.

(a) case in which company A acquires real control over company B without majority ownership of the shares.
(b) case where company B retains its own control but falls under the influence of company A. This he calls "Capital Participation".

Company A may influence company B from different perspectives:

(i) technological -- A provides technology and know-how to B.
(ii) market-related -- A utilises B's market channels.

His rationale behind designating these cases as "capital participation" is that nearly in every case, A acquires some of the shares of B. Such share ownership may be reciprocal, that is, B may acquire shares of A at the same time that A acquires shares of B. This system of cross shareholding among firms is practiced in Japan (Odagiri (1994); Sheard (1994): 311-49). He refers to all these methods of external corporate expansion as mergers and acquisition.

An alternative possibility is that instead of a clear-cut distinction between merger and TO, there are cases where a TO could be in the form of a merger. If a firm B is merged in firm A, so that B loses its separate entity while A continues its existence, then for all practical purposes, firm B is taken over by firm A. Here A is called the "amalgamated" or "acquiring" firm and B the "amalgamating" or "acquired" firm (Dasgupta (1989)).

According to Singh (1971), "TO" occurs when firm A acquires more than 50% of the equity of firm B. "Merger" occurs when firms A and B amalgamate to form a new legal entity C (both A and B are considered to be statistically dead).
According to Mueller (1969: 643-659), a merger between two companies A and B takes place when the managers of A approach B's managers directly; they negotiate the conditions of the amalgamation and they agree upon a mutually satisfactory price; then B's managers use their influence and proxy power to persuade their stockholders to approve the merger. In short, a merger takes place with the mutual agreement of the managements of the merging companies. A TO (or acquisition) occurs when the managers of firm A directly make a tender offer and buy the shares of the stockholders at firm B at a price, which is substantially higher than the current share price on the stock market. Such a TO usually takes place with opposition from B's managers. In other words, a TO involves a direct transaction between the managers of A (the acquiring firm) and the stockholders of firm B (the acquired firm). Thus Mueller and Hay and Morris think in same line.

Hay and Morris (1992: 496) appear to consider mergers as basically agreed coalitions between two companies, and TOs as the ones that are hostile to the management. They start from the classification of acquisition of firm(s) by another firm say A, in terms of the type of transaction involved and in terms of the markets involved. In the former category they distinguish among other things, between agreed mergers and contested TOs. An agreed merger is one in which firm A acquires firm B in a bid recommended by B's management to B's shareholders. Contested TOs usually occur by means of tender offer, in which firm A makes an offer directly to firm B's shareholders, over the heads of B's management (who may try to defend this company). It may therefore transpire from Hay and Morris's classification that mergers are agreed or friendly co-operative arrangements, whereas TOs are essentially hostile.

A third type of corporate fusion activity mentioned in Hay and Morris above that is associated with mergers and acquisitions, in terms of transactions involved is "management buy-out" where the unwanted subsidiary is sold to its managers (or more generally, to the employees) rather than to a separate company. Weston, Chung, and Hoag (1996: 739) go further to define a management buy-out as a going-private transaction led by the incumbent managers of a formerly public firm. In general however, management buy-outs need not be confined to the selling of subsidiaries. It may be a selling of corporations, subsidiaries, divisions and also product lines of a company.

Hay and Morris (1992: 496) also identified another variant of mergers and TOs which they characterised as "divestment". Divestment occurs when a firm with a number of business units or subsidiaries, sells off an unwanted subsidiary, as a part of corporate restructuring, with a view to creating optimal portfolios of business, to another firm, where this sold-off unit becomes an additional subsidiary, fitting into its own scheme of things. In general, divestitures involve selling of assets/product lines/divisions/subsidiaries, for cash, stock or both. They are aimed at focussing on core areas, raise funds to pay off other prior commitments, greater strategic focus and disposing of saturated or reducing business, so as to ultimately enhance corporate value. Such divestitures could be in the form of spin-offs, split-offs, split-ups, equity carve-outs, etc. In spin-off transactions, the subsidiary is spun off from the parent’s fold into an independent entity. This is also called “demerger”. Split-off
transactions involve a group of shareholders receiving subsidiary’s shares subject to the conditions that they would relinquish their shares in the parent company. In split-up transactions, the parent spins off all the existing divisions and subsidiaries to its shareholders and ceases to exist. In post split-up period, several divisions and subsidiaries would be independent entities. In equity carve-out, only part of subsidiary’s equity owned by parent is offered to the public in exchange for cash or debt without losing control.

### 2.1.3 Classification of Mergers and Takeovers on the basis of Product Profile

So far as the classification of acquisitions in terms of markets involved or product profile is concerned, Hay and Morris (1992: 496) distinguished between horizontal, vertical and conglomerate mergers. According to them, horizontal mergers occur when both the acquiring firm and the acquired firm operate or compete in the same product market. When a firm acquires a supplier or a customer firm, it is a case of vertical merger. Under, vertical merger, the two coalescing firms are vertically related to each other either forward or backward. If there is no horizontal or vertical relationship between two merging firms, then it is defined as a conglomerate merger.

In reality however, combinations between diversified firms include elements of two or even all three of these classifications. It is interesting to note that, here, Hay and Morris, do not speak anything about acquisitions. It thus gives the feeling that in the context of acquisitions in terms of markets involved, they seem to have treated mergers and acquisitions as similar forms of corporate market control activities.

In this connection it may be mentioned that in the writings of Griffiths and Wall (1991) we find that there can also be another type of corporate unification called “lateral integration”, when the firms which combine are involved in different products, but have some element of commonality. This might be in terms of factor input, such as requiring similar labour skills, capital equipment, or raw materials; or it might be in terms of product outlet. In practice, it is difficult to distinguish such a fusion from a conglomerate merger. Weston, Chung and Hoag (1996: 733) have defined a concept of “concentric” merger. In this case, there is a carry-over in specific management functions (e.g., marketing) or complementarity in relative strengths among specific management functions rather than carry-over/complementarities in only generic management functions (e.g. planning). Concentric mergers are also called product extension mergers. Product extension merger is a type of conglomerate merger which is characterised by a combination between firms in related business activities that broadens the product lines to the firms (Weston, Chung and Hoag (1996: 743)).
2.1.4 Conclusion

The general trend observed among the writers is to take acquisition and TOs synonymously. However, there exists an economically meaningful distinction between mergers and TOs, is the way in which these two types of amalgamations take place. Another broad difference between mergers and TOs is that the latter requires funds for the acquisition of one firm by another, while mergers usually take place by an exchange of shares of the merging firms with shares of the new legal entity.

While the terms TOs, mergers and acquisitions all refer to a change in management, they differ in the form and manner in which this change is carried out. A TO is achieved by buying shares of the target company. An acquisition refers to an outright purchase of a business undertaking. In a merger, the transferor company is dissolved and its assets and liabilities vested in the acquiring company. This is by far, the most conventional and popular exposition of the notion of mergers, TOs, acquisitions and associated concepts in the economic literature. However, the general tendency seems to be that of using the concept of merger as a generic term, involving amalgamations of all sorts, — acquisitions, TOs and mergers.

In this study too, somewhere we use "mergers", somewhere "TOs" and somewhere else, "mergers and TOs/acquisitions". However, in all cases, we will imply the combination of mergers, acquisitions and similar activities in the corporate control market. This is done, to maintain conformity with the general practice. Mergers, TOs or acquisitions, here depict a situation where companies coalesce or firms unite in some form and management change takes place. So far as the classification of mergers and acquisitions in terms of product profile is concerned, we have distinguished between horizontal, vertical, conglomerate, lateral and concentric mergers.

2.2 Factors Promoting Merger and Takeover Activities

2.2.1 Internal versus External Investments by Firms and Mergers and TOs

As already mentioned in Section 2.1.1, in order to achieve its growth objective, an "active" firm must make investments in various areas. Investment activities can take at least two forms — internal investments and external investments. Internal investments are the continuation or expansion of existing projects or the addition of new projects internally. Investment activity can also be external in the form of horizontal, vertical, product-extension and geographic market-extension mergers [1] or any other conglomerate merger and TO activity. Then the question becomes what determines the choice of mergers and TOs as against internal development, as a major form of corporate growth.

Growth through internal investment is considered to be time consuming, requiring research and development (R&D), organisation of production, market penetration and in general a smoothly working organisation. The cost of building an organisation internally may exceed the cost of external investment via an acquisition. Moreover,
through merger a company can quickly obtain an already established firm, either in the same industry or in a new market. There may be fewer risks, lower costs, or shorter time requirements involved in achieving an economically feasible market share by the external route. The firm may be able to use securities in obtaining other companies, whereas it might not be able to finance the acquisition of equivalent assets and capabilities internally. Other firms may not be utilising their assets or managements as effectively as they could be utilised by the acquiring firm and there may be opportunities for the acquirer to complement the capabilities of other firms. There may also be tax advantages to the acquiring firm in the acquisition of certain companies. These are some of the factors that motivate corporate unifications.

Literature on Mergers and TOs
To investigate the intricacies behind the driving forces behind TOs and mergers, we present an overview of the existing literature on industrial organisation in general, and on mergers and TOs in particular. The overall literature on mergers and TOs provide a number of standard causal factors behind such corporate fusions. The bulk of the literature on the causal factors surveyed in this study incidentally happens to be British and American. A rich literature on mergers and TOs has developed in UK and USA, which can be attributed partly to the occasional experience of intense merger and acquisition activities by those countries, referred to as the "merger waves" (Lewellen (1971: 521-537)).

On the basis of the available literature on merger-motives we have distinguished between "economic" and "extra-economic" factors promoting corporate consolidation activities. "Economic" ones are those which are not speculative or manipulative to begin with. The literature on mergers has also provided some other factors, which we call "extra-economic". They account for the "dubious reasons" for mergers; mergers that are based on the purposeful manipulation of the expectations of investors by the merger promoters.

In this section, we will first present a synopsis of the economic factors behind mergers. In Section 2.2.2 we present the three competing hypotheses determining the causes behind mergers - profit-maximisation hypothesis of the neoclassical model of the firm, non-profit-maximisation hypothesis of the managerialist school and the valuation-discrepancies hypothesis. Apart from these, there are other economic factors promoting mergers, which are then discussed in the same section. We then put forth the "speculative" motives found in the literature in Section 2.2.3, and in Section 2.2.4 we finally try to integrate the discussed notions. All the causal factors behind mergers and acquisitions discussed in this chapter may not exist in the Indian situation. But, such an in-depth literature survey is deliberately undertaken to build a perspective so that it becomes simpler to identify the actual and potential factors operating behind mergers and TOs in India in future.
2.2.2 Alternative economic factors causing mergers and TOs

A. Profit-Maximisation Hypothesis and Mergers

As mentioned earlier, the firms in the traditional firm theory were assumed to be single-product, indivisible, decision-taking units, maximising profit under conditions of certainty [2]. Profit was generally viewed as net-wealth, net wealth being measured by the present value of the future stream of profits expected to accrue to the firm. Profit was maximised in this set-up, subject to the demand and cost constraints, i.e. accepting the demand and cost structure as given. The firm hereby adopted a passive policy as it reacted passively to the structural conditions faced in pursuit of its objective of profit maximisation and was thus a passive agent. Moreover, in the traditional approach of the firm, since the owner and the operator was the same, therefore the control was exercised unambiguously by the individual owner, who was the sole claimant on profitability.

With firm as a passive, profit maximiser in the traditional theory, the concept of merger and acquisition as a strategic decision, in the sense of altering the market structure in which the firm operated, did not arise, unlike as in the modern counterpart. Here, the motive for merger, if any, could be attributed to the traditional entrepreneurial or personal reasons for selling the control. In fact, before the advent of the corporate form of control, firms grew to maturity, largely through the skill, energy and vision of one man, and then, in many cases, declined under the less robust guidance of the founder's descendents. In this situation, it would often be more profitable to sell the concern before the rot set in. The founder of the firm rather found it worthwhile to merge with a larger firm, whose superior managerial skill could ensure the successful operation of his own firm, if he thought that his capabilities were no longer sufficient to cope with the successful running of the firm or if he had little faith on his inheritors (Sen (1969)).

Mergers, as strategic decisions enter the traditional theory of the firm within the profit-maximising framework when the firms take an “active” stand. In such cases the firms might further their objectives by merger if monopoly power enabling monopoly profit is created, or if economies of scale, broadly construed, yielding lower costs are realised, etc. (Devine, Lee, Jones and Tyson (1993): 195). These consequences of merger are together sometimes referred to as “synergistic effects”, i.e., effects resulting from the meshing together of firms in such a way that their profits when merged exceed what the sum of their individual profits would have been had the firms remained unmerged. We will discuss below some well-known hypotheses concerning the factors underlying the merger and TO activities by profit-maximising “active” firms.
I. Market Power Theory

Market power theory suggests that through control of the firm's environment, the prospect of profit is improved, at least in the long run. There are a number of approaches to the explanation of acquisitions and mergers that are placed under the general umbrella of market power theory. These approaches place the seeking of market power and strengthening of position as key elements behind mergers and TOs. The typical argument here is that the acquiring firm, by merging with or taking over another firm reduces competition. This results in an increase in market power that may help the acquiring firm to withstand adverse economic conditions, and increase long term profitability via, the charging of higher prices and the reaping of monopoly profits. Thus, the market power approach stresses the increased market power as an important source of increased profits. In other words, the emphasis is on market power rather than productive efficiency as the source of increased profits.

The market power theory (Aaronovitch and Sawyer (1975, 1975a); Newbould (1970); Cowling, Stoneman, Cubbin, Cable, Hall, Dornberger and Dutton (1980); Whittington (1980)), as mentioned above, is a bundle of different approaches, all of which stress the dominance of seeking of market power as the main motive to acquisitions and mergers. Among the different approaches, three assume particular relevance and importance.

1. Acquisitions and mergers are undertaken to increase the market power of the firms involved so as to increase monopoly control of the environment in which the firm operates. The market power may arise in the product market through horizontal integration, which results in elimination of competition and increase in concentration which can lead to an ability of the acquiring firm, to charge higher prices for outputs.

Or, such market power may arise in the factor markets or final product markets, through vertical integration, generating an ability to buy inputs at lower prices or selling of finished products to the end-users at profitable terms. Downstream mergers for example, are most often formed in order to ensure a market for the final product, by foreclosing competitors from it. Upstream vertical integration may also be used for acquiring market power, via increasing or creating barriers to entry and/or placing competitors at a cost disadvantage.

Conglomerate mergers and acquisitions are a form of cross-entry. A firm established in one industry merges with or takes over another firm established in another unrelated industry. Thus conglomerate mergers do not give market power of the same form as horizontal or vertical mergers. However, they acquire other forms of market power which usually increase their expected earnings. The most important effects of such economic market power arise from the ability of conglomerates to pursue several policies which affect their profits. Such policies are: reciprocal buying agreements with customer firms, predatory pricing, 'tie-in-sales' agreements, exclusive dealing agreements,
cross-subsidisation of the various branches of the conglomerate and prevention of potential competition by taking over a competitor firm.

(2) The changes (sometimes, adverse) in the economic climate which acts as a trigger in the search for market power. The changes may be as follows:

(a) a fall in demand, relative to capacity, which leaves the industry with excess capacity and faced with the prospect of price-cutting competition and declining profits. In this situation firms may merge (even with their rival(s), if need be) in order to secure a better vantage point from which to rationalise the industry. Such merger moves may be necessary for the survival of the firms, allowing a more rational treatment of over-capacity. The elimination of the excess capacity is achieved with less difficulty after the merger of some of the firms involved, rather than the removal of excess capacity through price competition, profit declines and bankruptcy.

(b) an increase in international competition with the invasion or increased penetration of domestic markets by foreign producers. In such a situation, consolidations (through mergers or TOs) of domestic firms may produce size, large enough to fight foreign invasion.

(c) legislative change, particularly the virtual outlawing of restrictive practices. For then cooperation or linkages between independent companies is made illegal through the tightening of legislation; but if acquisitions are not controlled then cooperation between these companies can continue if they are under common ownership, so as to control the markets. Since restrictive practices legislation has made many of the practices that involves collusion (in order to control the markets) illegal, between companies, merger, by “internalising” the practices, has allowed them to continue.

(3) This strand stresses the importance of size, particularly size relative to rivals, customers and suppliers. Size may be useful in any protracted battle with rivals and allows a firm to outlast its rivals. It may be useful in bargaining with customers and suppliers. It may help to protect a firm from being acquired by other firms with whom it does not wish to be associated. As one firm increases its size and power, it diminishes the relative size and power of other firms providing those other firms with an incentive to merge to restore the balance. Thus, the size relative to others, rather than the absolute size, which is of importance.

Usually the very act of merging increases the firm’s size, both in absolute terms and in relation to other firms. It is clear, therefore, that increased size will be both a by-product of the quest for increased market power, and itself a cause of increased market power.
Critique
A standard objection against the market power theory is that permitting a firm to raise its market share by merger has the possibility of resulting in "undue concentration" in the industry, leading to an undesirable market structure. The argument in brief is that if a few firms account for a substantial percentage of an industry's sales, these firms will recognise the impact of their actions and policies upon one another. This recognised interdependence will lead to a consideration of actions and reactions to changes in policy that will tend toward "tacit collusion". As a result, prices and profits of the firms will contain monopoly elements. Thus, if economies from mergers cannot be established, it is assumed that the resulting increases in concentration may lead to monopoly elements.

Moreover, in contrast to other approaches, these approaches make little of the distinction between acquisition and merger, and view most acquisitions as being agreed by both parties and intended to strengthen the joint position of the firm involved.

II. Economies of scale

Economies of scale are usual explanation given for mergers. It involves the concept of complementarity of capabilities -- of inputs, management expertise or of finance. The theory assumes that economies of scale do exist in the industry and that prior to the merger, the firms are operating at levels of activity that fall short of achieving the potentials for economies of scale. By this theory we can explain horizontal, vertical and even conglomerate mergers.

Economies of scale arise because of indivisibilities, such as people, equipment and overhead, which provide increasing returns if spread over a large number of units of output. Thus in manufacturing operations, heavy investments in plant and machinery typically produce such economies. Here we have to distinguish between real and pecuniary economies of scale. Real economies arise from a reduction in factor inputs per unit of output, while pecuniary economies are economies realised from paying lower prices for factor inputs, due to bulk transactions.

Real scale economies may arise from the technological (R&D) activities, synergistic effects, marketing and distribution activities, transportation, storage, inventories and managerial economies. Among the most obvious possible sources of real economies of scale are lower marketing and distribution costs, lower transportation costs and reduction in inventories. It is also possible by the general reorganisation of the operation of the merged firms, to consolidate the functions of production, R&D, marketing, purchasing, administration and accounting, so as to eliminate duplication of facilities and under-employment of personnel. Theoretically such production, marketing, transportation, inventory and R&D economies are more readily attainable with horizontal mergers, where the activities of the firms are of the same nature and can be easily streamlined. Realisation of such economies is hard to see in vertical mergers and even harder in conglomerate mergers where the coalescing firms belong to unrelated industries.
However, synergistic economies, managerial economies and pecuniary economies may be realised in all types of mergers. Synergy is said to exist when the combination of firms or activities results in a situation where the total is more than the sum of the individual parts. It is often described as the ‘2+2 greater than 4’ case. Synergy results from the complementarity of activities, or from spreading of existing managerial skills over a larger operation. While synergistic effects arising from complementarity of functions within firms are theoretically attainable in all types of mergers, synergy from managerial talent is more likely to be attained in horizontal mergers, because management is experienced or specialised in running a certain line of business. Thus if managerial economies are to be realised with conglomerate (or even vertical) mergers, the underlying condition would be that the managers of the acquiring company are equally conversant with handling operations of highly diversified type.

Pecuniary economies may be realised by all types of mergers, from lower prices for factor inputs owing to bulk transactions. Such economies are most important for horizontal mergers. For vertical and conglomerate mergers the most important pecuniary economy is that of cheaper finance.

One way in which economies may be achieved in vertical integration is by combining firms at different stages of industry so as to achieve more efficient coordination of the different levels. The argument here is that costs of communication and various forms of bargaining can be avoided by vertical integration (Williamson (1975)). Here the merger generates managerial economies to the extent that it ensures efficient coordination of different stages of production. It also generates cost reduction and hence pecuniary economies of scale.

There may also be complementarity between merging firms with respect to availability of investment opportunities and internal cash flows. This is more valid in the case of conglomerate mergers. It is argued that a large conglomerate has a large cash flow with which it can cross-finance its various branches. Furthermore, it has access to outside finance (bonds and issue of new stocks) at the lowest attainable rates.

A firm in a declining industry will produce large cash flows since there are few attractive investment opportunities. A growth industry has more investment opportunities than cash with which to finance them. Here the merger may take place between firms of unrelated industries and hence conglomerate merger. The merged firm is then expected to have a lower cost of capital due to the lower cost of internal funds as well as possible risk reduction, savings in floatation costs and improvements in capital allocation. This is a manifestation of the pecuniary economies of scale. Various models have been posed by economists over time demonstrating synergy gains from mergers and TOs within the framework of profit-maximisation hypothesis under horizontal, vertical and conglomerate mergers (Logue and Naert (1970: 663-67), Davies and Whinston (1962: 241-262), Steiner (1975)).
B. Non-Profit Maximisation Hypothesis and Mergers and TOs

Birth of Joint-Stock Companies
Historically, firms in the early nineteenth century were generally small, single-product, privately-owned companies operating in small local markets. They abstracted from all internal characteristics and from diversity in production. The resulting indivisible single product unit was presumed to have one goal; and in so far as this could be interpreted as saying anything about real-world firms, it implied either that all members of a firm were profit-maximisers, or that the management control system employed was such as to ensure that no actions or decisions significantly diverged from the pursuit of profit-maximisation.

It is argued that the development of the railway networks in the western world and corresponding development of technology changed this dramatically. These hitherto small, privately-owned firms had experienced substantial growth at some historical point of time, varying in different countries, in the process of which they acquired several characteristics. These are size (which may be measured in terms of assets, employees or sales), diversity of production (which can come about through internal diversification or through mergers and acquisitions) organisational complexity and separation of ownership and management.

With industrial revolution and the resultant advent of technology, it became technologically possible to produce in large scale; the importance and potential benefits of large-scale production were also realised. However, to produce on a large scale involved a lot of money, which the individual entrepreneur might not have been in a position to contribute out of his own sources or by borrowing. Even if he could, he might not have been willing to bear the risk hazards of investing the huge sum of money. But, at the same time, the entrepreneur, as a rational economic entity was lured by the return of large-scale production. To retain return and spread out risk and thereby increase risk-adjusted return, the solution was to raise money (capital) from and share risks with, external sources by imposing the clause of ‘limited liability’. The emergence of joint-stock limited liability company can be understood in these terms (Arrow (1965: Ch. 3)).

The ‘limited liability’ clause implies that the liability of the shareholders is limited just to the extent of shares contributed by each shareholder. The ability to spread the risks of production and trading and to engage in them or finance them without putting one’s non-invested wealth at risk were a major spur to the expansion of economic activity by firms. This was the starting point of joint stock companies -- the modern corporation of today. Each individual who contributed capital to the working of the firm, however small the contribution might be, was recognised as the owner of a share of the company’s capital, and hence the shareholder.

This raising of money from individuals led to the issue of stock-holding, conferring a part share in ownership of the firm to people not necessarily involved in the day-to-day or even strategic decisions determining the firm’s development. The inclusion of the shareholders as one of the stakeholders in a firm had two aspects.
First, with the generation of the class of shareholders, there was a need for an appropriate financial policy that would ensure the suitable division of profit between dividends payable to the shareholders and that to be retained internally (or to be paid out to bondholders). Secondly, the view of the firm that emerged became substantially different from the traditional firm. The modern firm is essentially a set of contracts. There are a number of inputs — capital, labour, management, etc. — each with different owners who transact among themselves. The firm is the nexus of long-term contracts restraining the behaviour of transactors. It allocates the steps in the organisational decision-taking process, defines the residual claims, and sets up devices for controlling the problems that arise from having agents act for factor owners. Normally, there is one party who is common to all contracts and has the right to negotiate and renegotiate with the other parties independently; and there is one party with the residual claim, who may choose to sell his claim (Alchian and Demsetz (1972): 777-795 and Fama and Jensen (1983): 301-26). Traditionally these two parties were seen as the same person or group — the entrepreneur who owned the firm and therefore had a special interest in it. In the managerial firm, the two intentions are split. Shareholders commit the capital that they own, but it becomes clear that the “firm” as a set of contracts is not owned by anyone. Given that shareholders can both diversify their holdings across companies and easily sell their holding in any one company, in a manner not possible for a manager’s human capital, it is probably the manager who has the overriding special interest in the firm, even though he is not the residual claimant.

Agency Problems and Managerialism

Berle and Means (1934) is acknowledged to be one of the first authors to have argued that there was a growing divorce of ownership and control arising from the ownership of modern (and large) corporations being widely spread among a large number of shareholders. This led the shareholders to have little, if any, involvement in the management of a firm, and a management with little ownership interest. According to their view, since the shareholders supply the capital, they are recognised to be the major claimant to the corporate returns and are deemed the major stakeholder in the capacity of being the owner, at least according to the Anglo-American scheme of things. The day-to-day functioning of the company is however, taken care of by the salaried managers, who control firm’s operations, but hold, few if any, shares. Consequently, ownership of a firm and its effective control becomes largely divorced from each other. This is the theory of managerial capitalism.

Theoretically, the separation of ownership from control leads to a divergence of interests among the principals (the shareholders) and the agents (the managers), thus generating in the process the agency problems. Agency problems arise basically because contracts between managers (decision and controlling agent) and owners (risk bearers) cannot be costlessly written and enforced. Resulting agency costs include the costs of structuring a set of contracts, costs of monitoring and controlling the behaviour of agents by principals, costs of guaranteeing that agents will make optimal decisions or principals will be compensated for the consequences of suboptimal decisions, and also the residual loss, that is, the welfare loss experienced by principals, arising from the divergence between agents’ decisions and decisions to
maximise principals' welfare. This residual loss can arise because the costs of full enforcement of contracts exceed the benefits.

In their seminal paper, Jensen and Meckling (1976: 305-360) formulated the implications of agency problems. An agency problem arises when managers own only a fraction of the ownership shares of the firm or there may be no ownership of shares. The decision-takers (the managers) within the firms, being no longer the owners do not receive the profits made. This partial or zero ownership situation may cause managers to work less vigourously than otherwise and/or to consume more perquisites (luxurious offices, company cars, memberships in clubs) because the majority owners bear most of the cost. The managers have no incentive to maximise profit for shareholders. They pursue profitability up to the minimum necessary for survival and indulge in non-profit maximising behaviour. Further, the argument goes that in large corporations with widely dispersed ownership, there is not sufficient incentive for individual owners to expend the substantial resources required to monitor the behaviour of managers.

With a one-man owner-manager firm the owner will normally bear the risk inherent in production and distribution -- primarily the risk that products will not be sold as expected and that losses will be incurred as a result. But with managers and owners/shareholders, the important question arises as to who bears the risks. In reality, in the absence of perfect capital market and perfect information flow for the managers to know precisely what evaluation shareholders place on uncertain outcomes, managerial decision-takers, whether they wish or not, have to take decisions incorporating at least partly their own risk evaluations. The prime example of this is the allocation of internal funds, which though owned by the shareholders, are in all but the most extreme circumstances used by managers with little or no direct reference to shareholders' preferences. Managerial shouldering of risk inevitably introduces managerial objectives into decision-taking, and these may differ from the profit-maximising objectives of shareholders.

The constraint on managerial discretion to pursue a non-profit-maximising strategy is determined by the enforcement costs facing wealth-maximising shareholders. There is a clear disadvantage of dispersion of shareholding, namely the scope of shareholders to shirk ownership control responsibilities while still hoping to gain the rewards associated with ownership, and this is one reason why enforcement costs can be high. If there were no enforcement costs involved in shareholders getting managers to act entirely on their behalf, then, despite the existence of managerial discretion, firms would act as profit-maximisers. Any management that did not pursue this goal would simply be replaced. In practice, there are generally substantial enforcement costs, as a result of the limited information available to shareholders on whether management is maximising profits, the cost of monitoring performance, the difficulty of replacing firm-specific experience obtained by managers, and the cost of mounting, fighting and winning a shareholders' fight against an incumbent management. But this does not preclude the possibility that the separation of ownership and control and the potential for non-profit-maximising behaviour by managers will none the less constitute a major element in the behaviour of many modern corporations. In fact, the effect of separation of ownership from corporate
control depends on the extent to which managers' objectives differ from those from the owners, and on the effectiveness of the constraints, if any, on managers' decision-taking discretion.

In their theories, the protagonists of the separation theory like Marris (1964), Williamson and others (Williamson (1963); also see Aaronovitch and Sawyer (1975); Singh (1971, 1975); Kumar (1985) and Meeks and Whittington (1975)) have suggested that the prime objective of managers is growth of the firm, rather than the wealth of the shareholders. In these theories the growth of the firm raises managerial utility by bringing higher salaries, power, status and job security to managers. Managers may therefore be more interested in the rate of growth of the firm than in its profit performance. The managerial desire to grow often takes the form of desiring to manage bigger companies. This often takes the firm beyond the point which maximises owner's welfare. Marris argued that the desire for such things as salary, status, power and security led to the pursuit of size in addition to, or at the cost of profit, and that the best way to allow for size when time enters the analysis is to presume a growth maximisation objective, as a desire for size naturally implies a desire for growth. Marris in particular, dwells on the difference between the traditional capitalist, for whom the character of the goods and services he produces may well be an element in his utility function, and the bureaucrat in the large modern corporation, for whom the major concern is the skill which he can bring to bear on a problem. In practice, however, salary, status, power and security may well be the main signs of success in modern capitalism.

Many other motives have been suggested, including desire for professional success, adventure, creativity, competitiveness or game playing, service and social obligation. These are, however, less fully agreed and probably not pervasive (Hay and Morris (1991)).

The most frequently argued view is that managerial motives in capitalist firms result in a desire for large size. The most thoroughly examined aspect of this is the relation between managerial salary and company size. In a major study of executive compensation in the USA, Roberts (1959:111) found that salary levels appeared to be correlated much more with the size of firms as measured by sales than with profits, implying that the desire for increased salary would lead to greater emphasis on the pursuit of large size rather than large profits. The empirical result was confirmed in a study by McGuire, Chiu and Elbing (1962: 753-61), which found sales and executive compensation to be significantly correlated in five out of seven cases given, but profits and executive compensation not correlated at all. In the UK, Cosh (1975:75-94) found the natural logarithm of chief executives' remuneration to be determined mainly by size and very little influenced by the return on capital. Ciscel (1974: 613-617) found only rather weak correlations between senior executives' compensation and various possible determinants, but a much stronger one between the compensation of the executive group as a whole and sales rather than profits.

The growth of firms requires growth of available funds, growth of capital, and of demand, and the appropriate integration of these over time. Analysis of growth therefore requires a dynamic framework. It also requires analysis of managers' central
role in coordinating activities over time, and indirectly provides the benefits of size and increased discretionary expenditure. While the growth model of Marris belongs to this dynamic type, certain static non-profit maximising models have also emerged. However, tractable static models of such behaviour can largely be grouped around two basic themes: sales maximisation version of Baumol (1958: 187-198) and a modified version of the same by Yarrow (1973: 155-173; 1976: 267-279) and expense preference version attributable to Williamson (1967). Different TO implications emerge from these models.

**Implications for TO**
Baumol’s sales-maximisation model with a profit constraint brings out no TO implication. Yarrow’s model points out that the sales-maximisation model with a rate of return on capital constraint, i.e., with a more general constraint specification, rather than Baumol’s profit constraint will have TO implications. Yarrow pointed out that the constraint on managerial decision to pursue a non-profit-maximising strategy is determined by the enforcement costs facing wealth-maximising shareholders. The possibility of their removing managers or selling shares and creating conditions ripe for TO means that there is a constraint on the deviation between the maximum stock market valuation and the actual one that results from the firm’s behaviour. The size of the maximum deviation itself depends on the size distribution of shareholders and the cost of actual intervention to enforce policies acceptable to shareholders.

We summarise the spirit of the Marris growth model and associated TO implications in the following way (Marris (1963: 185-209; 1964: 1-45, 131-201, 224-265), Hay and Morris (1991: 329, 331, 334). The managers seek to maximise the growth subject to the avoidance of a TO by another firm. A firm is assumed to be vulnerable to TO when it is “undervalued” because the price of its shares falls to a low level relative to its capital worth, i.e. the value of its assets so that the firm becomes a bargain to a potential acquirer. There is a TO constraint on the managers on their pursuit of growth, so that in order to avoid TO, firms must keep their valuation ratios above some minimum level.

If a company attempts to grow rapidly, it will tend to retain a high proportion of its profits for reinvestment, with less profit therefore, available for distribution among the shareholders. The consequence may be a low share price, reducing the market value of the firm in relation to the book value of its assets, i.e. reducing the valuation ratio.

Two trends of TO threat come out of this theory.

1. As the valuation ratio falls, the probability of being acquired rises.
2. There is a minimum valuation ratio below which the corporation is certain of being acquired.

Or, in other words, it is argued that a high valuation ratio will deter TOs while a low valuation ratio will raise the vulnerability of TOs.
However, in practice, there are certain difficulties in measuring the valuation ratio, for both the numerator and the denominator present valuation problems. While the market value for quoted companies is easily obtainable, the share price fluctuates from day-to-day, and more importantly, the general level of share prices exhibits large fluctuations over time. The problem with the denominator is that firms differ to the extent to which book values and the real values of the assets diverge. This divergence can arise from factors like inadequate accounting for depreciation, and failure to revalue assets to take account of inflation.

**TOs viewed as panacea to agency problems**

According to several views, the agency problems mentioned above may be efficiently controlled by some organisational and market mechanisms. Fama and Jensen (1983: 301-325) hypothesise that, when a firm is characterised by a separation of ownership and control, decision systems of the firm separate decision management (initiation and implementation) from decision control (ratification and monitoring) in order to limit the power of individual decision agents to expropriate shareholders' interests. Control functions are delegated to a board of directors by the shareholders who retain approval rights on important matters including board membership, mergers and new stock issues.

According to Fama (1980: 288-307), a number of compensation arrangements and the market for managers may mitigate the agency problem. Compensation can be tied to performance through such devices as bonuses and executive stock options. Managers carry their own reputation and the labour market sets their wage levels based on performance reputation.

Fama and Jensen opine that the stock market gives rise to external monitoring device because stock prices summarise the implications of decisions made by managers. Low stock prices exert pressure on managers to change their behaviour and to stay in line with the interests of shareholders.

When the market for managers in the form of these mechanisms are not sufficient to control agency problems, the market for TOs of firms comes into play and provides an external control device of last resort. According to this view, therefore, merger and TO activity is a method of dealing with the agency problem. A TO through a tender offer or a proxy fight enables outside managers to gain control of the decision processes of the target while circumventing existing managers and the board of directors. Manne (1965: 110-120) emphasised a threat of TO if a firm’s management lagged in performance either because of inefficiency or because of agency problems.

**Mergers and TOs furthering Managerial Interests**

In the above section, mergers and TOs were considered as a means to control agency problems and hence viewed as a solution to such problems. Some observers however, consider these corporate control instruments as a manifestation of agency problems, rather than a solution. The managerialism theory as set by Mueller (1969: 643-659), argues that the agency problem is not solved, and the merger activity is a manifestation of agency problems of inefficient, external investments by managers. The managerialism explanation for mergers hypothesises that managers are motivated
to increase the size of their firms. Managerial theories would suggest that fast growing firms having already adopted a growth maximisation approach, are the ones most likely to be involved in merger activity.

To be precise, the managerial theories are basically an extension of Marris' Theory. The theory of Marris can be extended in a manner which suggests that the pursuit of managerial interests lies behind many acquisitions. The theory suggested that managerial interests can be proxied by growth size and security. One way in which size can be quickly increased is through acquisitions, particularly when financed by share-exchange rather than by cash. The security motive led Marris to argue that a firm must maintain a particular valuation ratio. But if size confers security upon a firm by reducing the probability of being acquired then the firm has the incentive to make acquisitions itself in order to avoid being acquired itself. Thus fast growth leading to increased size rather than a higher valuation ratio becomes the route through which security from TO is achieved. Further, a positive linkage between size of the firm and the income of the executives would generate incentives for the executives to promote acquisitions to increase and thereby their income. In sum, there may be considerable incentives for managers, arising from the advantages to them of increased size of their firm, to promote acquisitions for faster growth and increases in size.

Penrose (1951: 109-111) had attached importance to merger as a means of raising the level of the managerial constraint on the rate of growth of the firm. Although highly suggestive, Penrose's work has not sought to develop a theory to account for variations in the extent and type of merger. Subsequently, however, Mueller (1969: 648-654) has presented a formal model of mergers in which the merger activity is attributed to the growth-maximisation goal of managers. Mueller's theory is premised on the assumption of a separation of ownership from control, shareholders seeking profit and managers seeking growth. To sum up, given the growth-maximising assumption, merger will occur in situations that are devoid of "synergistic" effects or superior managerial skills, due to the lower rate of discount of the managers of the acquiring firm relative to that of the seller's of the acquired firm, who may be either managers wishing to get out or shareholders. In support of his hypothesis, Mueller has referred to the growing relative importance of conglomerate mergers in the United States, which, given his views on managerial ability, appear best accounted for by a growth-maximisation assumption about managerial objectives.

**Mueller versus Reid — The Approach of Reid**

Mueller’s basic hypothesis was managers went into mergers to promote growth objectives. An attempt to discriminate between the alternative hypotheses of merger for growth and merger for profit, based on the managerial theory of firm, has been made by Reid (1968). He has used as a sample the 478 of the 500 largest US industrial firms in 1961 as listed in the Fortune for which the necessary data were available. The period covered was 1951-61, during which time the firms involved made over 3,300 acquisitions — more than half of the 6,176 mergers reported by the Federal Trade Commission in that period. He classified these 478 firms according to their merger intensity. The firms were divided into four groups depending on the number of mergers undertaken: no mergers, 1-5, 6-10 and 11 or more. Next, he
related intensity of merger to two sets of variables: growth variables (change in sales, assets and employees) and different profit variables. The average growth and profitability performance of each group was then calculated. He found that the more intensive the level of merger activity, the relatively better the performance of the growth variables and the relatively worse the performance of the profit variables. Because of the correspondence between the merger activity and the growth variables, Reid concludes that managerial firms are more merger-prone. But Reid presupposes what he set out to prove: he assumes that manager-controlled firms are growth-oriented. Next, when he finds that merger-prone firms are performing well in terms of size-related variables, he concludes that manager-controlled firms are more merger-prone. Firms that relied solely on internal growth, grew on average faster than firms with a low merger intensity (1-5) but more slowly than those with a high merger intensity (6 or more). On the other hand, non-merging firms had a strikingly better record than merging firms from the standpoint of the original shareholders. Further analysis suggested that firms engaging in pure conglomerate-type mergers grew most rapidly, while firms engaging in pure internal growth grew most profitably, although growth by conglomerate-type merger was more profitable than growth by other types of merger.

*Reid versus Scherer — Scherer’s viewpoint*

Scherer (1970: 121-122) has opined that some caution is needed in evaluating Reid's study. In particular, it is necessary to consider the possibility that differences in the incidence of merger were due to differences in the environmental conditions confronting firms rather than to differences in motivation. When firms were classified on an industry-basis, the significance of the results was somewhat reduced. If further standardisation of the situation of firms, e.g., with respect to the quality of management and competitive strength, had been possible, the apparent direct relationship between merger and growth and inverse relationship between merger and profitability might have disappeared.

Reid has made no attempt to classify firms as manager-controlled or shareholder-controlled; he has merely argued that the results are consistent with the hypothesis that mergers tend to be for growth, not for profitability. However, they are also consistent with the hypothesis that merger is the result of the internal and external pressures and opportunities confronting the firm. If Reid could have separated manager-controlled firms from owner-controlled firms and carried out his test, the results would have been more tenable. But since he could not do so, his results remain inconclusive.
C.  

Valuation Discrepancies Hypothesis and Mergers

The Value Discrepancy theory (Gort (1969: 624-642)) is based on a premise that the real world is a world of uncertainty, where there is a discrepancy of valuation judgements regarding the present value of the earnings of a firm, among shareholders, given imperfect information and uncertainty about future business conditions. In perfect capital markets valuation discrepancies cannot persist in the long run because arbitrage would eliminate them. However, when uncertainty, incomplete knowledge, transaction costs and other market imperfections are taken into account, valuation discrepancies are likely to be a common phenomenon. With imperfect capital markets different investors may well be expected to reach different valuations of the same firm(s) arising from differences in expected future profitability. Such valuation discrepancies are the cause of mergers and acquisitions. The general proposition of this hypothesis is that one firm will only bid for another firm if the value which the potential acquirer will place on the potential victim is greater than the value placed on it by its current owners. The undervaluation may be due to different causes (Weston, Chung and Hoag (1996: 198-199):

1. Management of the target company might not be operating the company up to its potential. So, an acquirer who believed that it could raise profits by raising efficiency, would place a higher value on the firm than the current owners.

2. The acquirers have inside information. How they acquired the special information may vary with circumstances, but if the bidders possess information which the general market does not have, they may place a higher value on the shares than currently prevails in the market.

3. The potential owner may have a longer time horizon than the present owners, and this would reflect in the higher valuation of the target company.

4. There may be a difference between the market value of assets and their replacement costs. For example, with inflation, the share prices get depressed. Another impact of inflation would be to cause current replacement costs of assets to be substantially higher than their recorded historical book values. These twin effects may cause a decline in the ratio of the market value of the firm shares to the replacement costs of the assets represented by these shares (the q-ratio), which means that corporate assets on average sell below their replacement costs.
In general, the difference in valuation arises through the acquirer firm’s higher expectations of future profitability, often because the potential acquirer takes account of the improved efficiency with which it believes the future operations of the acquired firm can be run. Whatever be the actual cause of undervaluation of the target firm, the ultimate reason lies in the differential efficiency between the bidder and the target firms. For example, in the last case, why would a firm add to its capacity at a time when corporate assets on average, sell below their replacement costs? It must be true that the acquiring firm is more efficient than an average firm or at least than the acquired firm. Thus, the undervaluation theory underlying the value discrepancy hypothesis cannot stand alone and requires an efficiency rationale.

It has been argued that it is in periods when technology, market conditions and share prices are changing most rapidly that past information and experience are of least assistance in estimating future earnings. As a result, differences in valuation are likely to occur more often, leading to increased merger activity. The value discrepancy hypothesis would therefore predict high merger activity when technological change is most rapid, and when market and share price conditions are most volatile.

It will be seen that the value discrepancy hypothesis retains the profit-maximisation assumption, although in a more complex form. According to this theory, departure from profit-maximisation opens the way for the value of the firm to the acquirers to exceed the same firm’s value to the current owners through differences in current profits and those which the acquirer believes he could achieve. The argument is that a failure to maximise profit would depress the value of the firm and so present an outsider — a corporate raider — with the opportunity to purchase sufficient shares to acquire control, replace the incumbent management, revert to profit maximisation, and hence realise a profit in the form of increased value. This threat may be enough to dissuade a manager, fearful of dismissal — perhaps because of the possibility of unemployment or at least an unwelcome entry on the curriculum-vitae — from neglecting the interests of owners in the first place; and if not, then the discretionary behaviour would be transitory — lasting only until a TO. This line of argument is probably more applicable to the case of a quoted company with numerous shareholders than it is to a privately owned firm. In the former case, where the identity of the owners and controllers coincide, lower profits and capital value can continue in that any potential acquirer cannot enforce the sale of shares by existing shareholders.

This theory tells us that the value of a firm can be raised on raising profit through the attainment of synergistic gains by the firm. Acquisition is seen as a route through which efficiency and profitability are raised as firms are acquired by new owners who believe they are able to raise profitability. This process would be mutually advantageous to the firms involved. The owners of the acquired firm benefit through realising a higher value for their ownership of the firm than previously, and the acquirers gain through the purchase of the firm at a price less than the value they place on it. The price actually paid for a firm by its acquirer is expected to lie between the valuations placed on the incumbent firm by the shareholders of the acquiring firm and that of the acquired company.
The extent of any gain to the acquiring firm, and the extent to which a firm can allow its value to fall below the maximum achievable, depends on two factors. They are the costs (advertising, legal and brokerage fees, etc.) of acquisition and the size of the pool of potential acquirers. If that pool is large, it could be expected that there will be competition among the potential acquirers, which tends to bid up the price which is offered for the victim firm. The upper limit to the price would be expected to be that price which leaves it only just worthwhile for the acquisition to proceed. Hence, it could be expected that when there are a large number of potential acquirers, the price is bid up close to that upper limit. In such a case, the shareholders of the acquired firm would gain, and those of the acquiring firm would gain a little.

Similarities and Differences between Value Discrepancy theory and Marris' theory

Gort (1969: 624-642) has developed a theory of mergers based on the assumption that valuation discrepancies are inevitable, due to several factors which give rise to systematic variations in such discrepancies in valuation.

Although based on different hypothesis, the Value Discrepancy Theory of Gort can be compared with the Managerial Theory of Marris. Similar to Marris, Gort argues that if a firm is undervalued but if other firms expect to do better with the same assets, it will be taken over.

Both of them see acquisitions as playing a key role in limiting the extent to which firms can depart from profit maximisation and still survive. Departures from profit maximisation can arise from inefficiencies (reflected in a sub-maximum profit) in the value-discrepancy model, and/or from sacrificing dividends for growth (which is particularly important in the theory of Marris). Especially in Marris, TO bid is considered to be an essentially hostile act, at least from the perspective of the present managers. The threat of acquisition is seen as the major constraint on the current controllers and actual TO is the punishment for overstepping the mark.

Both of the theories focus on the features of firms which are predicted to be acquired, and say little about the characteristics of the firms predicted to make the acquisitions. For example, the value-discrepancy theory indicates that firms with profitability below the potential maximum would be a prime candidate for acquisition. Thus the acquirer is expected to raise its profitability to avert a TO. However, nothing is said directly about the current profitability of the acquirer (assuming that it is operating another firm). If there is a correlation between the acquirer's pre-acquisition record of profitability and its ability to raise the acquired firm's profitability then it would be expected that the profitability of the acquired firm would be relatively high and would tend to be above that of the acquired firm.

The theory of Marris predicts that acquired firms have below average valuation ratios, and the frequency of acquisition rises with falling valuation ratios. On a similar argument in reference to the value discrepancy theory, it can be argued that the valuation ratio of an acquiring firm will be above that of the victim firm.
D. An integration of the aforesaid theories — the approach of Hay and Morris

Hay and Morris (1991: 512-21) have very effectively integrated the aforesaid theories and views regarding the possible motives of mergers and acquisitions, generating in the process, a precise and compact idea of such fusion activities in the corporate sector.

According to them, under the idealised conditions of efficient resource use by the firm's managers, absence of agency problems in the firms and an efficient stock market in the strong sense (i.e. where there is no discrepancy between share prices and fundamental values), the possible "traditional" motives for mergers are:

1. Increased market power due to increased concentration: mergers provide a faster path to market dominance, compared to the competitive war between firms. It has the additional advantage of not increasing the total production capacity in a market, not growing very rapidly.

2. Reduction in advertising and other promotional expenditures: a merged firm may be able to reduce competitive expenditure on advertising and other promotional heads, especially where merger allows some amalgamation of product lines.

3. Efficiency gains not otherwise available:

Such efficiency gains can be of different types:

- Production economies can be obtained out of economies of scale, by bringing together two smaller plants of sub-optimal size.

- Economies in R&D.

- There can be indivisible or spare resources which cannot be utilised fully by one firm, and amalgamation would imply a fall in per unit costs.

- Economies in obtaining finance for merged firms because of lower unit cost of raising capital (including risk) from capital markets for larger issues.

- Elimination of transaction costs in case of vertical integration.

These are the traditional motives behind merger and/or TO activities, i.e. motives that operate when there are no visible inefficiencies anywhere.

However, if the first simplifying assumption stated above is dropped (retaining the other two), then the existing management is assumed not to be fully efficient in the use of available resources. Or, in other words, the managers are not making the best use of the assets so as to maximise their value. Therefore, there exists a misallocation of resources and a resulting need for reallocation of assets to ones who will make
better use of these assets and hence the market valuation of the company will rise. Two forms of inefficiencies are possible.

1. The firm may be allocating its resources in such an inefficient way that it is neither maximising growth nor maximising profits. Consequently, the market valuation of the firm is at a sub-optimal level.

2. Given the fact that there exists a trade-off between the rate of growth of a firm and market valuation (which is linked to the profitability of the firm), the management may choose a growth rate that reduces market valuation below its optimum level. This type of inefficiency was pointed out by Marris.

The means to overcome such inefficiencies on the part of the existing management is TO. By TO, the assets are reallocated to new managers who make better use of the assets. Such TOs are profitable by virtue of the improvement in the post-merger performance that they generate and the motive for them is the resulting increase in the firms' valuation. This kind of TOs is designated as "Allocational" TOs by Hay and Morris.

Likewise, if we replace the second idealised condition by incorporating the existence of agency problems (i.e. managers may well have objectives other than profit or shareholder-wealth maximisation with only minor constraints on them) into the scheme of things, it leads to a new type of motive for mergers as part of the growth strategy of managerially controlled firms. Such TOs are called "Managerial" TOs by Hay and Morris.

It is evident that Hay and Morris base the notion of managerial motives behind TOs on Marris' theory of acquisitions. To reiterate, it has been pointed out by Marris that the managers can follow growth objectives, distinctly different from the value maximisation objective of the firms by the shareholders. In his model, he established a negative relation between growth and profitability. The basic logic is simple: growth of a firm requires reinvestment of earnings which reduces the profit available to a firm. Managerial TOs can be motivated on the same grounds. Pursuing policies that promote the internal growth of a firm implies a trade off between growth and profitability with a negligence towards the latter, which is not true of growth of a firm through merger. Such managerial motives also open up the possibility of a profit maximising firm to be taken over.

Finally, if the third assumption is relaxed, and imperfections in stock market valuation of securities (i.e. substantial divergence of stock prices from their fundamental values) is allowed for, then this leads to a new motive for TOs. A raider identifies an undervalued company, acquires it, holds the shares till the hitherto lower market price comes very close to the fundamental value, reaps the gain in value without having to make any changes at all to the operation of the company, and in the process creates only a redistribution and not any generation of assets. This type of TOs is referred to as the "Acquisitional" TOs in Hay and Morris.
E. Other Factors Affecting Mergers and TOs

Free Cash Flow Hypothesis

Jensen (1986: 323-329; 1988) considers the agency costs associated with conflicts between managers and shareholders over the payout of free cash flow to be a major cause of TO activity. According to Jensen, shareholders and managers have serious conflicts of interest over the choice of corporate strategy. Agency costs result from this conflict of interest that can never be resolved perfectly. When these costs are large, TOs can help to reduce them, according to Jensen.

Jensen defines free cash flow as cash flow in excess of the amounts required to fund all projects that have positive net values when discounted at the applicable cost of capital. He states that such free cash flow must be paid out to shareholders in the form of dividends, if the firm is to be efficient and maximise share price.

However, the management is inclined to pay lower dividends to the shareholders because of certain reasons. First, the pay-out of free cash flow reduces the amount of resources under the control of managers and thereby reduces their power. In addition, they are then more likely to be subject to monitoring by the capital markets when they seek to finance additional investment with new capital. Also, because of heavy taxation in many countries, the management of a large number of companies often declare lower dividends than what it could afford, thereby building up hidden assets. The same situation could arise if a company's shares are held by a small group of persons, but already in the high-tax brackets, would not like the tax burden to be increased by greater declaration of dividends. All these factors generating low dividend payments lead to poor share prices in the stock-market since the market value of shares depends to a large extent on the rate of dividend paid out by the firm. A company which has been declaring low dividend over a number of years, would have low market price for its shares. A company of this type could easily be acquired at a low price which in normal circumstances would have cost much more and hence they are prone to TOs. Also these companies are considered to have hidden or accumulated reserves and as such are good bargains.

Companies can avoid TOs if they pay out the current amount of excess cash. In addition to paying out the current amount of excess cash, Jensen considers it important that managers bond their promise to pay out future cash flows. An effective way to do this is by debt creation without retention of the proceeds of the issue. Jensen argues that by issuing debt in exchange for stock, for example, managers bond their promise to pay out future cash flows more effectively than any announced dividend policy could achieve. This he calls the control function of debt.

A company which has low gearing (to say that a company has a low gearing is to say that it relies rather heavily on own capital and less on borrowed capital) is usually having an inefficient capital structure. This is because reliance on borrowed capital lowers the tax burden on companies and hence provides tax advantage and shifts risks to the creditors. Of course, this presupposes that the company's return from business should be higher than the rate of interest a company has to pay. A company with low
gearing, would therefore be a good buy, since after securing it, the capital could be more fully utilised by simply increasing the gearing, i.e., by increased borrowing.

He recognises however, that increased leverage involves costs. It raises the risks of bankruptcy costs. There are agency costs of debt as well. One is for the firm to take highly risky projects that benefit shareholders at the expense of bondholders. He defines an optimal debt/equity ratio where the marginal costs of debt equal the marginal benefits of debt.

Jensen argues that in leveraged buyouts (LBOs), the high debt ratios undertaken cause the increase in share price. But high debt ratios in LBOs provide tax advantages and shifts the risks to creditors. Also, in LBOs the executive group is provided with a large ownership stake in the company which will have substantial value if the LBO succeeds. It is possible that the incentives provided by the strong ownership stake and other characteristics of LBO situations account for the rise in value rather than the bonding effect of the high debt ratios.

Critique
There are few implausible elements in the free cash flow theory, which act as a basis for scepticism. This hypothesis holds that the conflict of interest between managers and shareholders could be resolved by the risky and hence less efficient path of loading a firm with debt. For example, management compensation packages that include giving managers a stake in improving share price and therefore aligning their interests with those of the shareholders would provide stronger and more healthy incentives. If this represents dividing management compensation into multiple forms, it would not be costly to the shareholders.

Furthermore, the free cash flow theory is inconsistent with the writings of Fama and Jensen (1983: 301-325; 1985: 101-119) on the theory of the firm. In their articles on the theory of the firm, Fama and Jensen argue that the widespread use of large corporations with diffused ownership among a large number of relatively small shareholders takes place because it is the most efficient form of business organisation for large enterprise activity. They argue that there are advantages to this form of organisation, particularly that it enables small shareholders to diversify their risks efficiently. They go on to claim that effective control is achieved by the managerial labour market, through compensation arrangements, through the board of directors and through the threat of TOs. If separation of ownership and control is efficient despite conflicts of interest and if mechanisms are already in place to deal with the agency problems of managers versus shareholders, the use of high debt ratios as a bonding vehicle is not necessary.

Diversification
Here a cash-rich company may prefer to use that cash for acquisitions rather than distribute it as extra dividends for reasons cited in the Free Cash Flow Hypothesis. That is why one may observe cash-rich firms in stagnant industries merging their way into new industries. These firms may argue that the end of such diversification of the activities of the firm through mergers could be the reduction of business risk. A reduction in business risk, if attained, reduces the discount rate of the merger and
hence increases the market value. As risk is lowered, the market value of the merged firm exceeds the values of the companies operating independently. If the firm wants to diversify its activities, the argument runs, it is safer (less risky) to do it by merger with an exceeding firm, established in the new product, with established distribution channels and accumulated product-differentiation advantage. The internal development and promotion of new products require time, new know-how and probably extensive and expensive R&D efforts as well as marketing effort.

Critique
The advantage from a possible risk reduction in the variability (risks) of earnings of the merger may be offset by the high costs and other disadvantages of conglomerate firms so that the discount rate which the investors apply to the earnings of the merged firm may in fact increase, resulting in a lower market value of the new entity. A merger does not necessarily result in a reduction in the investors’ discount rate and the increase of the market value of the merged firm. Finally, the dispute is that whether risk-reduction should be considered as a "bonafide" motive that is valid in the "economic" sense.

Differential Efficiency
The theory suggests that there are firms with below average efficiency or that are not operating up to their potential, however defined. If a company is not utilising its assets efficiently, it could be taken over by a more efficient company, especially if the latter feels that it could utilise the assets of the acquired company more efficiently and thereby realise gains. The most likely potential acquirers would be the firms operating in similar kinds of business activity where the need for improvement could be more easily identified. The acquiring firm would have the background for identifying below-average or less-than-full-potential performance and have the management know-how for improving the performance of the acquired firm.

A variant of differential efficiency hypothesis is the managerial synergy hypothesis, which can be rephrased as "inefficient management theory". It states that if a firm has an efficient management team whose capacity is in excess of its current managerial input demand, the firm may be able to utilise the extra managerial resources by acquiring a firm that is inefficiently managed due to shortages of such resources. The managerially efficient firm may want to utilise its excess managerial capacity by expanding in its own industry (horizontal integration) if the industry demand condition permits. Or, the aforesaid efficient firm may try to make a new entry to some other unrelated industry, by way of conglomerate merger especially if the target management is so inept that virtually any management could do better. The hypothesis regarding conglomerate mergers requires some theoretical assumptions, as follows.

- Release and disemployment of excess managerial resources of the acquiring firm is not feasible as the management is efficient as a team and is subject to indivisibilities or economies of scale.

- Capacity expansion in the industry of the firm with excess managerial resources is not possible due to industry demand conditions.
However, for the acquiring firm, the entry in the new industry to be profitable or competitive, it must have, technological knowledge base, together with the managerial capital that it already has. Thus, a rational acquirer will always attempt for a "toe-hold" entry through acquisition of an incumbent firm with the requisite organisation capital, thereby utilising its excess managerial capacities.

So far as the inefficient or underperforming firm is concerned, it could improve its managerial performance by employing additional managerial input through direct employment of managers or contracting with outside managers. Direct employment of managers may be inadequate since it does not guarantee the organisation of an efficient management team within a relevant period of time. The contracting solution is not likely to be adopted since management of a firm requires investment in firm-specific knowledge and the anticipated appropriation of the firm of the quasi-rents accruing to this firm-specific asset will lead to the "ownership" of the management by the firm (Williamson (1975)). Further, if inefficient management requires a critical mass of managerial talents, its attainment by the smaller, underperforming firm may not be feasible.

In such a situation, the agency costs are so high that shareholders have no way to discipline managers, short of costly mergers. Under the conditions, a merger between the two firms will be a synergistic one, since it combines the non-managerial organisation capital of the acquired firm with the excess managerial resources of the acquiring firm.

**Tax-induced mergers**

Another important motive for mergers is to be found in the tax laws, more specifically in the company-law set-up of a country. Tax laws, which for instance, exempt share exchange from capital gains tax, influence mergers. A firm with accumulated tax losses and tax credits can shelter the positive earnings of another firm with which it is joined. The ways in which this can be done depends on the provisions of tax laws and corporate laws of the country concerned.

Under certain conditions it is possible to observe an increase in the market value of a firm acquiring another which has a large tax-loss carry forward. Tax laws allow income deferral. Thus the laws of the acquired firm can be subtracted (for tax purposes) from the current income, the previous year's income, or be carried forward (and be subtracted from the future income) for up to several years (it is five years in USA), depending on tax laws of the country concerned. It is argued that this tax-loss carry forward may reduce the taxable income of the merged entity, making it fall into a lower tax bracket, with the attendant reduction in the tax rate. It is argued by some economists (for example, Dewey (1961: 255-262) that many mergers take place because the tax laws encourage firms to acquire unprofitable firms in order to obtain a tax write-off.

A company running at a loss is not an attractive proposition to its shareholders, so that the shareholders would like to dispose of their shares at a low price. Another company in a high tax bracket may find it useful to purchase the tax-loss company
and thereby reduce its own tax burden. This is the potential tax-based benefit to the acquiring firm.

In considering the effect of a lower corporate tax rate on the market value of a merger, one must take into account not only the above tax-loss carry forward advantage but also the disadvantage of a lower tax rate associated with the fact that interest payments on debt are tax-deductible. A reduction in tax rate reduces the tax advantage of financial leverage (debt financing). In other words, although a fall in the corporate tax rate improves the firm’s earnings after taxes, it also reduces the tax advantage of debt. Thus, the net effect of a reduction in tax rate on the value of a merger cannot be known on a priori grounds.

However, Steiner (1975: 85), interviewing managers of merging firms, found that in rare cases were the mergers motivated solely by tax considerations. Tax savings were only incidental in the calculations of the merging firms and the prime motives for mergers was not tax considerations. The effect of company-laws on merger is not dealt with extensively in the literature, except for the effect of anti-monopoly acts on mergers in different countries, especially in UK and USA (for such studies in UK, refer to Hannah and Kay (1977) Beesley and White (1972) and Sutherland (1969). For similar studies in USA, refer to Adelman (1961): 236-54; Steiner (1975)).

Liquidity-induced mergers
Another motive for mergers which has been advanced by Aaronovitch and Sawyer (1975: 187-188) is that in a restrictive credit environment firms may merge if one of them is highly liquid or a highly liquid firm could be taken over by another firm which is facing credit problems, the assumption being that relative liquidity confers an advantage and is a stimuliser. Aaronovitch and Sawyer state that firms that have higher liquidity levels take over firms that have lower. Firms that for whatever reason build up substantial internally generated funds seek for expansion opportunities and merger activity could be one of the paths chosen. On the other hand, firms that have low liquidity seek purchasers who can supply urgently needed working capital for current needs or expansion. They found that acquired companies in UK had much lower liquidity than average quoted companies. Also, firms with low liquidity levels takeover firms with high liquidity (using share-exchange to do this). Singh’s (1971: 58) study however contradicts the differential liquidity explanation of mergers. He found that the liquidity of acquired firms were not significantly different from non-acquired firms.

Increased Debt Capacity and Financing Interest Costs
According to this hypothesis, when two firms merge, the debt capacity of the merged firm increases. The amount that the creditors are prepared to lend a corporation, depends, among other things, upon their estimate of the likelihood that the corporation will default, i.e., the probability that the firm’s earnings will be lower than its required payments on debt. A merged corporation can divert cash from one of its divisions to another, if the latter’s earnings are insufficient to cover its debt payments. Hence lenders of a conglomerate face a smaller risk of default, and are prepared to provide more capital to the merged entity than they would give to the two individual separate firms. Whereas a conglomerate’s diversification does nothing for
its shareholders that they cannot do for themselves, it can provide greater security to creditors than creditors can provide for themselves when dealing with the constituent separate firms. Thus lenders are willing to provide relatively more debt to a merged firm than to the independent firms. The advantage for merger is greater for conglomerates than for horizontal mergers, since the returns (profits) of the various branches of a conglomerate are less correlated in any one period. With a greater use of debt the value of the merged firm should be greater than the sum of the values of the individual firms, and we have a rational financial justification for merger, in terms of financial synergy.

Moreover, with merger, the firms can, under certain circumstances, borrow at lower interest rates than they could separately. The rationale behind this can be explained in terms of a well functioning bond market. The explanation is that while they are separate, they do not guarantee each other's debt; if one fails the bondholder in that company cannot ask the other for money. But after the merger, each enterprise effectively does guarantee other's debt — if one part of the business fails, the bondholders can still take their money out of the other part. Because these mutual guarantees make the debt less risky, lenders demand a lower interest rate.

Now, the lower interest rate may not necessarily mean a net gain to the merger. This is because, first, the firms enjoy a lower interest rate only when they merge; but it does not make sense for the two firms to merge just to get the lower interest rate. Secondly, they get the lower interest rate only by having to guarantee against each other's debt, thereby giving the bondholders better protection. As a result, there is no net gain.

Let us suppose a situation when two firms first borrow and then merge. The bondholders will be happy as they are now guaranteed by both the firms. The shareholders lose, other things being equal, because they have given the bondholders better protection but have received nothing for it.

There is one situation in which mergers can create value by making debt safer. This is in the case of the choice of an optimal debt ratio as a trade-off of the value of tax shields on interest payments made by the firm against the present value of possible costs of financial distress due to borrowing too much. Merging reduces the probability of financial distress, other things being equal. If it allows increased borrowing, and increased value from the interest tax shields, there will be a net gain to the merger (Myers (1976)).

Stock Market Conditions
Stock market conditions have been attributed by some as a possible motive behind mergers. It is generally agreed that there is a very close relationship between merger activity and stock market conditions (Nelson (1959: 116-124, 1966). An early attempt to explain this relationship was the hypothesis that when share prices were buoyant, merger “permitted a capitalisation of prospective monopoly profits and a distribution of a portion of these capitalised profits to the professional promoter” (Stigler (1950: 30). Although most favoured as an explanation of the turn-of-the-century merger wave in the USA, the role of promoters' profits in the UK merger boom of the 1920's
have also been remarked (Hannah (1976: 67-68). Markham (1955: 143, 181) has identified such profits as in general the most important single motive at merger peaks. But this hypothesis has been dismissed by Gort (1969: 638) on the grounds that, since most acquisitions are financed by share exchange and any cash used has in the main been accumulated internally by the acquiring firm, the scope for gains by promoters of mergers is too small to provide an adequate basis for a general theory of merger. His alternative is that high levels of share prices are a contributory factor in creating a situation in which valuation discrepancies are large enough to call forth merger transactions.

2.2.3 Mergers Due to Manipulative Effects of Expectations of Investors

The value of the stocks of a firm depends on the expectations of both buyers and sellers regarding the future earnings of the firm. Expectations are affected by uncertainty, incomplete information, and the attitudes, temperaments and other personal attributes and characteristics of investors. Expectations in stock markets are particularly sensitive to real or rumoured events or prospective events. Accordingly, valuation discrepancies of stocks may arise from the different assessment of the available information and prevailing conditions by the various institutional investors, or from the deliberate manipulation of the expectations of investors by the firms promoting mergers. Here we shall concentrate on the latter source of value discrepancy and hence mergers and TOs. Value discrepancy due to differences in assessment of information and environment and resulting corporate control activities have already been dealt with in the preceding relevant section.

Stock Watering Practice

Stock watering (Koutsoyannis (1982: 244)) involves spreading misleading information, planting rumours and tampering in general with the stock market to convince investors about nonexisting monopoly power or economies-of-scale prospects. This enables promoters to sell the stock of newly consolidated firms at prices which far exceed their economic value. Promoters, in this case, hasten to sell their stock before the bubble bursts. This sort of spreading of misleading information and consequent "bubble bursts were very frequent during the frenzied merger movement in the 1897-99 and 1926-29 periods in US. Subsequent US legislations (the Security Act of 1933 and the Stock Exchange Act of 1934) curbed the power of merger promoters to spread misleading information. But new ways have been invented to reap speculative gains through promoting a merger, and without breaking a law.

The "Price/Earnings Ratio Game" or "Bootstrap Game": Mergers and Earnings Per Share

This game is more prevalent in conglomerate mergers, where some mergers occur with no evident economic gains. Nevertheless the conglomerates' aggressive acquisition strategy produces several years of rising earnings per share (EPS) and stock prices. Here, the method adopted by merger promoters is to convince investors that conglomerates have a kind of perpetual growth and hence the price of its shares will rise, yielding lucrative capital gains, although in reality, this acquisition offers no
evident economic gains in the post-acquisition situation (presumably, partly because the two firms are unrelated so that they stand in a conglomerate relationship). So the firms should be worth exactly the same together as apart (since there does not exist any synergistic gain through the merger). Therefore, net profit should be unaffected by the merger.

The art of the financial manipulator is to ensure that the market does not understand the deal. The investors misled by the plans announced by the acquiring firm to introduce modern management techniques into the other firm (which the acquirer plans to bring into its fold as one of its divisions) could easily mistake the increase in the EPS for real growth. If they do, the price of the merged conglomerate rises and the shareholders of both firms receive something for nothing. In such a system, everyone is better off though the combined total earnings have not increased at all. This is called the "Bootstrap Effect" (Myers (1976)), because there is no real gain created by the merger and no increase in the two firms' combined value; but the EPS of the combined firm rises. Since share price is unchanged, the price-earnings ratio of the acquiring firm falls in the post merger situation.

In general, the price of the shares of the conglomerate will continue to increase provided that two following conditions are fulfilled:

* the acquired firm has lower price-earnings ratio than the conglomerate;
* investors continue to maintain the same expectations about the price-earnings ratio of the conglomerate

It is quite conceivable that the growth performance of the merged conglomerate may deteriorate, having absorbed a firm with a less spectacular growth achievement. If investors, however, are led to believe that this will not occur, that the conglomerate will continue to equal its original performance, then the price of shares of the acquiring firm will rise.

However, theoretically, there is a limit to bootstrapping game. If one such game is successful, it will soon be imitated. Thus the price-earnings ratios of the potential acquirable firms will be bid up, and their number will decline. At the same time, the conglomerate which has pursued such a game may well be expected to have a lower profitability and develop considerable managerial diseconomies. Hence such manipulative effects cannot be expected for long.

### 2.2.4 Conclusion

In the above discussion we have tried to present an integrated view of the different causal forces generating mergers and TOs over time, as posed by different economists. As is evident from the above analysis, it is not easy to assess the present state of economic theory relating to the causal factors triggering merger activity. No generally agreed theory has been developed. Instead, what is offered is a series of partial theories designed to provide explanations for particular types of merger in
fairly specific circumstances, or concerned with merger activities at different levels of analysis. Given these limitations, what we have endeavoured in the aforesaid discussion, is to provide a synoptic view of the existing literature on the possible motives behind merger and TO activities.

In general, though different authors put primary emphasis on different motivating factors, Singh (1971: 10) has summarised the more important reasons usually given for mergers and acquisitions as follows:

- desire to achieve production economies of large-scale and multi-unit operations;
- possibility of achieving distribution and advertising economies;
- financial advantages of large size;
- strategic control of patents and technology;
- acquisition of financial resources;
- response to legal and institutional environment;
- tax-advantages;
- gains from sale of securities;
- gains of promoters;
- desire to limit competition, etc.

Singh has pointed out that most of the literature on mergers was descriptive and non-theoretical in nature, at least till the late fifties and there were only scattered references to various motives of mergers (Singh (1971: 10)). It was only with the publication of R.L. Marris's seminal work in 1964 that a beginning was made in providing a formal theoretical rationale for mergers and his work triggered off a number of other theoretical analysis of mergers.

However there are a few economists whose have totally ignored the existence of and the role played by causal factors making possible the realisation of mergers and acquisitions. For example, Samuels (1972: 1-11) reviewing the work of earlier analysts came to the conclusion that "economies of scale" or synergy resulting from merger is a myth. He stated that "economies of scale" and “rationalisation” (the usual reasons given for mergers) are made for public consumption to justify the mergers in terms of national gains. However, the real reason for a merger could be as simple as that a company is a good buy.
Mergers according to Product Profile and the Factors behind Mergers

As already mentioned in Section 2.1.3, so far as the classification of mergers and acquisitions in terms of product profile is concerned, we can distinguish between horizontal, vertical and conglomerate mergers. We can relate these three methods of coalescing with some of the various motives analysed above. Horizontal integration is generally resorted to for gaining economies of scale, increasing competitiveness and to reduce competition. Vertical mergers are entered into for achieving operational efficiencies through reliability of imports, better material control, gaining competitive power through controlling input prices and to create entry barrier in terms of scale, market and technology. Conglomerates mergers are intended to gain competitive and cost advantage through synergies. Also, diversification into unrelated business helps reduce the overall risk.

2.3 The Possible Effects of Merger and Takeover Activities – Some Views

A large number of studies available in the economic literature regarding the effect of mergers have been done from the profitability perspective where various indices of profitability have been taken as a measure of corporate performance. Also, stock market performance has been taken as an indicator of post-merger performance of firms. Another theory of the performance of merger and TO activity found in the literature is that the source of the value increases in mergers is redistribution among the stakeholders of the firm. Expropriated stakeholders under the redistribution hypothesis may include the bondholders, the government (in the case of tax savings) and organised labour. However, studying the effects of mergers on market concentration is relatively less frequent. But, in the Indian context, the issue of concentration as an effect of merger and TO activities acquires importance particularly with the repealing of the MRTP restriction in 1991 and the rise in the number of mergers since then. We will first present the first two approaches on consequence of mergers and then try to collate the studies on concentration.

2.3.1 Alternative Theories of Post-merger Performance

The profitability view

Various attempts have been made in USA and UK to study the performance of merged firms. Usually these studies took two forms. In assessing the performance of the merged firms, different studies used different yard-sticks. While some economists such as Singh (1971), Meeks (1977), Weston and Mansinghka (1972: 25-39) and Lev and Mandelkar (1972: 95-104) relied on the rate of return on net assets as well as other financial ratios in assessing the performance of the merging firms, a number of researchers based their evaluation on the effect of mergers on equity shares (for example, Kelly (1967), Hogarty (1970: 317-327) etc.). They usually confined themselves to whether share prices, earnings per share, etc. improved or deteriorated after the mergers.
**Performance Study based on Company Fundamentals**

**Singh's study**
One of the detailed analysis of merger performance was done by Singh (1971: Chap.7) In his research, he covered mergers and TOs over the period 1954 to 1960. He concentrated on the comparison of the performance of taken-over firms with surviving firms, i.e., non-taken-over firms. He considered 4 profitability indicators – the pre-tax rate of return on net assets, the post-tax rate of return on equity assets, the dividend return (gross of tax) on equity assets and the pre-tax "productive" rate of return. Apart from these he also considered the growth-rate of net assets and the valuation ratio.

Singh's conclusion was that the non-acquired firms, on the whole, had a better record than the acquired firms with regard to the four measures of the rate of return, the growth rate and the valuation ratio. In his study, there was a decline in relative profitability in 50% cases of post-merger firms on comparison of profitability records of the acquiring firms (after TO) with the combined profitability of amalgamating firms. His study leaves a question mark whether profitability alone is a good criteria to assess the success of mergers.

Singh (1971: 161-163)) also attempted to test the efficiency of mergers by comparing the average pre-merger profitability of both the firms with the post-merger profitability of the merged firms. To take account of the industry and the state of the economy on profitability, the figures compared were those for firm's profitability in relation to the average profitability in the firm's industry in the relevant year. The relative profitability of the acquiring firm in the year of acquisition and for one and two years after acquisition were compared with the combined (weighted average) relative profitability of both the acquiring and acquired firms before acquisition. Singh found that in a majority of cases there was an actual decline in the relative profitability of the acquiring firms.

**Meek's study**
Meeks in his study of mergers in UK for the period 1948-1971, attempted to test statistically, whether mergers led to efficiency. Meeks took profitability as a measure of performance. In order to eliminate the influence of macro-economic and industry environment on the profitability of firms, he expressed the profitability of firms as a proportion of the current year's profitability of the industry in aggregate. Next, Meeks carried out adjustments to eliminate the accounting bias which creeps in when the acquirer pays more for the victims than what it is worth prior to merger and enters the value of the acquired firms in its own book at the higher value.

Meeks compared the pre-merger performance of the firms with their post-merger performance. The pre-merger reference period was taken to be the average of three years prior to merger. The post-merger performance considered was from the year of merger to the next seven years. Meeks found that in the year of merger, there was a slight improvement in profitability but in each of the next seven years, there was a decline in profitability. Thus, Meeks concluded that mergers had unfavourable impact on profitability.
Meeks further tried to test the Penrose-Marris hypothesis that high growth companies would, after a point, face a decline in managerial efficiency leading to a fall in profitability. So one might expect a merger which represent a large proportionate growth for the acquirer, to create greater problems than in the case of a merger leading to low proportionate growth. Meeks classified the firms into four groups according to the ratio of victim size to amalgamated firm size. Next, for each group of companies, he estimated the pre-merger and post-merger profitability. He found that the performance of the group of firms for which the size of the taken-over firm was large, was in no way inferior to the groups for which victim's size was small. So it appears that the firms taking over large firms did not suffer any assimilation problem.

Meeks also tested the proposition that diversified mergers are less profitable, since there are few things common between the acquirer and victim, so that there will be limited economy in such mergers. Comparing the pre-merger and post-merger profitability of diversified firms, Meeks found that the performance of the diversified firms was somewhat better than that of the non-diversified firms.

The study of Weston and Mansinghka
Weston and Mansinghka considered in their study 63 conglomerate companies. They compared the performance of their sample with two control groups randomly selected. One control sample was randomly for industrials and the other included both industrials and non-industrials. Their data cover the periods 1958-68 and 1960-68. They found that greater than average relative growth of acquirers reflected merger activity rather than greater internal growth. The earnings of the conglomerates at the start of the period were lower than those of the controls but by 1968 they were not significantly different. Weston and Mansinghka concluded that the conglomerate merging firms were able to improve their profitability to the level of the average of the industry. They regarded this as evidence of successive "defensive diversification" of over-specialised companies in industries such as aero-space, textiles etc.

The study of Lev and Mandelkar
Lev and Mandelkar studied 69 matched pairs of firms covering the period 1952-63. Each acquiring firm in a major merger was matched with a firm from its own four-digit industry by asset size. Profits and other measures were computed for the 5 years prior to merger and for 5 years after merger. They considered both levels and dispersion of selected measures of performance. They found that acquiring firms were more profitable in terms of subsequent stock market performance. They also found that mergers did not reduce the variance of the combined company's stock relative to the stock of the control. Thus, stockholders' risk-reduction as a motive was ruled out.

Other Studies
Manne (1965: 110-120) concluded that acquired firms were unprofitable firms resorting to mergers to overcome their financial problems. Hayes and Taussig (1967) in their study of takeover bids in the USA for the period 1957-66, found that acquired firms were unprofitable and over-liquid firms. Singh also came to the same conclusion for merger cases in UK for the period 1954-60. Hayes and Taussig and
Singh found the acquiring firms to be somewhat above average in profitability with a tradition of retaining the reinvesting profits rather than paying large dividends.

**Kelly's study**
Kelly (1967) studied a sample of 21 matched pair of firms in the period 1946-1960. The merging number of the pair was selected so that it had achieved at least 20% increase in sales due to merger. The control was matched according to size and industry and the constraint that it had achieved no more than a 5% increase in sales due to merger. Kelly considered the market performance of the stocks of companies, comparing 5 pre-merger years with 5 post-merger years. Kelly found no difference in the performance of the two groups of firms. But he found that merging firms grow faster and had higher Price/Earnings ratios than their non-merging counterparts. However, this did not lead to increasing stock prices over a period. Kelly concluded that acquiring firms apparently paid too high a premium for the extra sales they acquired. His chief policy conclusion was that corporate investors ought to re-evaluate their policies and apply a higher discount to merger acquired sales.

**Hogarty's study**
Hogarty (1970: 317-27) in his study covered 43 merging firms over the period 1953-64. He compared the performance of the merging firms with the average performance in the acquirer's industry. His performance indices were mainly stock prices and also certain aspects of dividend policies. He found that in most cases the merging firms performed worse than the industry average.

**Redistribution hypothesis**
While the performance study of mergers mainly concentrated on profitability over the sixties and the seventies, the eighties witnessed another approach to the theory of the performance of merger and TO activities that was based on redistribution. It held that the source of the value increases in mergers is redistribution among the stakeholders of the firm. Expropriated stakeholders under the redistribution hypothesis may include the bondholders, the government (in the case of tax savings) and organised labour. Possible shifts are from bondholders to stockholders and from labour to stockholders (Schleifer and Summers (1988); Williamson (1988: 61-67)) and/or consumers. However, most of the studies (such as those by Asquith and Kim (1982: 1209-1228); Dennis and McConnell (1977: 349-365); Kim and McConnell (1977: 349-365) etc.) find no evidence that shareholders gain in mergers and tender offers at the expense of bondholders. Even in debt for common stock exchanges, most of the evidence indicates that there is no negative impact on bondholders even though leverage has been increased. However, in leveraged buy-outs in which debt is increased by very high orders of magnitude, there is evidence of negative impacts on bondholders (McDaniel (1986: 413-460)). To the extent that taxes are part of the explanation for mergers, redistribution is involved. It is a redistribution from the government tax collector (really the general public) to the firm (Weston, Chug and Hoag (1996)).

**The Concentration hypothesis**
As is already said in the discussion on market power in Section 2.2.2 permitting a firm to raise its market share by merger has the possibility of resulting in increased
concentration in the industry, leading to an undesirable market structure based on monopoly power to the acquiring firm. The argument in brief is that if a few firms account for a substantial percentage of an industry's sales, these firms will recognise the impact of their actions and policies upon one another. This recognised interdependence will lead to a consideration of actions and reactions to changes in policy that will tend toward "tacit collusion". As a result, prices and profits of the firms will contain monopoly elements. Thus, if economies from mergers cannot be established, it is assumed that the resulting increases in concentration may lead to monopoly elements, which will have adverse welfare consequences.

A number of empirical studies have sought to gauge the extent of welfare loss through the exercise of market power under monopolistic situations. Harberger (1954: 77-87) made the first study of this kind in 1954. He first calculated the welfare or deadweight loss in any particular market by a simple formula based on sales revenue, price and price elasticity of demand and then summed across markets to get the welfare loss for the economy. His cross-section studies using data aggregated at the industry level indicate that the activities of the manufacturing sector of the USA in the 1920s resulted in a reduction in welfare equivalent to 0.1% of GNP.

Methods similar to Harberger's have been used among others by Schwartzman (1960: 627-630), Bell (1968: 233-241), Worcester Junior (1973: 234-245) and Siegfried and Tiemann (1974: 190-202), to give similar low estimates of welfare losses. By contrast, the different approach taken by Cowling and Mueller (1978: 727-748) suggests that welfare loss may be substantially higher.

Table 2.1 presents a summary of the empirical studies on the welfare effects of monopoly. Most of these studies use a Harberger type approach deriving low estimates of welfare reduction. Gisser (1986: 756-757) is an exception. His low welfare loss estimates are based on the Cournot model of oligopoly. Those that indicate much higher ranges generally use methods similar to Cowling & Mueller. The general inference is that the presence of monopoly results in small deadweight loss. However, where firms' costs are increased as a result of monopolisation, X-inefficiency or extra expenditure incurred to defend the monopoly position, then welfare losses, may rise considerably.
Table 2.1

A Summary of the Empirical Studies on the Welfare Effects of Monopoly

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Author</th>
<th>Period</th>
<th>Country</th>
<th>Welfare Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Harberger (1954)</td>
<td>1924-28</td>
<td>USA</td>
<td>0.1</td>
</tr>
<tr>
<td>2.</td>
<td>Schwartzman (1960)</td>
<td>1954</td>
<td>USA</td>
<td>0.1</td>
</tr>
<tr>
<td>3.</td>
<td>Kamerschen (1966)</td>
<td>1956-61</td>
<td>USA</td>
<td>5.4-7.6</td>
</tr>
<tr>
<td>4.</td>
<td>Bell (1968)</td>
<td>1954</td>
<td>USA</td>
<td>0.02-0.04</td>
</tr>
<tr>
<td>6.</td>
<td>Worcester (1973)</td>
<td>1956-69</td>
<td>USA</td>
<td>0.2-0.7</td>
</tr>
<tr>
<td>7.</td>
<td>Siegfried &amp; Tiemann (1974)</td>
<td>1963</td>
<td>USA</td>
<td>0.07</td>
</tr>
<tr>
<td>10.</td>
<td>Wahlroos (1984)</td>
<td>1962-65</td>
<td>USA</td>
<td>0.04-0.90</td>
</tr>
<tr>
<td>11.</td>
<td>Gisser (1986)</td>
<td>1977</td>
<td>USA</td>
<td>0.1-1.8</td>
</tr>
<tr>
<td>14.</td>
<td>Wahlroos (1984)</td>
<td>1970-79</td>
<td>Finland</td>
<td>0.2-0.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1971-74</td>
<td>France</td>
<td>0.21</td>
</tr>
<tr>
<td>16.</td>
<td>Pezzioli (1985)</td>
<td>1982-83</td>
<td>Italy</td>
<td>0.4-9.4</td>
</tr>
<tr>
<td>17.</td>
<td>Funahashi (1982)</td>
<td>1980</td>
<td>Japan</td>
<td>0.02-3.00</td>
</tr>
<tr>
<td>18.</td>
<td>Oh (1986)</td>
<td>1983</td>
<td>Korea</td>
<td>1.16-6.75</td>
</tr>
</tbody>
</table>


Until the 1970s it was generally believed that monopoly was harmful to economic welfare. However, studies which attempted to quantify this effect have often shown the reduction in welfare to be remarkably small (typically under 1% of GNP). This gave the impression that large-scale expenditure by governments to control monopoly abuses was unwarranted.

On the other hand, an alternative idea grew that monopoly may actually improve society’s welfare. If the monopoly has lower costs, productive efficiency gains may outweigh the welfare losses caused by market power and empirical relationships between profit and concentration may be explained not by market power but by greater efficiency. From the perspective of transaction cost economics this superior efficiency is attributable to firm-specific factors conferring unique advantages to particular firms (Ferguson and Ferguson (1994: 107))
2.4 Concept and Types of Corporate Governance and its Relevance in the Market for Corporate Control

2.4.1 Notion of CG

The study of the performance of firms after mergers cannot be complete unless we take care of the CG dimension of corporate analysis. In fact, the role of CG in the study of mergers emanates from the view of some economists that corporate performance under mergers is largely attributable to the effective role of corporate management in modern joint stock companies that are structurally ridden with principal-agent problem as ownership becomes separated from control (Kitching (1972: 40-63); Samuels (1972: 1-11)).

CG basically describes rules, practices and procedures by which management of companies interacts with stakeholders, i.e. owners, employees, consumers and suppliers. The popular view of CG (the Anglo-American (AA) view) is that CG deals with the accountability of company management to stakeholders (generally, the shareholders) of the company so as to protect the latter's interests by disciplining errant management. If necessary, it prescribes ousting the existing management for mismanagement and throwing open the company to bids and selecting a new team to run it. The need for such monitoring arises due to agency problems that are likely to come up if the objectives of the stakeholders are not implemented by the management, which is acting as their agent. In other words, there arises a need to minimise the agency costs associated with joint stock companies (mentioned in Section 2.2.2 above) through proper governance of the firms both internally and externally.

Objective of Good Governance

Good CG implies that the institution is run for the optimal benefit of the stakeholders from short-term and long-run perspectives so that the firm concerned may “flourish and grow so as to provide employment, wealth and satisfaction, not only to improve standards of living materially but also to enhance social cohesion” (Charkham (1994: 1)). When formulated in this way, it is clear that good CG requires accountability at all levels in an organisation.

2.4.3 Alternate Routes to CG for the Limited Liability Joint-Stock Companies

Mayer (1998) has pointed out that CG may influence performance through several routes. These are through influencing managerial incentives, disciplining, financing and investment decisions, corporate restructuring and instilling commitment and trust. These routes are in turn activated through several structural and institutional factors pertaining to a corporation. These are (i) the ownership structure, (ii) the financial structure, (iii) the structure and functioning of company boards and the associated internal control systems and (iv) the legal, political and regulatory environment within which the firm operates.
The Structure of Ownership

The ownership structure indicates to a large extent, the way companies are managed and controlled. At the most simplified level of analysis, the ownership structure can be either dispersed among individual and institutional shareholders as in UK and US or can be concentrated in the hands of a few as in Japan or Germany. The former structure conforms to the image of a corporation portrayed by Berle and Means where dispersed shareholding leads to agency conflicts with no single individual shareholder having sufficient motive to monitor and control the performance of a firm. An extensive theoretical and empirical literature has developed on agency problems and ways to combat the problem through appropriate designing of incentives (Jensen and Meckling (1997)) and disciplining devices, e.g. TO. Small shareholders and institutional investors can exercise good governance via the market for corporate control by offloading their shares if a company is under-performing and thereby expose the company to a TO threat. The effectiveness of such a response in turn will be conditional on the existence of a liquid capital market and well functioning market for TOs.

On the other hand, a concentrated ownership structure is characterised by large shareholders who are found to be quite active in CG either through their representations on company boards or because they have greater incentive of monitoring given that they have much larger stakes in the corporation. Dominant shareholders are also found to be much better informed than the dispersed shareholders. Under such a system therefore, there is a lesser role for outside monitoring through the market for corporate control and greater reliance is placed on internal non-market monitoring mechanisms through forging closer personalised relations, commitment and trust.

Structure of Board of Directors

The boards of directors have also an important role to play in the management and control of companies. The primary responsibilities of any company board are to evaluate proposals put forward by the company management and to honestly discharge their fiduciary responsibilities towards the firm’s investors. The structure of boards may vary in the sense that it can be single-tiered as in most countries, or double-tiered as in Germany. Also, there is a variation across countries and across firms with respect to the mix of executive and non-executive directors. A larger proportion of non-executive directors tend to signify that the board does not largely represent the interests of inside management to the detriment of those of the outside shareholders. Some studies and reports (Fama (1980); Weisbach (1988); Cadbury (1992)) argue that performance measures are often highly correlated with the turnover of the chief executive officer (CEO) for firms in which outside members dominate the board of directors. Research with respect to Japan and Germany where insider-dominated boards prevail, shows that boards are quite passive except in extreme circumstances, discussed in the next subsection. However, the overall evidence on the relationship between the board structure and its effectiveness appears to be mixed.
The Financial Structure
The financial structure or capital structure of a firm, i.e. the proportion between debt and equity also has implications for the quality of governance. Contrary to the Modigliani-Miller hypothesis that the capital structure of the firm has no bearing on the value of the firm (discussed in details in Chapter 5 in the section of alternative capital structure for firms), recent research has shown that financial structure matters.

While under equity ownership, shareholders attempt to ensure CG by generating a threat of TOs, as in US and UK, debt contract can also be perceived as an effective mechanism for solving agency problems, whereby the creditors exercise control on the running of a company. Here, a failure of the management to adhere to the terms and conditions of a debt contract triggers off the transfer of some control rights from the management to the lender. Herein comes the significance of the lending institutions in monitoring management. Banks and financial institutions (FIs) in general, as creditors and in some cases also equity holders can perform the important function of screening and monitoring firms as they are better informed than other investors. This is experienced in Japan.

The Institutional Environment
The legal, regulatory and political environment within which a firm operates determines to a large extent the quality of CG. For example, the extent to which shareholders can control the management depends on their voting rights defined in company law. Similarly, the extent to which creditors will be able to exercise financial claims on a bankrupt company will depend on bankruptcy laws and procedures. And the extent to which the market for corporate control efficiently operates to discipline under-performing management depends on the TO regulations.

However, it is argued that in the long run product and factor market competition would force firms to minimise costs and as a part of this cost minimisation exercise the firms would ultimately adopt the most efficient CG mechanisms. Thus, according to this view, there is not much need to systematically design regulatory structures or worry about the appropriate governance reforms. But critics (such as Jensen (1997)) have emphasised the importance of economic, legal and political institutions in CG by pointing out that product and factor market competition are slow to act as a control force and by the time their disciplining takes effect, large amount of investor capital and other social resources may have been wasted.

2.4.3 Types of CG
There are three well-defined governance systems that have emerged worldwide, each possessing in varying extents, each of the characteristics of CG stated above. One is of the A-A “market-based” type, the one pertaining mainly to USA and UK. This belongs to the mainline price theory. It involves the notion of widely dispersed shareholders, owners of equity (i.e., shareholders) as the only stakeholders in the firm, reliance on the stock-market alone or principally, for disciplining the managers of a firm, and a fairly vigorous market for corporate control (or TOs). The other can be represented by the Japanese “relationship-based” system characterised by less
liquid capital markets, relatively inactive TO market and a greater concentration of shareholder power with banks, corporates and government through large bank and inter-corporate holdings. This style acknowledges the existence of other disciplining devices, than the stock-market, in which workers are given a voice in running the firm and in strategic decisions that affect their own future. The third one is the German style of CG, which is also primarily a “relation-based” system and has more in common with the Japanese system than the A-A.

In the previous subsection on the alternate routes to CG, we have already discussed several prime characteristics of these various types of CG without formally going into the classification. However, in this subsection we will discuss few of those characteristics in general and a few other specific ones, according as the case may be, for each type of CG.

**A-A Model of CG**

The primary elements of CG in Australia, Canada, New Zealand, the US and the UK share many similarities, which collectively is referred to as A-A style of CG. The A-A model is based on the ideal of shareholder democracy and the perceived need to prevent the abuse of corporate power through maintaining the accountability of corporate managers to corporate owners, i.e., the shareholders, through the board of directors and proxy-voting mechanism. It relies on the “exit” option whereby shareholders dissatisfied with the company performance will offload their shares making the company susceptible to a TO.

The A-A model is deliberately chosen in our analysis as a starting point, to provide the basis for comparison, because the countries pursuing the A-A structure of CG have active TO markets. Further, these countries have seen many cycles of TO activity and hence have well-developed sets of laws governing TO (Kester and Luehrman (1993: 439) Moreover, the Indian TO regulations have been modelled closely along the lines of the UK City Code of TOs and Mergers, which is the most prominent and comprehensive among sets of regulations which govern TOs in UK. This note however, describes only the features of the American system as a representative illustration of this larger set.

**The Structure of Ownership**

In general, the ownership structure in US is relatively dispersed than Japan and Germany in the sense that households and pension funds in the USA own comparatively more of US corporate equity than their corresponding entities do of Japanese and German equity (see Table 2.2 below). The types of institutions that hold major equity positions in American companies are the pension funds, investment companies (mutual funds (MFs)) and endowments. In fact, most of the equity-owning institutions are financial in nature. However commercial banks and other deposit institutions are not permitted to own stock outside their trust departments and hence cannot become institutional shareholders. Although individuals own half of the shares, they do only 20% of the trading and consequently 80% of the trading in shares in US is institutional trading (Kester and Luehrman (1993. 441)).
Table 2.2
Comparative Corporate Ownership Structures, 1990-91

<table>
<thead>
<tr>
<th>Institutions</th>
<th>US (%)</th>
<th>Japan (%)</th>
<th>Germany (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FINANCIAL SECTOR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks (all types, including bank holding companies)</td>
<td>0.3</td>
<td>25.2</td>
<td>8.9</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>5.2</td>
<td>17.3</td>
<td>10.6</td>
</tr>
<tr>
<td>Pension Funds (Public and Private)</td>
<td>24.8</td>
<td>0.9</td>
<td>-</td>
</tr>
<tr>
<td>Investment Companies and Other</td>
<td>9.5</td>
<td>3.6</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>39.8</td>
<td>47.0</td>
<td>19.5</td>
</tr>
<tr>
<td><strong>NON-FINANCIAL SECTOR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Financial Business</td>
<td>NA</td>
<td>25.1</td>
<td>39.2</td>
</tr>
<tr>
<td>Household</td>
<td>53.5</td>
<td>23.1</td>
<td>16.8</td>
</tr>
<tr>
<td>Government</td>
<td>-</td>
<td>0.6</td>
<td>6.8</td>
</tr>
<tr>
<td>Foreign</td>
<td>6.7</td>
<td>4.2</td>
<td>17.7</td>
</tr>
</tbody>
</table>


However, large shareholders, especially MFs and pension funds do not actively participate in CG and are not represented on the corporate board. This refraining of institutional shareholders from interference in management is, due to certain major laws that influence corporate ownership and governance by FIs in the US, as listed below (Kester and Luehrman: 445):

- Glass-Steagall Act of 1933
- Securities and Exchange Act of 1934
- Investment Company Act of 1940
- The Bank Holding Company Act of 1956
- Employee Retirement Income Security Act of 1974
- Various state insurance regulations

Composition of the Board of Directors
The main organ of American CG is the board of directors, typically 13 or 14 members, who are elected by the shareholders. This board safeguards shareholder interests by overseeing management and board selection, reviewing financial performance and allocation of funds and ensuring that the corporation acts in a legally and socially responsible manner. Approximately one-third of these directors are insiders and two-third are outsiders, or those with no direct affiliations with management. The managers are accountable to the board of directors and directors to shareholders. The chief executive officer (CEO) is the most powerful of the managers and directors. The executive directors are the operating managers who are also on the board of directors. This group typically includes 4 or 5 members and it always includes the CEO.
The outside directors are chosen because they are considered essential for maintaining a neutral board capable of objective oversight. But such a system may have associated costs too. The reliance on outside directors also introduces information asymmetries to the board, as the directors are totally reliant on the management for information about the working of the company. This information asymmetry can lead to an agency problem. Together with this, there also exists the problem of shortage of time that most directors can devote to their board positions. One reaction to the time and information constraints on directors has been the use of committees for delegating some board responsibilities.

The CEOs, who are also the chairmen of the board in many American companies, often choose the nominating committee for the directors, or even indirectly nominate the directors themselves. Through this process, it may so happen that the board may promote the selection of directors sympathetic to incumbent managers, thereby diluting management’s accountability to the board. Voting procedures for the election of directors may also reduce management’s strict accountability to the board. Most shareholders who vote for or against a slate of management-nominated directors, vote by proxy. Although write-in candidates are allowed, the effort required to coordinate the shareholders to install an alternative board is infeasible in most situations. The composition of corporate boards reveals a propensity to choose members who could be inclined a support incumbent management; 63% of all board members are CEOs of their own corporations (For this topic, see Lorsch and Maclver (1989: 2,9,18,58,87)).

CG and the Market for Corporate Control
The A-A model of CG assumes that a typical firm is owned by the large number of small and diversified, individual shareholders, who do not have direct control over the firm's day-to-day management. Shareholders, including institutional investors are “mostly weak and passive” (Black (1977)). The shareholders face severe “collective action” problems in monitoring the managers’ decisions. Each shareholder owns a small fraction of the company’s stock, and thus receives only a fraction of the benefits of monitoring but must bear the full cost of his own monitoring efforts. Thus, the burden of “enforcement cost” falls too much on the shareholder.

When shareholders fail to take interest in the governance of the company, or when their governance proves ineffective (due to passivity, for instance), low quality (inefficient) managers are able to remain in power or management’s allegiance to the shareholder may falter. In either of these cases, the company’s share price is low and generates a gap between the stock’s actual price and its perceived potential value. If this gap were to grow large enough, a TO would ensure that control over the company’s assets eventually would go to those who could earn a higher return on those assets and a TO agent would take over the company through the stock market [4]. Thus the AA model is market-driven. Here the shareholders exercise their monitoring over corporate functioning through the stockmarkets. The shareholder minimises the cost of real or perceived mismanagement by the quick and certain process of selling the stock rather than by the long and highly uncertain process of attempting to change management behaviour.
Here an ideal system of CG tries to do several things. It gives managements enough freedom to manage well and in the best interests of shareholders. It also gives the shareholders (especially, the equity shareholders) enough information to judge whether their expectations are being fulfilled (for example, whether they are getting their money's worth). And if not, it gives them the power to act decisively by selling their shares, shoving off the incumbent management and replacing it with a fresh one to acquire the company and raise the market value of shares. Thus, in a way, an effective CG structure implies an effective and active market for corporate control. This is the notion of "allocational takeovers" in Hay and Morris (1992).

Thus, in the A-A structure of CG, the capital market acts as a solution to corporate inefficiency or ineffectiveness of governance. CG is monitored by the shareholders where TOs play a major position. Theoretically, therefore, the threat of hostile TOs should ensure that assets are controlled by those who are best able to manage them and in the US, with its well-developed market for corporate control, hostile TO is the ultimate check on management. The mere threat that TOs could occur is sufficient to discipline the managers and minimise agency costs associated with the separation of ownership and control. That the agency problem is a potential and major cause of corporate TOs in advanced capitalist countries has been stressed by Jensen (1994), who says that such agency problems played a major role in the acquisitions of the last decade in USA.

The theory thus emphasises role of a virtually unregulated market for corporate control and the TO mechanism as the ultimate monitoring and disciplining force on incumbent management. TOs of joint stock companies are believed to be a system of ensuring the efficiency of management as inefficient management will be changed by shareholders selling their shares to those seeking to take over the company. The argument is that a competitive market for firms would always be able to find out the true value of the components making up a firm and would provide a natural selection process for singling out not only inefficient managers but also inefficient structures of a firm (Marris (1964)). As long as TO threats are credible, incumbent management is kept on the toes and the company's shareholders as well as society at large benefit because resources are being efficiently utilised. The existence of anti-TO measures such as employee stock ownership plans, poison pill defenses, staggered boards and super-majority provisions diminishes the threat of TO in many cases [5].

To some, hostile TO enhances social welfare by ensuring the efficient deployment of resources. There is evidence that hostile TOs increase shareholder wealth substantially. Jensen (1994) estimated that from 1977 to 1986, mergers and TOs produced gains for selling firm shareholders aggregating $346 billion (in 1986 dollars). Some researchers have shown that American manufacturing firms, that displayed subnormal productivity levels before TO have demonstrated higher productivity growth after TO (Lichtenberg and Siegel (1990: 165-194)).

This is, in a nutshell, the premise on which the TO theory has been developed in the typical A-A literature on CG (Sheard (1994)). The strategic elements of this theory are:
• The ultimate owners of the firm are the small, well-diversified, individual shareholders, who can play an active role in CG through the effective functioning of the market for corporate control. They make full use of their property rights. They can sell their shares when and to whom they like, at the market price, thereby making a profit.

• Acquisitions are perceived to be a legitimate instrument that allows capital and assets to find the management capable of generating the best returns from them. In other words, the TO mechanism, which operates through the market process, is viewed as an integral aspect of CG. Management is exposed to external hostile TO threats through the stock-markets thus leading to corporate restructuring, often at the cost of employment. The market for corporate control is open and competitive. There is the competition through the stock market, a la the TO mechanism.

• Hostile TO is viewed as the principal means of capital market discipline in management and a major form of corporate control.

Thus, this model gives greater emphasis on stock prices and the ability to raise capital efficiently. It also places prime emphasis on the shareholders' interests, because they are the ones who put their money into a company. And, it becomes the responsibility of the management of a company, to use its assets efficiently and make money for the owners; but it is also incumbent on the shareholders not to be lazy.

To sum up, the AA view is that since a company, after all, is in the business of using its assets efficiently, and making money for its owners and since it is the shareholders who put their money into a company, the interests of the shareholders as the ultimate owners of the company, are paramount. Accordingly, parameters such as the "return on net worth" or "economic value added" have come to attain great importance in the context of corporate performance.

**Critique**

The A-A school rests on the premise that there exists agency problems in the internal organisation of the modern joint-stock firm, characterised by the separation of security ownership and control; as such, there is a need to monitor and discipline the errant and inefficient management. This is done through the market for corporate control, via the process of corporate TOs through the stock market, thereby promoting a more efficient utilisation of capital resources. As Singh (1998: 181) points out, textbook theory suggests that there are two distinct ways in which the establishment of a market for corporate control may do this.

• *The threat of takeovers may lead inefficient firms to perform better:*

• *Even if all firms were on their efficiency frontier, the amalgamation of some through the act of takeovers may lead to a better social allocation of resources via synergy.*
However, a review of the analysis and evidence on the markets for corporate control in UK and USA indicate several reasons why these potential virtues of a market for corporate control may not actually materialise in the real world and even if they do, then what their drawbacks are particularly from the perspective of economic development. Some of them are discussed below.

* According to Professor Bagchi (1997: 18), behind this A-A theory, which puts its faith in the market as the final arbiter of the fate of firms, there is a basic assumption, that the capital market can not only discover the true present value of a firm and provide a natural selection process for singling out the inefficient managers as well as inefficient structures of firms, but also can ensure that the TO payments are made in accordance with that value. In reality, however, there can be some problems with the functioning of the capital market.

Bagchi argues that even with transparent accountancy and auditing methods, it is very difficult to get at the true present value of a large firm with many divisions and many products as its domain of operation. Problems of informational inadequacies in the shape of asymmetric and incomplete information may hinder the process of arriving at the precise measure. Moreover, the capital market is a notoriously imperfectly competitive mechanism, in which bubbles, share-pushing, insider trading [6] and bear interests can play havoc with attempts to judge the true value of a firm. Finally, this theory does not take into account, the fact that there may exist similar agency problems in the capital market as well. The managers of financial funds can have the same incentive problems as managers of firms. If this occurs, then stock market no longer remains a market for controlling the management and making the realised rate of return equal to the expected rate of return. The A-A or Fama-Jensen-Meckling [7] style of CG ignores this part of the story.

* Real world markets for corporate control, even in advanced economies are subject to an inherent imperfection; it is far easier for a large firm to take over a small one than the other way round, although it may be so that the smaller firm is a relatively more efficient one. In other words, there is no evidence that the market works in such a way to punish the inefficient and unprofitable companies and reward the efficient ones. Empirically, selection in the market for corporate control takes place much more on the basis of size than that of profitability or the firm's stock market valuation. In a TO battle it is the absolute size that counts rather than absolute efficiency. The acquisition process may thus indeed act in a perverse way since a large unprofitable company can increase its immunity to TOs through the TO process itself -- by becoming larger through the acquisition of small firms. This consideration is especially important for developing countries like India where there are large, potentially predatory conglomerate groups. These could TO smaller, more efficient firms and thereby reduce potential competition to the detriment of the real economy (Singh (1998:182)).
There are in practice huge transaction costs involved in TO activities in UK and USA, which hinder the efficiency of TO mechanism. Changing management through TO proves to be a very expensive way of accomplishing this task. This consideration is particularly important for developing countries for which the transaction costs would be rather expensive and at the same time lead to large unfavourable redistribution of wealth (Singh (1998:182, 184); Peacock and Bannock (1991)).

A freely functioning market for corporate control runs serious dangers of increasing concentration of industry and of stifling the development of efficient small and medium firms. This is because the industrial organisation studies, based on accounting data, show that, the amalgamated firm is likely to have greater (and certainly no less) monopoly power than the pre-merger firms considered on their own, this empirical finding is interpreted as indicating mergers lead on average to a fall in microeconomic efficiency. This is particularly relevant for developing countries like India, with its large conglomerate enterprises (Singh (1998: 185,190).

Grossman and Hart (1980: 42-64)) have suggested that because of the “free-rider” problem, the TO mechanism may not work efficiently. Any individual shareholder may feel that his action is unlikely to affect the outcome of a disciplinary TO bid. It would therefore be best not to accept a raider’s offer and to wait until the share price rises further after the successful bid. They argued that if all shareholders act in this way, the disciplinary TO bids would not materialise and the raiders would not have sufficient incentives to undertake such bids at all (Singh (1998:183)).

Moreover, the A-A theory of CG considers that only the equity shareholders, as the owners of capital, are the risk-bearers in a firm. They are therefore the only legitimate residual claimants to the profits of the firm and in the presence of any agency problem with the managers that reduces their own returns, have access to disciplinary device, by selling off their shares, thereby activating a market for corporate control. It may be pointed out that this system of CG fails to acknowledge that workers are also risk-bearers and that their exposure to risk in the case of a failing firm is in some senses greater than for the owners of equity or managers of the firm. Thus, the A-A mechanism fails to honour the implicit contracts of the workers in the acquired firm with the pre-acquisition management. This is a socially perverse outcome of the TO process as such abandonment of implicit contracts is socially harmful as it discourages firm-specific accumulation of human capital by workers (Singh (1998:183); Schleifer and Summers (1988)).

Economists (Williamson (1975, 1985); Goldberg (1980: 91-12)) have stressed that many firms possess idiosyncratic assets including human capital and firm-specific ways of learning and knowledge accumulation. It follows that if workers acquire specialised, idiosyncratic knowledge by working in a firm and thereby render it more productive, then workers also become value-
adding stakeholders in a firm and must therefore theoretically have a voice in CG. The A-A theory ignores this point.

Another criticism of a virtually unregulated market for corporate control as an instrument of CG, as advocated by the A-A school, may be that TOs are generally expected to lead to a change in the personnel of managers or other key personnel, or even the management style of the firm. A free-wheeling market for corporate control might be unable to bring out the true productive potential of the idiosyncratic assets including human capital, possessed by the firm (Bagchi (1997: 18-19)). In this sense, TOs would imply substantial costs for the incumbent firms.

An equally strong criticism of TOs, as a mode of CG in the A-A system is that TOs greatly intensify the normal stock market pressures towards speculation and short term returns and thus encourage short term behaviour. The argument in its simplest form is that, the managers of the firms of UK and USA are obliged to meet the earnings per share (EPS) target (set by market expectations) every quarter or every half year, depending on the frequency of the stock market’s reporting requirements for corporate earnings. If these market expectations of short-term earnings are not satisfied, the firm’s share price falls, making it vulnerable to TO. At the same time, on the other side of the market, the investors who are, by and large, institutional fund managers, are also obliged to have a short-term outlook. This is because of the highly competitive structure of fund management industry and the fact that fund managers’ own performances are often judged by their principals on the basis of their performances over relatively brief time periods. The net result is a culture dominated by immediate gain and TO speculation on both sides of the market (Singh (1998: 187); Rohatyn (1986: 30)).

A similar idea was pronounced by a TO defense lawyer, Martin Lipton. He said,

_The takeover activity in the U.S. has imposed short-term profit maximisation strategies on American Business at the expense of research, development, and capital investment. This is minimising our ability to compete in world markets and still maintain a growing standard of living at home (Jensen (1997: 22))._

*Magenheim and Mueller (1988: 171-193) and Ravenscraft and Scherer (1988: 194-210) argue that companies acquired may already be efficient and that their subsequent performance after acquisition is not improved.

However, the A-A model of CG is in effect “crisis-driven” — it is a means of dealing with crisis in profitability. It contends that crisis-oriented, highly selective, and sporadic intervention of shareholders through the market for corporate control, is the only solution to CG problems. Perhaps a better approach would aim at crisis-prevention, in part through more open and regular communication among managers, boards, workers and major investors.
An alternative to shareholder-monitoring in CG through reliance on the stock market and regarding the owners of equity as the virtually the only stakeholders in a firm is, giving greater discretionary power to the managers and the workers. The Japanese (and German) system of CG, which lays lesser role for stock-markets for the disciplining of managers, subscribe to this view. These countries do not have a free market for corporate control in the A-A sense, enabling raiders to mount hostile TO bids against the wishes of the incumbent management. On the other hand, managers are induced to seek the organic growth of the corporation they work for. In contrast, incentives in the A-A system emphasize financial engineering and growth by merger.

The shares of Japanese and German companies are said to be held by permanent owners whose aims are perpetuation of the enterprise and building corporate position and thus optimising long term private and social returns, rather than short run profit maximisation. The greater focus on long term corporate position — encouraged by an ownership structure and governance process, that incorporate the interests of employees, suppliers, customers, and the local community — allow the Japanese and German economies to better capture the social benefits of private investment. The greater concentration of ownership and investor participation encouraged by the Japanese and German systems reduces the large “agency costs” — notably the conflict of interest among management, shareholders and lenders — and the “information costs” — the inability of outsiders to know about what insiders know -- faced by the investors of the A-A economy, particularly USA. Lower agency and information costs in turn mean less perceived risk for investors; and lower risk, other things equal, translates into lower rates of return expected by investors and higher stock prices (Chew (1997: 2)).

**Japanese Model of CG**

The distinguishing feature of Japanese CG is the tendency for large corporations to engage in tight, long-term commercial relationships. Such corporate networking is highly manifested in the enduring business relationships characteristic of Japanese industrial groups, or keiretsu, an affiliation of related companies whose interests are aligned partly through long-lasting and informal supply contracts [8]. Others are newer companies that sprang up around a major bank such as the Industrial Bank of Japan or the Dai-Ichi Kangyo Bank, or around a major industrial corporation such as Toyota, Hitachi, or Nippon Steel (Kester and Luehrman (1993: 445)).

**Composition of the Board of Directors**

Though outwardly similar in some respects, Japanese boards differ from those of most Western companies in various ways. For example in Japan, the typical board has 21 members, whereas the large companies are controlled by boards consisting of about 20 to 25 directors. Although formally elected by (usually unanimous) shareholders at annual meetings, the slate is nominated by the management itself. (Kester and Luehrman (1993: 446)). The president is the CEO. In each company there are 3 or 4 directors called executive directors, including the president, who are given special rights to represent the company (Kaplan (1997: 253). But unlike the practice in A-A economies, where we find independent, outside directors, virtually all
Japanese directors are insiders chosen from the ranks of top management itself. The inside directors have power, outside directors do not. Also the membership on Japanese boards mirrors a company's close commercial or financial relationships.

The group bank -- the Main Bank of the group, often sends an employee to become a board member of a group firm. When a bank employee is sent to a group firm in this way, he usually leaves the bank, becomes a permanent employee of the industrial firm and serves as a board member for more than 10 years. Thus, he is not an outside director, but can become an important source of information for the bank in critical times. When a firm is in serious financial trouble, the group bank sometimes sends current employees to act as directors and thereby intervenes in the management of the firm in order to rescue it. Thus in the Japanese system the Main Bank performs a monitoring and control (intervention) role as a kind of delegated "insider" rather than as the kind of arms-length institutional investor envisaged in US policy discussions of active investors (Sheard (1994: 337)).

Firms other than the FIs also send their employees to other firms, but rarely to the FIs. This highlights an interesting feature, namely, that the relationship between banks and non-financial firms in board member exchange is typically uni-directional; the banks send their employees as board members to the industrial firms (the corporate borrowers), but the firms seldom send theirs to the banks. Thus, non-financial corporations do not exercise joint control over the banks. Instead, the functioning of "monitoring the monitor" appears to be carried out by the banking authorities (Ministry of Finance and Bank of Japan) as part of their charter to maintain stability in the banking and financial systems (Hoshi (1994: 289); Sheard (1994: 337)).

An important aspect of CG in Japan is that there is a close relationship between director despatches and Main Bank (lender/borrower) relationships. The flow of directors from banks to firms occurs primarily between banks and firms between close financial relations. Major banks frequently arrange for senior executives in late career to enter client firms as senior managerial directors. However, major share-owning stakeholders in a Japanese company often obtain indirect representation through former executives that assume positions on the boards of companies with which their former employers do business (Sheard (1994: 337)).

**Contractual Relationship, Information Sharing and CG**

The keiretsu of Japan is characterised by a relationship based on stability in group affiliation, mutual loyalty among the favoured status group members and reciprocity in intra-group trade, as far as practicable. The trading relationship between two companies formally begins with the signing of a "basic agreement", usually a close, long-term contractual relationship subject to annual renewal. These basic agreements contain articles expressing intent to engage in mutually beneficial business transactions, to establish and maintain an atmosphere of mutual trust in business dealings and to respect each other's autonomy. The agreement does contain some legal requirements (such as confidentiality clauses), but they are not regarded as legally binding by the management. The basic agreement contains the proviso that any disagreements regarding the contracts would be settled amicably after mutual
consultation. Most institutional holdings are covered by widely understood and rigorously observed agreements not to sell any shares held in connection with an ongoing business relationship. To the contracting businesses, such agreements signal a commitment to one another and serve to strengthen business relationships. They are also an obstacle to TO, and thus serve to entrench management.

The trading or business relationships entered into through the signing of the basic agreement require effective communication between the contracting parties and such communications are developed through management transfers and lifetime employment. Middle-level managers and engineers may be temporarily transferred to a related company to help solve specific problems or to work on joint projects. Such transfers provide extensive networks of enduring personal relationships between individual managers in related companies that may facilitate future transactions between the companies by enhancing trust between the company’s managers. The managerial and employment system in Japan involves mutually held expectations of continuing associations between employees and firms and imperfect secondary and other labour markets. This is the concept of lifetime employment [9]. However, the concept of lifetime employment is valid in Japan, only for skilled male employees. Such employees and management, under the Japanese system, identify themselves with those of the company, which, as a consequence is regarded as a sort of community. They are unwilling to be acquired. Any offer to acquire the company is therefore likely to be taken as an intrusion. The management in this situation, is unwilling to accept a tender offer, and a hostile TO attempt is bound to meet serious resistance.

Beside the informal web for communication provided by management transfers, with its reliance on trust and forbearance of managers, there is also the practice of information sharing, fostered both informally and through institutionalised networks. A company has a Main Bank — the lead lender, which often holds both the equity and debt of a company. It is usually the largest supplier of capital to the company and has the best information base on the company.

Moreover, groups of related firms often have some sort of organisation of senior officers. This organisation is called “kinyo-kai”, a council that meets monthly to promote friendship and exchange views on sundry business and economic matters. Suppliers of some large manufacturers, many of which rely on the same company for the major part of their business, also meet in associations called “kyoryukukai” or “cooperation clubs”. These organisations not only promote mutual friendship, but also serve as a platform where suppliers meet to collect and disseminate information about their experiences with one another and with the manufacturing company. At this level, two things happen. One is that each party’s reputation is tested through discussions at this forum. Any firm trying to exploit its market power at the expense of a supplier might find its reputation at stake, thereby injuring its ability to do business with other firms on favourable terms. The risk to each supplier of a small customer base is reduced by the process of such amplification of the reputation of the manufacturer. The result is the reduction of the play of hidden information. In addition, the monitoring by the Main Bank (as the supplier of capital) diminishes the amount of hidden information and reduces the scope for undertaking hidden action.
The Japanese companies (like their German counterparts) tend to rely more extensively on implicit relational contracting. By tying themselves, to one another in groups through equity participation and various personal and institutionalised information-sharing networks, yet abstaining from outright majority ownership and control, Japanese corporations have been able to exploit powerful market incentives that derive from independent asset ownership. Concurrently, the close involvement of major stakeholders in a firm enables them to adapt their relationship with the company to the prevailing environment. In lieu of arm’s-length transactions among many strictly autonomous market participants, or extensive integration of asset-ownership under large administrative hierarchies, Japanese corporations engage in tight commercial relationships formed by relational contracts, personal trust among managers and extensive information sharing. The existence of large minority equity claims among major stakeholders helps mitigate the abuse of such business relationships (Kester and Luehrman (1993: 446, 453).

**Share Ownership**

The Japanese system of corporate control is characterised by a system of multilateral, fractional share-interlocking centering on the top shareholder positions. Thus, reciprocal equity ownership generally links companies with important business relationships. Cross-holdings involve only minority equity positions with no more than a few percent of outstanding shares being exchanged on a bilateral basis. Table 2.3 shows selected cross shareholdings of a major Japanese keiretsu, the Mitsubishi group. In the aggregate, about 25% of the stock of member companies in an industrial group is owned under cross-holding arrangements within the group itself (see Table 2.4). Substantial numbers of shares are also owned by corporations and FIs with important business ties to companies within a group, even if they are not themselves part of that group (Kester and Luehrman (1993: 445).

By "share interlocking", we mean that in a firm's issued shares, there exists a significant proportion of shares held by its transaction partners who consist of the FIs, insurance companies, customers, suppliers and trading companies. The firm also owns shares in them. Each firm typically has a large number of interlocks. Each interlock individually represents a minor parcel of shares, but collectively may contribute a majority of the firm's voting shares. Generally, the most prominent interlocking in terms of both, number of shares and market value is with the bank that would be recognised as the Main Bank of the firm. Market value of shares is equal to the number of shares multiplied by the average of high and low share prices during a period.
Table 2.3

Selected Cross Shareholdings in the Mitsubishi Group, 1990

<table>
<thead>
<tr>
<th></th>
<th>Mitsubishi Bank (%)</th>
<th>Mitsubishi Corp. (%)</th>
<th>Mitsubishi Heavy Industries (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mitsubishi Bank</td>
<td>–</td>
<td>5.0</td>
<td>3.6</td>
</tr>
<tr>
<td>Mitsubishi Corp.</td>
<td>1.7</td>
<td>–</td>
<td>1.6</td>
</tr>
<tr>
<td>Mitsubishi Heavy</td>
<td>3.0</td>
<td>3.2</td>
<td>–</td>
</tr>
<tr>
<td>Industries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total owned by</td>
<td>18.1</td>
<td>25.5</td>
<td>17.2</td>
</tr>
<tr>
<td>Mitsubishi group</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: (Kester and Luehrman (1993: 455).

Table 2.4

Percentage of Reciprocally Owned Shares in Japanese Industrial Groups, 1987

<table>
<thead>
<tr>
<th>Industrial Group</th>
<th>Percent reciprocally owned (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mitsui group</td>
<td>25.3</td>
</tr>
<tr>
<td>Mitsubishi group</td>
<td>24.5</td>
</tr>
<tr>
<td>Sumitomo group</td>
<td>24.5</td>
</tr>
<tr>
<td>Fuyo group</td>
<td>18.2</td>
</tr>
<tr>
<td>DKB group</td>
<td>14.6</td>
</tr>
<tr>
<td>Sanwa</td>
<td>10.9</td>
</tr>
</tbody>
</table>

Source: (Kester and Luehrman (1993: 456).

As mentioned above in the section on contractual relationship, the share inter-locking provides an insulation against TOs. In fact, the Main Bank does not allow an immediate TO of a company, because in this relationship-based structure, a long-term view is adopted, taking into account the interests of the shareholders, creditors, customers, suppliers and all other stakeholders in the company, rather than maximising period-by-period profit. The management is given a chance to correct the deficiency and TO is not taken as the immediate corporate reaction to indiscipline. Therefore disposing of the shares by the shareholders, in the face of a managerial inefficiency is technically not so easy in the Japanese model of CG. Here, the interests of the other stakeholders are also taken care of. In other words, a more subtle effect of cross-shareholding arrangements between transacting companies is to uphold the types of claims against the company by the various stakeholders like the key suppliers including the suppliers of credit, and major equity owners.

In this system, the individual ownership of listed Japanese corporations is small. This is shown in Table 2.2. Here, the shareholders play a passive role in the working of
the management and rely on FIs (mainly banks and insurance companies), which have large stakes in industrial companies, to monitor the companies on their behalf. Generally, these FIs leave the overall management of the firm to the incumbent managers. The large holdings of banks and insurance companies prevent big investors from "voting with their feet". Instead, these large investors are in close contact with companies, monitoring closely what the management are up to. If action is needed, it is normally restricted to the boardroom.

Complementary to this system of share-interlocking is the stable shareholding arrangements among the interlocked firms. A stable shareholder holds shares as

- a friendly-insider -- friendly and sympathetic to incumbent management;
- agrees not to dispose of the shares to third parties unsympathetic to incumbent management, particularly to hostile bidders or bidders trying to accumulate strategic parcels of shares. They generally do not sell their holding even under rising stock prices, unless they themselves are in financial difficulty, and/or the current management agrees;
- agrees in the event that disposal is necessary, to consult the firm, or at least, to give notice of its intention to sell.

Stable shareholdings influence the way in which CG operates in Japan. The CG mechanism through the stable shareholding arrangements rests with the (transacting) firms and not with the individual shareholders, in the way it does in USA or UK. The stable shareholding arrangements ensure that the individual shareholders are disfranchised from CG [10].

However, on the basis of the second and third points above, it transpires that the stable shareholders accept some restrictions on the exercise of property rights -- especially the rights of "voice" (i.e., corporate control) and "exit" (i.e., transfer of shares). The stable shareholders take a noninterventionist stance in corporate management.

However, in the Japanese CG, selective intervention -- directly and explicitly -- occurs from time to time, by one or more equity-holding stakeholders in the affairs of another company when necessary to correct a problem. Typically, such intervention is undertaken by a company's Main Bank. The Main Bank closely monitors the company's business and financial conditions and intervenes in times of nonperformance in the face of impending financial distress of the troubled company. This responsibility generally falls on the distressed company's Main Bank because it is usually the larger supplier of capital and has quicker access to more information than most other equity-owning stakeholders. It also typically holds both debt and equity claims against companies for which it acts as Main Bank. Apart from financial distress, Main Bank intervention may occur in times of dispute resolution, or sheer deal-making. Intervention is not limited to banks, however. Although less common, major industrial stakeholders sometimes intervene and take decisive steps to supplant an important supplier's or customer's autonomy with temporary de facto
administrative control when nonperformance becomes imminent (Kester and Luehrman (1993: 446)).

Thus the stable shareholding arrangements form a latent, inside corporate control coalition, who take a passive and non-interfering role in CG, thereby delegating considerable discretionary authority to incumbent management. This insider-based system of CG in Japan may be partially related to the employment system therein, which is based on lifetime employment (for the skilled male employees) especially in large corporations.

Takeovers — the Japanese Experience
The incidence of hostile TOs is low in Japan because of the factors already mentioned. Since the stakeholders including the employees adopt a longer time perspective, this system is expected to generate a longer time commitment to the company. Odagiri (1994) ascribes the Japanese phenomenon to that country’s lifetime employment system in large corporations. It is also due to the pattern of shareholding in Japanese companies is such that nearly 75% of a typical corporation’s shares are held in "friendly-hands", i.e., the corporation’s suppliers, subcontractors, and other stakeholders. With only about a quarter of the shares with the general public, it is unlikely that there will be much hostile TO activity.

The cross shareholdings among Japanese companies play a larger role in the governance process than as merely a signal of commitment to a long-term relationship. They also have the effect of creating a complex blend of claims held by two companies against one another. One important benefit derived from this tendency to hold a blend of different financial and other contractual claims against a company is to reduce the frictions that might arise among various stakeholder groups with separate and distinct claims. The incentives to breach contracts with suppliers and customers in the interests of transferring value to shareholders, or to borrow money and then take extraordinary risks that might benefit shareholders at the expense of lenders, are reduced when the injured stakeholders are the company’s own principal shareholders. Helping troubled companies work out temporary financial problems will also be easier when the principal providers of capital hold roughly comparable bundles of senior and junior, short-term and long-term claims against the company, conflicts of interest and free-riding problems are expected to be minimised (Kaplan (1997: 252).

The endogenous insulation from competition is however state-contingent. It holds as long as the firm is performing well, but in times of corporate failure (lack of managerial resources, financial crisis, etc.) an amicable intervention by the Main Bank can be expected. The Main Bank first tries to sort out the problem, especially if the dwindling of the fortunes of the company is due to some board imbroglio, and then takes recourse to Tos only as an ultimate device.

The Japanese system is thus crafted so as to prevent TOs unless the firm is performing badly, and then to have a TO -- bank intervention occur in a predictable way by an informed party. This is critically different from the AA system of CG which relates to open market TO of firms in states -- good or bad [11].
Critique
Professor Jensen has referred to the "agency costs of free cash flow" in the Japanese economy the manifestation of which, according to him, is the widespread, value-reducing, corporate diversification, as well as massive over-capacity in many industries. This he feels is due to the Japanese system's ineffectiveness in forcing its large, mature companies to return excess capital to investors through dividends and stock repurchases (dividends are minimal and stock repurchases were prohibited, until recently). The problems stemming from the CG in the Japanese (and German) economy are summarised as: overinvestment in declining industries, failure to abandon unprofitable activities and excessive insistence on growth and market share (Chew (1997: 2); Prahalad (1997: 54)). Managers have not paid sufficient attention to their investors -- in large part because Japanese capital markets have long been distorted by regulatory controls. This is also confirmed by a 1992 report on the Japanese economy by the Nomura Research Institute. The principal conclusions of this institute were (Chew (1997: 1):

* The declines in [Japanese] corporate earnings and share prices have by far exceeded those that would have been expected in a purely "cyclical" downturn, and the Nomura Research Institute has attributed such declines to a "structural" over-capacity stemming from lax investment criteria employed by Japanese companies.

* In addition to denying shareholders any means of effective oversight or control over their investment policies, Japanese companies also tend to compound the problem by retaining excess capital rather than returning it to shareholders in the form of higher dividends or share repurchases. Failure to pay out excess capital leads to inefficiency.

In short, excessive work force, excessive product proliferation, over-investment in declining businesses, unrelated diversification beyond organisational capabilities and mismanagement of corporate excess cash balances are the relatively commonly observed inefficiencies of business in Japan. A positive effect lies in the transactional efficiencies embedded in inter-corporate business among Japanese companies.

German Structure of CG
Although a part of Western capitalist organisations the CG of German corporations bears a close resemblance to the Japanese style. In fact German CG has more in common with Japanese CG than the A-A.

Composition of the Board of Directors
One of the unique features of German CG is the structure of its board of directors, with its two-tiered structure. Such a two-tiered governance system was created in the 1870s to give bankers an organ of control with which to oversee their investments (Kester and Luehrman (1993: 449). The publicly owned and listed German companies, known as Aktiengesellschaft (AG), have, by law (whenever number of employees exceed 500), two-tiered boards of directors -- the management board and the supervisory board that meet together quarterly.
The Vorstand or management board has day-to-day executive and operational authority over the company and is the real decision-making body on most matters. Typically, it has between 5 and 15 members who are full-time salaried executives of the company; 7 or 8 of them are top managers. They include the Chairman (equivalent to the CEO). Each member typically has a functional speciality and is responsible for a "portfolio" of businesses or administrative functions. However, the members are supposed to run the company by consensus.

Members of the Vorstand are appointed by the supervisory board -- the Aufsichtsrat -- for terms lasting 3 to 5 years. Reappointment is generally anticipated, unless nonperformance or other imperatives mitigate such action. No overlap in membership is allowed between the two boards. The Vorstand must report to the Aufsichtsrat and gain its consent for major financial and investment decisions.

The Aufsichtsrat is one of the more important safeguards embodied in the German system of CG. It is a true supervisory board, not an executive one. It is usually composed of 9 to 22 members (in larger public companies, the supervisory board will typically have 19 members). The "Aufsichtsrat" part of the German board of directors is similar to the "outside" directors of an American corporation [12], or the "non-executive" directors of a British corporation. An important difference, however, is that these German "outside" directors are more commonly drawn from the executive ranks of other major corporations or FIs that have a major stake of some sort in the company in question. That stake may be a substantial equity investment, a long-standing lending relationship, a vertical purchase or supply arrangement, or as in Japan, some combination of these varied claims. Alternatively, they may be representatives of wealthy families, or family foundations that are large stock-owners. Unlike British or American boards, they are not strictly disinterested experts in some field appointed to give their presumably objective points of view, or sheer status lenders. Instead, as a group, these directors tend to focus on the company's most important investor and business relationships.

The Aufsichtsrat of AGs also contains representatives of labour -- worker councils or trade unions. Under the German Co-determination Act of 1976, half of the supervisory board are required to be elected worker representatives (in coal and steel such representatives were first legally required already in the 1940s). At least one of them must be a member of the company's management. The other half of the board is elected by shareholders and consists entirely of members who are not full-time employees of the company.

The directors in Aufsichtsrat can, and from time to time, will exercise considerable influence in the shaping of corporate strategies through the composition of the Vorstand. It is not uncommon, however, to have retired company executives to the Aufsichtsrat. In fact, the chairman of the Aufsichtsrat is quite often the most recently retired chairman of the Vorstand.

In Germany, employees and shareholders nominally enjoy equal representation on the supervisory board. Aufsichtsrat chairs are usually shareholder representatives. Shareholder representatives on supervisory boards are often chosen for their ties to
German industry. The largest shareholders -- business corporations, insurance companies and banks -- have considerable representation on the supervisory board (Kester and Luehrman (1993: 450); Kester (1997: 235-238)).

**Share Ownership**

The influence of large German shareholders is exercised largely through the Aufsichtsrat. Because shares of most German corporations are held in bearer form, it is extremely difficult to document the ownership structure of German corporations. But evidence suggests that, as a group, large German companies engage in fairly extensive cross-shareholdings. According to reports of a study by the German Monopolies Commission, there were 88 cross-shareholdings among Germany's largest 100 corporations in 1984. FIs are especially large equityholders in German companies, second only to other business corporations. In fact, banks own a significant fraction of equity in German companies. For example, Germany's largest bank -- Deutsche Bank -- owns 28.1% of Daimler-Benz's stock. More broadly, German banks as a group own nearly 9% of all domestically listed shares of German companies and own more than 25% of at least 33 major industrial corporations. Insurance companies owned closer to 11% of such shares (Kester and Luehrman (1993: 450-451). Table 2.2 above shows the German share-ownership pattern.

**Position of Banks in German corporate board and its effect on CG**

Although legally responsible for representing shareholder interests at large, German Aufsichtsrat members are also responsible to act as de facto representatives of, and monitors for, other stakeholder interests. Bank executives on the boards of industrial corporations are especially well-positioned to act in this capacity. Thus banks enjoy a special position in German industry.

German corporations are inclined to finance with bank debt rather than equity. There are reasons for this. Germany has a historically deficient capital market and also an annual net asset tax on corporations (1% per annum). To the extent their banks lend to the corporation in question, the interests of creditors as well as shareholders are directly represented. By virtue of banks' extensive lending business and large equity stakes in the German Mittelstand (middle market), bank executives may also indirectly reflect the interests of smaller suppliers, customers and subcontractors that service the needs of the larger industrial corporations.

In addition to direct share ownerships German banks also act as depositories for stock owned by other classes of shareholders. This role as share depository has been quite important to German CG because of the ability of banks to vote shares held in deposit on behalf of the depositor, subject to some restrictions. This is known as Vollmachtstimmrecht. This right of banks of voting of shares held on deposit, gives them considerable effective voting power. Effectively, banks control half of German shares. German law has been amended to require that banks solicit voting instruction from shareholders whom they represent and renew the right of proxy for shares held on deposit every 15 months. In the event of a TO offer, banks must inform shareholders of pending bids only if the offer is published. Still, banks continue to enjoy substantial liberty in the voting of shares held on deposit (Kester and Luehrman (1993: 451)).
As with Japanese company-bank relationships, shares of stocks owned by banks are traded infrequently, if at all. In most cases, the equity-owning bank of a large industrial corporation will be one of its Hausbanks (comparable to Japanese Main Banks) with which it has a long history of banking business. A Hausbank would be a primary lender to a company and would often enjoy representation on the supervisory board or an equity position in the company. Supervisory board members from such banks are valued for their knowledge of business and economic conditions, as well as for their detailed knowledge of the company. In times of financial crisis, the Hausbank would tend to be more willing to aid the company than would other banks. As in Japan, shares owned by Hausbanks are seldom traded (Kester and Luehrman 1993: 451).

Contractual Relationship
Top management of large corporations are given a wide decision-making latitude virtually everywhere and as in Japan, the German corporations also tend to rely heavily on implicit relational contracting, and on different safeguards and dispute resolution processes to enforce adherence to agreements. Long-term lender-borrower relationships and bank ownership of equity characterise German CG pattern. In these respects it is similar to its Japanese counterpart. However, so far as the composition of the board of directors is concerned, German governance provides stronger safeguards against the moral hazards associated with information asymmetries than the Japanese system. Japanese boards tend to be heavily dominated by strictly inside managing directors. Retired executives of equity-owning stakeholders sometimes join these directors as "alumni" representatives of their former employers. German supervisory boards in contrast, are at least half-composed of salaried executives of the corporation's major institutional shareholders or other important stakeholders.

In many other respects, however, German contractual governance provides somewhat weaker safeguards for the preservation of long-term relationships. Although supervisory board representation is concentrated among a relatively small number of executives who sit on many boards, the sort of temporary personnel transfers at lower levels of management that are so common in Japan are not so common in Germany. Information sharing is less institutionalised in Germany than in Japan, where inter-company management and supplier organisations are commonplace (Kester and Luehrman 1993: 453).

Market for Corporate Control
The market for corporate control is also virtually absent in Germany, as in Japan. This has been attributed to the country's corporate culture, the 1976 Co-determination Act, employee representation on the corporate supervisory boards and the concentration of share ownership (Singh 1998: 188). The deterrent factors behind hostile TOs in Germany are supposed to be basically three in number -- they are special position of banks, government antitrust policy and the structure of corporations.

The major banks have extensive stock holdings in different companies, they control shares held on deposit and they write the rigorous guidelines on TOs (in fact, there are no statutory rules governing TOs in Germany, only guidelines rigorously enforced
by banks). As such, a TO would be virtually impossible without the support of banks. The TO guidelines require the bidder to inform appropriate stock exchanges of an offer, refrain from insider trading before publication of an offer, publish the terms of the offer and give those who may have accepted a lower bid for their shares the higher price in the event that a second offer is made.

The German Cartel Office must clear any bid if the new concern would have more than DM 2 billion in sales annually. Also, the Cartel Office has the power to review the merger and require divestment ex post.

Some other structural aspects of German corporations and corporate law impede TOs. Major changes to the corporation require 75% approval by shareholders, law prohibits golden parachutes and strict conflict-of-interest rules impede most would-be management buyouts. Because companies with more than 2000 workers have an equal employee and shareholder representation on the supervisory board, employee support is a necessary precondition to TOs (Kester and Luehrman (1993: 452).

Critique
Although the German CG structure is similar to Japanese CG particularly with respect to the maintenance of long-term lender-borrower relationships and bank ownership of equity, yet the German model provides weaker safeguards for the preservation of long-term relationships. One limitation cited is that information sharing is less institutionalised in Germany than in Japan.

2.4.4 Conclusion
Table 2.5 derived from Kaplan (1997: 252), brings out the major differences in CG systems of US, Japan and Germany, with respect to several characteristics. These differences in CG systems are generally associated with differences in managerial behaviour and firm objectives.

Table 2.5

<table>
<thead>
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<th>A Comparison of US, Japanese and German Governance Systems</th>
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<td><strong>Ownership</strong></td>
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<td><strong>Board of Directors</strong></td>
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<td><strong>Capital Markets</strong></td>
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<td><strong>Banking System</strong></td>
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<td><strong>Executive Compensation</strong></td>
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<td><strong>Takeover/Control Market</strong></td>
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One view (the popular one) (Aoki and Sheard (1994)) argues that the close financial
ties and relationships in Germany and Japan reduce agency problems and lead to
more (more, in comparison to US) effective monitoring of the managers by the
shareholders where managers do not face a constant threat of TOs. Changing poorly
performing managements through costly hostile TOs and proxy fights are avoided in
this structure and thereby agency costs lowered because banks and large shareholders
have the power to make changes, rather than going through the corporate control
market.

This has enabled them to pursue long-term investments rather than be concerned with
short term movements in share price or profits. In fact, Japanese and German firms
are less concerned with or affected by short-term earnings, and are better able than
US firms to manage for the long-term, i.e., invest in projects with long-term pay-offs.
The view assumes that current stock prices can diverge significantly from long-term
shareholder values. Because banks and large shareholders have both better
information and more power to use that information than the widely dispersed
shareholders of the A-A corporate system, financing is said to be more readily
available for value-increasing long-term projects in Germany and Japan.

An external market for corporate control is small, if not altogether absent. In contrast
to US, friendly acquisitions play only a minor role in Japanese and German
governance (in 1991, for example, there were 18 such TOs in Japan) and hostile TOs
play no role, despite relatively low levels of insider ownership (Sherman and
Babcock (1997: 267)).

Moreover, because of the long-term vision, the corporations in Germany and Japan
are able to invest in the training of their workforces. In other words, in a stable
corporate environment, with sparse hostile TOs, the workers have the necessary
incentives to undertake expensive investments in firm-specific human capital, the
implicit contracts of the Japanese and German workers are honoured, unlike in the A-
A structure.

An alternate view (Milgrom and Roberts (1992)) is that the German and Japanese
systems entrench managers and employees at the expense of shareholders. Banks,
allied with incumbent managers, may receive abnormally high fees or interest rates in
exchange for agreeing to bail out managers (and their companies) in cases of poor
performance and financial distress, even when it is not efficient to do so.

To sum up, a review of the existing literature on CG systems in developed countries
suggests that it is difficult to ascertain as to which system is the best. In fact the CG
system that evolves in any country is the output of country-specific socio-economic,
political and cultural factors. To this extent they may be different. But certain basic
principles of CG, namely the role of the board of directors or that of the institutional
environment, the financial structure, ownership pattern exist in all systems in
different degrees and forms in the way that each considers to be appropriate.
2.5 Summary

Nature
In the first section we have tried to identify the exact connotation of the concepts of mergers, acquisitions and TOs and study their similarities and differences. The distinction between mergers and TOs lies in the way in which these two types of amalgamations take place. Another broad difference between mergers and TOs is that the latter requires funds for the acquisition of one firm by another, while mergers usually take place by an exchange of shares of the merging firms with shares of the new legal entity. While the terms TOs, mergers and acquisitions all refer to a change in management, they differ in the form and manner in which this change is carried out. However, the general tendency seems to be that of using the concept of merger as a generic term, involving amalgamations of all sorts, -- acquisitions, TOs and mergers. In this study too, we subscribe to this practice. So far as the classification of mergers and acquisitions in terms of product profile is concerned, we have distinguished between horizontal, vertical and conglomerate mergers.

 Causes
The second section of this chapter concentrates on the presentation of an integrated view of the different causal forces generating mergers and TOs over time, as posed by different economists. As is evident from the analysis, it is not easy to assess the present state of economic theory relating to the causal factors triggering merger activity. No generally agreed theory has been developed. Instead, what is offered is a series of partial theories designed to provide explanations for particular types of merger in fairly specific circumstances, or concerned with merger activities at different levels of analysis. Given these limitations, what we have endeavoured in the aforesaid discussion, is to provide a synoptic view of the existing literature on the possible motives behind merger and TO activities.

In the course of our analysis, we have related the three methods of coalescing of firms with some of the various motives analysed in this section. Horizontal integration is generally resorted to for gaining economies of scale, increasing competitiveness and to reduce competition. Vertical mergers are entered into for achieving operational efficiencies through reliability of imports, better material control, gaining competitive power through controlling input prices and to create entry barrier in terms of scale, market and technology. Conglomerates mergers are intended to gain competitive and cost advantage through synergies. Also, diversification into unrelated business helps reduce the overall risk.
Consequences
In this section we have briefly reviewed the studies available in the economic literature regarding the effect of mergers. A large number of studies have been done from the profitability perspective where various indices of profitability have been taken as a measure of corporate performance. Also, stock-market performance has been taken as an indicator of post-merger performance of firms. Another theory of the performance of merger and TO activity found in the literature is that the source of the value increases in mergers is redistribution among the stakeholders of the firm. However, we have discovered that studying the effects of mergers on market concentration is relatively less frequent.

Corporate Governance
In the section on CG we have brought out the major differences in CG systems of US, Japan and Germany, with respect to several characteristics. These are ownership pattern, composition and responsibilities of the board of directors, the structure of the capital market facing the firms and the role of equity and debt therein, the nature of the banking system prevailing in the country, the norms regarding executive and employee compensation and the structure of the corporate control market and the position of mergers and TOs as effective mechanisms for corporate control. Two opposing views emerge from this survey. One is the Anglo-American position that emphasises the role of a virtually unregulated market for corporate control and prescribes the TO mechanism as the ultimate monitoring and disciplining force on incumbent management. On the contrary, the Japanese (and German) model of CG argues that the close financial ties and relationships in Germany and Japan reduce agency problems and lead to more (more, in comparison to US) effective monitoring of the managers by the shareholders where managers do not face a constant threat of TOs. Changing poorly performing managements through costly hostile TOs and proxy fights are avoided in this structure and thereby agency costs lowered because banks and large shareholders have the power to make changes, rather than going through the corporate control market.

In general, a detailed survey of the existing economic literature on mergers and TOs has been made in this chapter. We do not claim to have examined in this thesis, the contemporary mergers and acquisitions in India from all the positions and perspectives put forth in this chapter. Nor is it possible. However, we can at least claim that this chapter has been self-contained, to the best of our ability, comprising a thorough investigation of the thoughts developed so far on corporate consolidations.
NOTES AND REFERENCES

1. Market extension mergers denote a combination of firms whose operations had previously been conducted in non-overlapping geographic areas.

Refer to Weston, Chung and Hoag (1996): 733.

2. Historically, five separate axiomatic arguments concerning the nature of rational behaviour, underlie the traditional view that firms are profit maximisers:

(i) the assumption that there is something unambiguous and potentially measurable which we can term "profit" and which is assumed to be maximised;

(ii) the "black box" assumption, that a firm acts as an individual decision-taking unit, behaving in the same way that an individual entrepreneur would behave, or at least in a way not significantly different from an economic point of view. This is termed the "holistic concept of the firm"; it precludes the necessity for examining the internal aspects of the firm — its personnel, organisation, lines of communication, etc;

(iii) the assumption that the utility function of the firm as an indivisible decision-taking unit has only one variable in it, namely profit as unambiguously defined;

(iv) the assumption of rationality; a number of different concepts of rationality have been introduced into the literature of economics in recent years, but the normal conditions required for a decision-taker's behaviour to be described as rational are two-fold:

(a) the decision-taker can weakly order the states of the world which can arise from his decision. This requires first that he can decide whether he prefers A to B, B to A, or is indifferent between them, and second that all such preference relations are transitive (preferring A to B and B to C implies preferring A to C);

(b) the decision-taker aims to maximise the utility he obtains from his decisions as between different states of the world;

(v) the assumption of complete, certain information, or the known probability of revenues and costs leading to the expected values of profit to the firms.

These five assumptions logically entail the traditional picture of a holistic firm maximising profits under conditions of certainty.
Each component assumption seemed to be compatible to the observation of typical owner-controlled firms. In most cases, the assumptions were seen as uncontroversial abstractions of a very complex world, in order to highlight the main aspects. Increasingly, however, a major reason for using the holistic profit-maximising concept of the firm under certainty was its convenience. This had the three elements of simplicity, ease of handling mathematically and the absence of alternative assumption about firm’s behaviour.


3. Synergy may be of two types—operating synergy (or operating economies) and financial synergy. Operating synergy may be achieved in horizontal, vertical and even in conglomerate mergers, to some extent.

The operating synergy theory postulates economies of scale or of scope and that mergers help achieve levels of activities at which they can be obtained. The theory based on operating synergy assumes that economies of scale do exist in the industry and that prior to the merger, the firms are operating at levels of activity that fall short of achieving the potentials for economies of scale. It includes the concept of complementarity of capabilities.

Operating synergy could result from combining complementary activities as, for example, when one firm has a strong R&D team while the other firm has a more effective production control personnel, the two firms combined will complement each other and generate operating synergy. Managerial economies in production, research, marketing or finance are sometimes referred to as economies in the specific management functions. Economies can be achieved in generic management activity such as the planning and control functions of the firm. Numerous possibilities for the source of synergy have been suggested.

Operating economies arise because of indivisibilities, such as people, equipment and overhead, which provide increasing returns if spread over a large number of units of output. Thus, in manufacturing operations, heavy investment in plant and equipment typically produce such economies. For example, costly machinery such as the large presses used to produce automobile bodies requires optimal utilisation. The research and development departments of chemical and pharmaceutical companies often must have a large staff of highly competent scientists who, if given the opportunity, could develop and oversee a larger number of product areas. In marketing, having one organisation cover the entire country may yield economies of scale because of the increase in the ratio of calling-on-customer time to travelling time, which in turn is due to the higher density of customers who called on by the same number of salespeople.
Another area in which economies can be obtained is in vertical integration. Combining firms at different stages of an industry may achieve more efficient coordination of the different levels. The argument here is that costs of communication and various forms of bargaining can be avoided by vertical integration.

The financial synergy theory hypothesises complementarities between merging firms not in management capabilities, but in the availability of investment opportunities and internal cash flows. A firm in a declining industry will produce large cash flows since there are few attractive investment opportunities. A growth industry has more investment opportunities than cash with which to finance them. The merged firm will have a lower cost of capital due to the lower cost of internal funds as well as possible risk reduction, savings in flotation costs and improvements in capital allocation.

Financial synergy arises mainly in the case of pure conglomerate type mergers, where the applicability of the managerial synergy hypothesis raises doubt. One reason is that managerial capacity of a firm presumably will not grow so rapidly as to allow multiple acquisitions in a few years with the purpose of extending the acquirer’s managerial efficiency. Another is that managerial synergy is more relevant in the case of horizontal mergers since carry-over of managerial capabilities is easier in this case. Thus all conglomerate mergers may not be explainable in terms of operating synergies. It is not the case that in all conglomerate mergers, the acquired firm was managed less efficiently, prior to the merger. There must be something more or something different to it.

Among a number of financial theoretical propositions on conglomerate mergers in the relevant literature, the potentially most important proposition is based on the distinction between internal and external funds. The non-trivial transactions costs associated with raising capital externally and the differential tax treatment of dividends may constitute the condition for more efficient allocation of capital through mergers from low to high marginal returns production activities and provide a rationale for the existence of conglomerate firms. According to Williamson, if an earnings retention bias exists, and since assigning cash flows to their sources constitutes a serious investment restraint, the economy organised along conglomerate lines might well enjoy an advantage over the specialised firm economy. The earmarking of funds in the latter may result in delayed responses to the market signals and otherwise arbitrary allocations of investment. In the conglomerate firm economy, by contrast, cash flows from whatever source, are not automatically retained by the sectors from which these funds originate but are (ideally) assigned on the basis of prospective yields instead. The conglomerate acts in this respect as a miniature capital market; it internalises the funds metering function normally imputed to the capital market.
Another widely discussed proposition is that the debt capacity of the combined firm can be greater than the sum of the two firms’ capacities before their merger, and this provides tax savings on investment income.

Still another possible dimension is economies of scale in flotation and transaction costs of securities.


4. Companies raise capital from the market and the stock price acts as an approval rating. Information about the quality of a company's management as well as its accountability is built into share prices. If the management, as the agents of the shareholders, consistently performs below expectations, ie., fails to realise the value of their assets by raising and employing capital efficiently, the individual shareholders deem the management inefficient, the share price falls and in retaliation to the low dividends that they get, the individual shareholders sell stocks and exit. This causes a further fall in the price of shares, and making it profitable for a TO agent to purchase the shares cheaply, by acquiring majority shares, displace the existing management and implement positive changes in the firm's management.

5. Employee Stock Ownership Plan (ESOP) is defined as a contribution pension plan (stock bonus and/or money purchase) designed to invest primarily in the stock of the employer firm.

Poison Pill is any anti-TO defense which creates securities that provide their holders with special rights (e.g., to buy target or acquiring firm shares) exerisicable only after a triggering event (e.g., a tender offer for or the accumulation of a specified percentage of target shares). Exercise of the rights would make it more difficult and/or costly for an acquirer to TO the target against the will of its board of directors.

Staggered board is also called a classified board. It is an anti-TO measure which divides a firm’s board of directors into several classes only one of which is up for election in any given year, thus delaying effective transfer of control to a new owner in a TO.

Super-majority provision is a requirement in many anti-TO charter amendments that a change of control (for example) must be approved by more than a simple majority of shareholders; at least 67 to 90% approval may be required.

Refer to Weston, Chung and Hoag (1996: 734, 742, 745, 746).

6. Insider trading is trading on the basis of unpublished and non-public information. Insiders not just cause wide fluctuations in the price of the
securities but also undermine the trust of the investors in the capital market. It is observed that when investors find that the stock prices are rigged, they simply shy away from the market. Consequently, the corporate sector cannot mobilise the savings of small investors and the economy is deprived of the investment required for trade and industry.

According to the SEBI (Insider Trading) Regulations 1992, an offence of insider trading would be deemed committed, if an insider deals in the securities of a company, either on his own behalf or on behalf of any other person, on the basis of any un-published, price-sensitive information, or if he communicates such information to any other person, with or without his request. Even if the person counsels anyone else in dealing in securities of any company on the basis of such information, he will be deemed to have committed the offence of insider trading.

However, the SEBI (Insider Trading) Regulations 1992 have been enacted to check mal-practices and restore the confidence of average investors in stock market operations. The regulations provide for civil and criminal liability for a person found guilty of insider trading. The government has granted powers to the SEBI for investigating, prosecuting and fining upto Rs. 5 lakhs those found indulging in insider trading.

Refer to Kumar, N. (1995) "Dealing with the 'insider'", Economic Times 28 July.

7. Fama, following Alchian and Demsetz, subscribed to the view that the firm was simply a team of inputs bound by a set of contracts, without any locus of superior authority. He took as his model a joint-stock company in which equity is owned and consequently risk is borne by one set of persons and the management is vested in another set of persons who will not generally fully coincide with the first. In the words of Fama, “The firm is disciplined by competition from other firms, which forces the evolution of devices for efficiently monitoring the performance of the entire team and of its individual members. In addition, individual participants in the firm, and in particular its managers, face both the discipline and opportunities provided by the market for their services, both within, and outside of the firm.”

Jensen and Meckling acknowledged this notion and held that managerial discipline can be ensured and thus agency costs could be reduced through an effective functioning of the market for corporate control, through the instrument of corporate TOs. Since the A-A theory is based on similar spirit, they can be regarded synonymous.


8. Japanese corporations are well known for their tendency to engage in tight, long-term vertical relationships. Such relationships achieve their highest
expression in so-called “keiretsu“ — complex groups of companies, federated around a major bank, trading company, or large industrial firm. Japanese keiretsu tend to characterised by a great deal of stability in group affiliation and loyalty as far as the preferred status group members give each other in their business dealings. Some keiretsu, such as the Mitsubishi, Sumitomo, Mitsui and Fuyo groups are actually descendants of pre-World War II zaibatsu, which were much more tightly knit group of related companies centered around a common holding company. Mitsubishi Motors, for instance, is a member of the Mitsubishi keiretsu, the modern descendant of the pre-World War II Mitsubishi zaibatsu. Likewise, Toyota and Nissan lie at the centre of reasonably well defined industrial groups made up of suppliers, dealers, insurers, other types of service companies and so forth.

Companies belonging to keiretsu account for only one-tenth of 1% of all incorporated businesses in Japan. But group members are generally much larger than the median Japanese firm. They account for roughly a quarter of total sales and paid-up capital of all Japanese corporations and just over half of all listed corporations in Japan are members of an industrial group. Most of the Japanese competitors have group affiliations. Even those that do not are likely to have entered into various reciprocal shareholding and trade agreements with other Japanese firms.

Refer to Kester and Luehrman (1993: 444-5); Kester (1991: 54-5).

9. A necessary, almost definitional, condition of lifetime employment system to operate is that the firm must remain in operation as a viable entity. To the extent that the employees of the large Japanese firm expect to enjoy a long-term association with the firm, they must entertain the notion that the firm will be in a position to offer ongoing employment. On this basis, it should be hypothesised that the firm will organise itself in such a way that its continued existence is more or less guaranteed.


10. Lack of dominant individual shareholding in Japan makes it practically impossible for the individual shareholders to form a coalition or establish a majority with proxies to influence management decisions. The cost of disseminating relevant information to the shareholders, persuading them and reaching agreements with them is larger, the more the share ownership is dispersed among small investors. The benefit of doing so, is on the contrary, smaller, the smaller is the share owned by each investor, for he will receive only the fraction equal to his share in the firm, of the benefits of the higher profits expected from such a move.

Refer to Grossman (1980: 42-64).

11. A firm is supposed to be in a good state when it is performing well, i.e., where there is more scope for appropriating rents and where it is most profitable for
an external party to do so. On the other hand, from this point of view, firms performing badly are in bad state. Bad state threatens the viability of the firm as an ongoing organisation and is most indicative of a signal in the sense of changes being required in the management.

12. In the US, the firm is governed by a board of directors of typically 13 or 14 members. Approximately one-third of them are insiders and two-third are outsiders. The CEO is the most powerful of the managers and directors. The executive directors are the operating managers who are also on the board of directors. This group typically includes 4 or 5 members and it always includes the CEO.

Refer to Kaplan (1997: 253).