Fordham Law Review

Volume 61 | Issue 1 Article 13

1992

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Recommended Citation

Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts On Harmonizing the European Corporate Governance Environment*, 61 Fordham L. Rev. 161 (1992).

Available at: https://ir.lawnet.fordham.edu/flr/vol61/iss1/13

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Cover Page Footnote

I am grateful to William Bishop, John Coffee, Jeffrey Gordon, Joseph Grundfest, Tim Jenkinson, Colin Mayer, Charles Sabel, Myron Scholes and to participants at the Brussels Take-over Symposium, the European Science Foundation Workshop on Corporate Control and Corporate Restructuring, and the New York University School of Law Faculty Workshop, for helpful comments on an earlier draft of this Essay.

ESSAY

THE POLITICAL ECOLOGY OF TAKEOVERS: THOUGHTS ON HARMONIZING THE EUROPEAN CORPORATE GOVERNANCE ENVIRONMENT

*RONALD J. GILSON**

INTRODUCTION

ECONOMIC policy debate in the United States during the 1980s focused on the dynamics of bidder and target tactics in hostile takeovers. Confronted with the largest transactions in business history, financial economists took advantage of developments in econometric techniques to conduct virtually real time studies of the impact on firm value of each new bidder tactic and target defense.[1] For courts and lawyers, hostile takeovers subjected standard features of corporate law to the equivalent of a stress x-ray, revealing previously undetected doctrinal cracks. Congress held seemingly endless hearings on the subject, although managing to enact only relatively innocuous tax penalties on particular defensive tactics the public found especially offensive.[2] State legislatures, closer to the political action, acted more substantively, if less wisely. Whether or not takeovers created new wealth they did result in its transfer, and at least one of the parties from whom wealth was transferred—target management—had remarkable influence in state legislatures.[3] When labor also came actively to oppose hostile takeovers, the coalition was virtually unstoppable. The decade saw some thirty-four states pass more than sixty-five major laws restricting corporate takeovers, including states discouraging partial offers and front-end loaded offers.[4]

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1. *See, e.g.*, Paul H. Malatesta & Ralph A. Walkling, *"Poison Pill" Securities: Stockholder Wealth, Profitability and Ownership*, 20 J. Fin. Econ. 347 (1988) (sample of 118); M. Megan Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. Fin. Econ. 313 (1987) (sample of 44).

2. *See, e.g.*, I.R.C. §§ 280G, 5881 (1988) (golden parachutes and greenmail).

3. *See* Mark J. Roe, *Takeover Politics*, Brookings Discussion Paper in Economics No. 91-4 (Sept. 1991); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457 (1988).

4. State antitakeover statutes are categorized in Jonathan M. Karpoff & Paul H.

The 1980s have now closed transactionally as well as chronologically. The first quarter of 1991 marked the lowest level of merger and acquisition activity since the first quarter of 1980.[5] The passing of this remarkable decade invites a broader perspective, which can be helpfully thought of as the political ecology of takeovers. An ecological perspective builds on the proposition that phenomena are embedded in interactive systems—a rich web of mutually dependent relationships. Thus, a seemingly independent event cannot be fully evaluated without understanding how it relates to the environmental forces to which it was a response and which, in turn, respond to it.[6] What the narrow focus of the 1980s debate missed was an appreciation of the complex economic corporate governance and political environments in which hostile takeovers are embedded. Corporate acquisitions are a response to real conditions in the economic environment. The choice among acquisition techniques, most importantly between friendly and hostile transactions, depends both upon the economic motivation for the transaction and upon conditions in the corporate governance environment. Finally, conditions in the corporate governance environment are directly influenced by politics; both what is allowed and prohibited is defined, in the first instance, by legislation.

My goal in this article is two-fold. I begin by sketching the political ecology of takeovers in the United States—the interaction of economics, corporate governance and politics that shaped the experience of the 1980s. I then make a tentative effort at applying the insights gained from an ecological perspective to the current endeavor to change dramatically the European corporate governance environment through the harmonization of takeover and company law in the European Community. Sheltered by the cloak of political naivete commonly allowed those attempting comparative analysis from a distance, I will argue that an ecological understanding of takeovers suggests a different approach than that reflected so far in the debate over the terms of harmonization. This approach is based on what I term the "mutability principle."

Part I outlines a simple model of the economic function of corporate takeovers as an equilibrating mechanism that takes effect when environmental change alters the efficient boundary of the firm. Part II describes the political ecology of takeovers in the United States during the 1980s. Recent empirical studies are drawn upon to demonstrate how the economic, corporate governance and political environments influence acquisition techniques. Part III then draws on developments in the ecology of

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Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. Fin. Econ. 291 (1989). A recent Pennsylvania statute penalizes even those who attempt a proxy fight and lose. The legislation subjects their profits to disgorgement for 18 months if the proponents had a 20% stock interest. *See* 15 Pa. Cons. Stat. Ann. §§ 2571-2576 (1992).

5. *See Merger Deals Take A Dive*, S.F. Chron., Apr. 16, 1991, at C2.

6. For economists, I suppose the comparison is between partial and general equilibrium analysis.

natural systems to highlight the single dominant characteristic of the political ecology of takeovers—constant and pervasive change. This characteristic, in turn, suggests the mutability principle as an organizing principle for harmonizing European takeover law. Part IV applies an ecological perspective and the mutability principle to comment on current efforts to harmonize European takeover law and offers a somewhat different, albeit politically naive, approach. Part V anticipates two objections to a mutability-based approach to harmonization, namely that: (1) the mutability principle is only the British model in disguise; and (2) that it operates to restrict beneficial regimes of implicit contracts.

I. A Simple Model of the Economic Role of Corporate Takeovers

An ecological perspective on takeovers begins with a simple model of their economic role. This model builds on the insight, originating with Ronald Coase[7] and developed most extensively by Oliver Williamson,[8] that ownership of productive assets—the efficient boundary of the firm—is determined at any time by existing technology, both industrial and transactional. While this approach traditionally animates explanation of why particular transactions are undertaken within a firm rather than across a market,[9] I want to shift the inquiry slightly to focus on the location of the asset used for the transaction and the process by which the particular asset or activity comes to be owned or undertaken by a particular firm.[10]

The model begins in period one with the economy in organizational equilibrium. At this stage all assets are owned by the entity that can most efficiently use them, conditioned upon existing and expected industrial technology and the transaction costs associated with shifting assets to a different entity, or restructuring an existing entity. Between periods one and two an unanticipated shift in technology occurs. This change may, for example, create economies of scope between previously unrelated activities,[11] or simply reduce the transaction costs of combining related activities. Corporate acquisitions occur in period two. The notion

7. *See* Ronald H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937), *reprinted in* Ronald H. Coase, The Firm the Market and the Law 33 (1988).

8. *See* Oliver E. Williamson, The Economic Institutions of Capitalism (1985).

9. *Id.* at 3-4.

10. The shift is more one of emphasis than of substance. Asking whether a transaction takes place within a firm or across a market is essentially identical to asking what entity owns the asset necessary to produce the object of the transaction. If the production assets are all owned by a single firm, the transaction takes place within a firm. If, on the other hand, the assets necessary to produce the object are owned by more than one firm, part of the production process will take place across a market.

11. To take a currently popular example, imagine that a technological change creates economies of scope between the manufacture of entertainment hardware, like video cassette recorders, and the production of entertainment software like movies. Sony then acquires Columbia Pictures and Matsushita acquires MCA.

is simply that of a dynamic market in organizational form. When technology changes the efficient boundary of the firm, a response is initiated.

From this perspective, the market for corporate control is an equilibrating process that reshuffles ownership of assets to the entity that, as a result of technological change, now values them more highly. Hostile takeovers are simply a subset of corporate acquisitions in which management of the acquiring and target companies differ about the efficient boundary of the target firm.[12] As a stylized example of the model that is consistent with the emerging data, imagine an equilibrium in which conglomerate organizations survive because of the high costs of shifting their assets to more focused and efficient uses, including management's defense of its empire and the difficulty of financing a challenge to take control of such large organizations. A technological change then occurs, such as financing becoming available to a new class of break-up entrepreneurs who profit by brokering the movement of conglomerate assets to more focused users.[13]

In this model, corporate acquisitions operate as a dynamic response to environmental change.[14] Such adaptive mechanisms are a critical part of an economic system. In their absence, the system will be at a disadvantage with respect to competitors better suited to respond to changed conditions.[15] Focusing on the dynamic role of corporate takeovers leads naturally to an examination of the factors that shaped the particular pattern of takeovers transpiring in the United States during the 1980s. Put differently, what was the political ecology of takeovers?

II. THE POLITICAL ECOLOGY OF TAKEOVERS IN THE UNITED STATES: THE 1980S

The model of corporate takeovers as an equilibrating mechanism

12. Of course, that difference also may reflect agency problems within the target firm; that is, target management or other stakeholders may prefer to retain the now inefficient existing boundary of the firm to protect their rents. In that case, the firm's boundary is determined by transactional, rather than productive, technology.

13. *See, e.g.*, Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, Brookings Papers On Economic Activity: Microeconomics 1990, at 1 (concluding that the gains in hostile takeovers stem from splitting up diversified companies); Amar Bhide, *The Causes and Consequences of Hostile Takeovers*, J. Applied Corp. Fin., Summer 1989, at 36, 52 (same); Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. Fin. 31, 47 (1990) (providing evidence consistent with the view that "the source of bust-up gains in the 1980s is the reversal of the unrelated diversification of the 1960s and the 1970s and hostile bust-up takeovers simply undo past conglomeration").

14. *Cf.* Richard E. Caves, *Corporate Mergers in International Economic Integration*, *in* European Financial Integration 136 (Alberto Giovannini & Colin Mayer eds., 1991) (applying similar model to explain the incidence of transnational acquisitions).

15. This model need not conflict with the somewhat metaphorical characterization of the market for corporate control as a contest between competing management teams. *See* Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983). As presented here, technological change triggers the contest and the management teams are merely the medium, not the message.

posits that the character of corporate acquisitions is shaped by interactions between the economic, corporate governance and political environments. First, corporate acquisitions emerge at a particular time in response to technological changes in the economic environment. Second, the acquisition form chosen from among those available in the corporate governance environment, also will be influenced by the economic environment with different techniques being better suited to different economic changes. Finally, the political environment will influence acquisitions by affecting the range of acquisition techniques made available in the corporate governance environment. This section reviews the empirical support for the posited interrelations.

A. *Empirical Evidence Concerning Corporate Acquisitions as a Response to Economic Change*

The most familiar account of corporate acquisitions as a response to changes in the economic environment depicts the life cycle of the conglomerate in the United States. The 1960s and early 1970s saw a wave of unrelated acquisitions by American companies that changed the face of American business.[16] From 1959 to 1974, the percentage of Fortune 500 companies with a single business dropped from 22.8% in 1959 to only 14.4% in 1974.[17] In contrast, "unrelated business" companies—those without a dominant business—dramatically increased in importance, representing 7.3% of the Fortune 500 in 1959 and 20.7% in 1974.[18]

The rationales for the conglomerate strategy were varied. At the managerial level, management skills were said to be generic, meaning that a talented management team could effectively direct the operations of any business. Thus, an acquisition strategy emerged that contemplated skillful central office managers coordinating the production activities of diverse operating units.[19]

The conglomerate strategy also was justified for financial reasons. Oliver Williamson saw conglomerate acquisitions as a response to an innovation in organizational technology—M-form management.[20] The claim was that resource allocation among diverse activities is better carried out internally by a central office than externally by the capital market because of savings on information costs and opportunism.[21] Financial jus-

16. *See, e.g.*, David J. Ravenscraft & F. M. Scherer, Mergers, Sell-Offs, and Economic Efficiency 20-55 (1987); Malcolm S. Salter & Wolf A. Weinhold, Merger Trends and Prospects for the 1980s, at 2-27 (Graduate School of Business Administration, Harvard University, 1980).

17. *See* Richard P. Rumelt, *Diversification Strategy and Profitability*, 3 Strategic Mgmt. J. 359-61 (1982) (Table 1).

18. *See id.*

19. Malcolm S. Salter & Wolf A. Weinhold, Diversification Through Acquisition 40-41 (1979).

20. *See* Williamson, *supra* note 8, at 273-97; Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. Econ. Literature 1537 (1981).

21. *See* Williamson, *supra* note 8, at 273-97.

tifications also included the benefits of portfolio diversification at the firm level, as well as the benefits of co-insurance in the face of risky bankruptcy.[22] Acquisitions were an equilibrating response to this innovation. They were a means by which the boundary of the firm was expanded to internalize the capital market, to diversify or to coinsure.[23]

The organizational experiment implemented by conglomerate acquisitions proved largely unsuccessful in practice. Using accounting data, Ravenscraft and Scherer sought to measure the success of conglomerate acquisitions directly by determining whether target company performance improves following the acquisition. Their study found that the post-acquisition earnings of the targets in conglomerate acquisitions of the 1960s and 1970s did not increase.[24] The promised improvement in operating performance simply did not occur.

Other studies attempted to measure performance indirectly by examining the acquiring company's actions subsequent to the acquisition, seeking to determine whether acquiring companies behaved as if their conglomerate acquisitions were successful. Michael Porter investigated the track record of thirty-three large United States companies' efforts at diversification over the period from 1950 to 1975. Put simply, he found it "dismal."[25] Porter reports that when a company entered an unrelated line of business by acquisition prior to 1975, 74.4% of the acquisitions were subsequently divested. Kaplan and Weisbach report similar results for a much larger sample composed of 271 acquisitions valued at more than $100 million that occurred between 1971 and 1982. By the end of 1989, acquiring companies had divested approximately 44% of their acquisitions. Strikingly, the divestiture rate was almost four times higher when the target company was not in a business related to those of the acquiring company.[26]

22. These justifications for conglomerate acquisitions are surveyed in Ronald J. Gilson, The Law and Finance of Corporate Acquisitions 341-360 (1986); George J. Benston, Conglomerate Mergers: Causes, Consequences, and Remedies 31-34, 45-49 (1980).

23. These motivations were reinforced by the antitrust enforcement policy of the period which vigorously and successfully contested horizontal and vertical acquisitions but was much less successful in blocking conglomerate mergers. *See* Andrei Shleifer & Robert W. Vishny, *Takeovers in the '60s and the '80s: Evidence and Implications*, 12 Strategic Mgmt. J., Special Issue, Winter 1991, at 51, 51, 52, 55, 58.

24. Ravenscraft & Scherer, *supra* note 16, at 75-122.

25. Michael E. Porter, *From Competitive Advantage to Corporate Strategy*, 87 Harv. Bus. Rev., May-June 1987, at 43.

26. Steven Kaplan & Michael S. Weisbach, Acquisitions and Diversification: What is Divested and How Much Does the Stock Market Anticipate (Simon Graduate School of Business Administration, University of Rochester Working Paper No. MERC 90-02, 1990). When the acquisition was unrelated, that is, the acquiring and target companies' four most important lines of business did not share one three digit standard industrial code—divestiture occurred over 58% of the time. *See id.* at 10. When the acquisition was related, that is, the acquiring and target companies did share one three digit code line of business, divestiture only occurred approximately 16% of the time. *See id.*

Empirical investigation also reveals that the portfolio effects of conglomerate organization were disappointing. A survey of the literature appears in Gilson, *supra* note 22, at 345-52.

By the 1980s, the market seemed to have figured out the problem. While it is by now a familiar empirical finding that acquiring firms on average do not earn abnormal returns in connection with an acquisition,[27] a more interesting picture appears when the sample of acquiring firms is disaggregated into those acquirors making acquisitions of related businesses and those making conglomerate acquisitions. The related acquirors earn statistically significant positive abnormal returns of 2.38%, while conglomerate acquirors earned negative abnormal returns of 1.89%.[28] Both the absolute difference between the experiences of the subsamples and its statistical significance were more pronounced in the 1980s than in the 1970s.[29]

The failure of the conglomerate movement of the 1960s and 1970s set the stage for the divestiture movement of the 1980s. Innovation in the first round, albeit ultimately unsuccessful, moved assets from focused to diversified entities. The perceived efficient boundary of the firm expanded. The rediscovery of specialization in the second round moved assets back to more focused organizations.[30] The efficient boundary of

27. For surveys of the empirical literature, see Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 Stan. L. Rev. 597 (1989); Gregg A. Jarrell & Annette B. Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, Fin. Mgmt. Autumn 1989, at 12; Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, J. Econ. Persp. Winter 1988 at 49, 49; Jensen & Ruback, *supra* note 15.

28. Morck et al., *supra* note 13, at 42.

29. *See id.*; Shleifer & Vishny, *supra* note 23, interpret this evidence as raising a serious question concerning market efficiency. Acquirors seem not to have been penalized for making conglomerate acquisitions in the 1960s and 1970s, and there is some evidence that the market, in fact, rewarded such acquisitions in this period. *See* John G. Matsusaka, *Takeover Motives During the Conglomerate Merger Wave* (University of Southern California Working Paper No. 91-33, 1991). How then, Shleifer and Vishny reason, could an efficient market get it so wrong in the 1960s and 1970s, but right in the 1980s? The analysis depends on what is meant by efficiency. While the data indicates the market was wrong in the earlier period, it was inefficient in only what one might call a "super-strong" form: that market price accurately predicts future values. However, the data is not inconsistent with the more familiar concept of efficiency—that market price is the best unbiased estimate of future values. The latter does not imply ex post accuracy. Where the information set changes—the conglomeration theory proved wrong—prior estimates will turn out to have been wrong. How this relates to current debates about fads or bubbles is unclear. Not all business strategies that turn out not to work should be considered fads. Such an ex post test reduces the concept of fad to a tautology—what does not work ex post must have been a fad ex ante.

30. *See, e.g.*, Bhagat et al., *supra* note 13, at 34-44. The authors find that two-thirds of the hostile acquisitions of more than $50 million between 1984 and 1986 involved either complete or nearly complete "bust-ups" of diversified companies. *See id.* Of the assets divested following these acquisitions, 70% went to buyers already operating in the relevant industry. Only 8% went to unrelated buyers.

Robert Comment & Gregg A. Jarrell, Corporate Focus and Stock Returns (Simon Graduate School of Business Administration, University of Rochester Working Paper No. MERC 91-01, 1991), documents the reversal during the 1980s of the move toward diversification in the 1960s. While Rumelt, *supra* note 17, reported a sharp drop in the number of single business Fortune 500 firms between 1959 and 1974, Comment and Jarrell report that the number of single business exchange-listed firms increased from 35.6% in 1978 to 54.3% in 1988. Comment & Jarrell, *supra*, at 7.

the firm retracted. In both cases, corporate acquisitions operated as a means by which organizational equilibrium was achieved following innovation.

B. *The Link Between the Corporate Governance and Economic Environments: Empirical Evidence on Economic Motives for Acquisitions and Acquisition Techniques*

The conglomeration/deconglomeration story also illustrates a second ecological interrelation—that between the change in the economic environment to which an acquisition responds and the acquisition technique observed within the corporate governance environment. Conglomerate acquisitions presented no serious threat to target management regardless of the underlying efficiency explanation. Target management was expected to continue to run the target's operations, but now with the benefit of the conglomerate's central office expertise. Internalization of the capital market through M-form organization would provide the target company and target management better access to capital. Diversification at the company level and the co-insurance effect would redound to the personal benefit of target management by reducing the risk of their investment in firm-specific human capital.[31] Conglomerate acquisitions posed no hazard to target management and offered a premium for target shareholders. It is no surprise, therefore, that virtually all conglomerate acquisitions during this period were friendly transactions.[32]

It is also no surprise that the deconglomeration process was characterized by a very different acquisition technique. Some companies, like many of those in the Porter and Kaplan and Weisbach samples, ultimately recognized that diversification had not succeeded and voluntarily divested their unsuccessful acquisitions. For these companies, internal monitoring proved sufficient to identify the problem and initiate a response. From an ecological perspective, however, the more interesting companies were those for whom internal monitoring proved unsuccessful. These were companies whose management chose to maintain the company's expanded boundary which was "efficient" only because of the high transaction costs of forced divestiture.

For these companies, an innovation in the capital market in the 1980s changed the efficient boundary of the firm by lowering the barriers to hostile takeovers, principally through the development of a widespread market for junk bonds. As a result, would-be acquirors, who in the past

31. *See* Gilson, *supra* note 22, at 360-70. While diversification at the firm level through conglomerate acquisitions cannot help shareholders, who can diversify on their own, managers typically cannot diversify their human capital. Diversification at the firm level serves this purpose for management.

32. This outcome was also affected by the fact that, until Morgan Stanley assisted International Nickel in its 1974 offer for Electronic Storage Battery, no major investment banking firm would assist a hostile acquiror. *See* Ron Chernow, The House of Morgan 598-602 (1990).

did not have access to substantial amounts of financing, were able to secure the funds to acquire and dismember a typically much larger target. The acquisition strategy of these acquirors did not contemplate operating the bulk of the target company's businesses themselves. Rather, the plan was to sell off the target in pieces. Each business would go to that purchaser who, because it offered the highest price, presumably could operate the business most efficiently. The proceeds of these sales would then be used to pay down the debt incurred in the transaction. The acquiror's function was in part brokerage—facilitating the transfer of some of the target's businesses to other operators—and in part traditional—keeping and operating those businesses which the acquiror believed it could improve.[33] A hostile takeover was necessary precisely because those companies that were inclined to refocus their operations could have done so voluntarily. Tautologically, the mechanism of a hostile takeover as a remedy for inefficient conglomeration was necessary only when a conglomerate's management declined to act voluntarily. In ecological terms, particular innovations in the economic environment, namely the recognition that conglomeration did not work and the advent of junk bond financing, fed back into the corporate governance environment and dictated a particular acquisition technique—the hostile takeover.

Emerging data concerning corporate acquisitions in the 1980s are consistent with this story. Amar Bhide examined the motives and consequences of the 47 hostile takeovers involving more than $100 million that were attempted in 1985 and 1986, and then compared that sample to a randomly selected control group of friendly acquisitions that occurred over the same period.[34] The results showed a striking difference between the economic motivations of the acquiror in hostile and friendly acquisitions. Two-thirds of the hostile acquirors expected the bulk of the gain from the transaction to come from restructuring the target's business, while only 17% of the acquirors in friendly transactions had similar plans.[35] Bhide also found the predicted difference in the character of the acquiror. In over 70% of the friendly acquisitions, the central figures in the acquiring company were "professional managers." In contrast, over two-thirds of the key individuals in the hostile acquisitions were a new breed of takeover entrepreneur.[36] A similar link between the nature of the disturbance in the economic environment and the governance technique that operates as an equilibrating mechanism also appears in a setting that parallels that of the conglomerate. Morck, Shleifer, and Vishny

33. In Pantry Pride's acquisition of Revlon, for example, the purchase price of $1.7 billion (financed in part by $725 million in junk bonds) was partially recovered by the sale of Revlon's prescription pharmaceutical business for $690 million, its Norcliff Thayer, Reheis, and Beecham subsidiaries for $395 million, and its Technicon subsidiary for $300 million. *See* Martin Lipton, *Corporate Governance in the Age of Finance Capitalism*, 136 U. Pa. L. Rev. 1, 11 n.40 (1987).

34. *See* Bhide, *supra* note 13, at 41.

35. *Id.* at 43.

36. *Id.* at 44.

examined the circumstances involved when a company's poor performance leads to an internal governance response where the incumbent board replaced operating management, as opposed to the external governance response of a hostile takeover.[37] Tracking a sample of 454 of the 1980 Fortune 500 companies over the period 1981 to 1985, the authors conclude that an internal governance response is more likely when a company performs poorly compared to industry competitors regardless of the health of the industry.[38] Hostile takeovers, on the other hand, are more likely where poor performance was industry-wide.[39]

The pattern that emerges is one in which resort to different acquisition techniques in the corporate governance environment is associated with different changes in the economic environment. In particular, hostile acquisitions appear to be associated with paradigm changes concerning the nature of a target company's business.[40] For now, however, characterization of the link between a particular change in the economic environment and the response in the governance environment that follows is less important than the fact that the link exists. This linkage, in turn, brings us to the third element of the political ecology of takeovers—the political environment.

C. *The Link Between the Corporate Governance and Political Environments: Empirical Evidence on the Politics of Acquisition Techniques*

To this point I have made three arguments: (1) that the efficient boundary of the firm is technologically determined; (2) that corporate acquisitions are best understood as an equilibrating response to technological changes that alter the efficient boundary of the firm; and (3) that the particular acquisition technique employed is influenced by the character of the technological change that initiated the process. I want to close the outline of the political ecology of takeovers by describing a further relationship that plays an important role in the political ecology of

37. *See* Randall Morck et al., *Alternative Mechanisms for Corporate Control*, 79 Am. Econ. Rev. 842 (1989).

38. *Id.* at 843.

39. *See id.* at 852.

40. In other circumstances, the change in economic environment dictates a friendly transaction. For example, there have been few hostile acquisitions of high technology companies. In such companies, human capital is a critical asset. Human capital, unlike industrial capital, is difficult to transfer. One can acquire ownership of a steel plant by acquiring the stock of the entity which holds legal title to the plant. Acquiring talented employees, in contrast, requires their consent. Structuring a transaction to provide target employees the necessary incentives to transfer their human capital to the acquiror typically requires cooperation between the acquiring and target companies that is impossible in a hostile setting. General Motors' acquisition of EDS is a good example. Creating a separate class of GM stock as consideration for EDS employees shareholders and providing EDS employees with a put on those shares that would be lost if the shares were sold or the employees left EDS—a structure designed to facilitate the effective transfer of the employees' human capital—would have been very difficult in a hostile transaction.

takeovers—that between the corporate governance and the political environments. The point simply is that the corporate governance environment—the range of available internal and external techniques for monitoring the performance of management and altering control over the corporation's assets—is dramatically influenced by politics. Governance techniques are either provided, tolerated or prohibited by law, which, in turn, is the product of the legislative process. To be sure, politics does not get the last word. Even when forces in the political environment act to restrict the availability of a particular governance technique, the economic and corporate governance environments respond, devising more or less effective substitutes for the restricted technique. But it would be a serious error to suppose that the political environment has no influence. Substitutes are rarely perfect, and the costs and delay imposed by the political process can often cause substantial changes in the outcome of market processes.

Mark Roe has most thoroughly mapped the interaction between politics and corporate governance, both broadly with respect to internal versus external monitoring of management and, more narrowly, with respect to the range of available acquisition techniques.[41] Taking as his task the explanation of the dominance in the United States of large corporations characterized by "concentrated management, and dispersed, diversified stockholders [that] shift[ ] corporate control from shareholders to managers,"[42] Roe rejects the simple Darwinian theory that "the large public firm evolved as the efficient response to the economics of organization."[43] Noting that Japan and Germany developed successful governance systems that center on large shareholders, typically banks, exercising continual monitoring of management, Roe stresses the influence of politics on corporate governance. American politics, fearing the concentration of power on Wall Street, imposed legal limits on the activities of financial intermediaries that made a Japanese or German style system impossible. In Roe's analysis, American "[c]orporate history can be seen as an effort to find substitutes for the direct monitoring that politics disallowed."[44] Put in slightly different terms, American politics dic-

41. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991).

42. *Id.* at 10.

43. *Id.*

44. Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. Fin. Econ. 7, 35 (1990). Some disagreement exists among commentators over which politically imposed restrictions account for the limited role of American banks in the corporate governance environment. Roe argues that many laws contributed to the result. *See id.* at 9-11. Joseph Grundfest stresses the separation of commercial and investment banking and restrictions on equity ownership by financial intermediaries. *See* Joseph A. Grundfest, *Subordination of American Capital*, 27 J. Fin. Econ. 89 (1990). In contrast, John Coffee notes that Japanese banks operate under restrictions similar to those in the United States, and that German banks nonetheless do not hold significantly larger equity stakes than would be allowed under U.S. regulation, despite not being subject to comparable regulation. *See* John C. Coffee, Jr., *Liquidity Versus Control: The*

tated external monitoring of corporate governance through the capital market as opposed to internal monitoring through financial intermediaries.[45]

Shifting his attention to the takeover movement of the 1980s, Roe recounts the managerial response to the innovation in the corporate governance environment involving junk bond-financed bust-up takeovers that altered the efficient boundary of the firm.[46] He argues that management "struck back in the political arena. By calling for political reinforcements, managers won [through enactment of antitakeover laws] in state-by-state political combat what they could not win [from] shareholders. They won freedom, nearly complete, from takeover."[47]

As with the link between the economic and governance environments, the emerging empirical evidence also supports a link between the political and governance environments.[48] If political action reduces the likelihood of takeovers by changing corporate governance rules, enactment of state antitakeover laws should be associated with negative abnormal returns for affected firms. Alternatively, because individual corporations can adopt their own antitakeover rules by shareholder vote, political action may have no measurable impact on the corporate governance environment. The data demonstrate that politics matter. The most recent studies of state antitakeover legislation show that companies that had adopted no firm-level defenses, presumably because shareholders would not approve them, experienced statistically significant negative abnormal returns of almost 4% on state enactment, companies that had previously

Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1313-14 (1991). Coffee argues that the influence of Japanese and German banks is accounted for by the fact that a few large banks were able to meet the capital needs of business, thereby assuring their influence. *See id.* at 1286-87. The politics of federalism in the United States, however, favored local over money-center banks, which kept banks too small to play that role. *See* Roe, *supra*, at 27. The difference is one of emphasis rather than direction. For purposes of my argument, both sides agree concerning the importance of the political environment in shaping the corporate governance and economic environments.

45. From the perspective of political ecology, politics has also influenced the Japanese and German corporate governance environment. As Reinier Kraakman and I have pointed out elsewhere, "which institution substitutes for which depends on your perspective." Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863, 879 n.56 (1991). While Roe characterizes takeovers as a substitute for the banker model in the United States, *see* Roe, *supra* note 41 at 37, Sheard characterizes the banker model in Japan as a "substitute [] for the missing takeover market in Japan." Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. Econ. Behav. & Org. 399, 399 (1989). For an interesting account of how the impact of World War II in Japan and Germany may have disrupted the interest group politics that Roe describes, thereby creating the necessary setting for post-war economic success, see Mancur Olson, The Rise and Fall of Nations (1982).

46. *See* Roe, *supra* note 3, at 13-16.

47. *Id.* at 28. Roe certainly overstates the impact of the great majority of state legislation. Nonetheless, the empirical evidence demonstrates that the legislation did have a substantial effect on the probability of takeovers. *See infra* notes 49-55 and accompanying text.

48. *See infra* notes 49-55 and accompanying text.

adopted firm-level defenses were essentially unaffected.[49] As Roe suggests, the outcome in the political environment trumped the outcome in the corporate governance environment.[50]

From an ecological perspective, however, the interactive process does not stop after one round. Due to a post-World War II decision to provide for retirement security in the United States primarily through private pension funds[51] and the implementation of large tax incentives encouraging workers to use such plans as their primary savings vehicle, by the 1980s shareholdings in large American corporations were not as dispersed as the standard Berle and Means rhetoric assumed. While in 1950 institutional investors held approximately 8% of U.S. equities,[52] by 1989 institutional investors held 50% of the equity of the fifty largest American corporations, 53.2% of the equity of the largest hundred, and 48.1% of the equity of the largest thousand.[53] These investors responded to management efforts to protect their companies from the market for corporate control by proffering shareholder electoral proposals seeking to dismantle firm-level defenses and to force companies to opt out of state antitakeover legislation.[54] In turn, acquiring companies altered their acquisition technique by coupling a tender offer conditioned on the lowering of takeover defenses with a proxy contest seeking control of the target company's board of directors. The message to target management was that reliance on firm level and state law takeover defenses will be futile if target shareholders give the acquiring company control of the target company's board.[55] The electoral activism of institutional shareholders made the threat of the new acquisition technique credible.

The history of takeovers in the United States during the 1980s illustrates the full range of ecological interaction. Change in the economic environment triggered acquisition activity effected through a particular

49. *See* Karpoff & Malatesta, *supra* note 4, at 308-13. A similar result has been reported with respect to the recent Pennsylvania statute. *See* Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J. Fin. Econ. 3 (1992).

50. *See* Roe, *supra* note 3, at 28.

51. *See, e.g.*, William Graebner, A History of Retirement 215-41 (1980) (tracing the legislative, economic and social factors that encouraged the development of private pension funds from WWII through the 1950s).

52. *See* New York Stock Exchange, Institutional Investor Fact Book 1990, at 4.

53. *See* Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets*, *in* Institutional Investing (Arnold W. Sametz et al., eds., 1991).

54. *See* Gilson & Kraakman, *supra* note 45, at 867-71. For an interesting account of companies opting out of the Pennsylvania antitakeover statute, see John Pound, On the Motive For Choosing a Corporate Governance Structure (Kennedy School of Government, Harvard University Working Paper, Dec. 1990) (on file with the *Fordham Law Review*).

55. AT&T's successful effort to acquire NCR followed this strategy. When NCR strenuously resisted AT&T's offer, AT&T launched a proxy fight for control of the NCR board, ultimately winning four board seats but not control. Following the board election, NCR entered into discussions with AT&T, and subsequently agreed to be acquired in a negotiated transaction. John R. Wilkie & John J. Keller, *NCR Agrees to AT&T Takeover*, Wall St. J., May 7, 1991, at A3.

transactional technique. Responsive change in the political environment altered the corporate governance environment to restrict the availability of this technique. This set off another round of change in the governance environment and, ultimately, in the acquisition technique observed. Out of this interaction, the efficient boundary of the firm emerges—a boundary that is "efficient" not in an abstract sense, but conditioned on the restraints imposed by the political system and the ecological processes described above.

III. THE CENTRAL ECOLOGICAL FACT: THE PERVASIVENESS OF CHANGE

Viewing the corporate takeover process through an ecological prism has a payoff beyond parsimony of explanation. It also allows us to bring to bear developments in the study of natural ecological systems on an ecological system of our creation, if not of our control. This section discusses one such development—recognition of the dominance of change over equilibrium as the normal condition of natural environments. The centrality of environmental change emphasizes an important characteristic of organizational survival, what I term the "mutability principle." The next Section argues that both the pervasiveness of change and the mutability principle have important implications for the shape of regulatory efforts to intervene in the corporate governance environment, the most ambitious example of which is the European Community's ongoing effort to harmonize European takeover and company law.

Study of the ecology of natural systems traditionally has been dominated by the concept of a natural equilibrium—the "balance" of nature. In this view, the normal condition of nature is a stable equilibrium. An ecological system reacts to environmental change by responses that return the system to the pre-existing equilibrium. Some ecologists now have begun to question whether ecological systems have such a natural equilibrium.[56] External change appears to be constant, and participants within the system both change and react to other changes in idiosyncratic ways, therefore, the state of nature is one of continuous flux. At best, the system experiences a succession of short-lived and quite different equilibria.[57]

The concept that a central characteristic of an ecological system is pervasive change fits well with recent experience in the system that concerns us here—the interaction of the economic, corporate governance and political environments related to takeovers. On the economic front, the

56. *See, e.g.*, Daniel B. Botkin, Discordant Harmonies (1990); Daniel B. Botkin et al., *Science and the Global Environment*, *in* Changing the Global Environment 3 (Daniel B. Botkin et al. eds, 1989).

57. Accessible accounts of this potential paradigm shift among natural ecologists appear in recent newspaper stories. *See* William K. Stevens, *Balance of Nature? What Balance is That?*, N.Y. Times, Oct. 22, 1991, at C4; William K. Stevens, *New Eye on Nature: The Real Constant is Eternal Turmoil*, N.Y. Times, July 31, 1990, at C1.

very nature of product markets and the manufacturing process appears to be changing dramatically. The post-World War II world in which a company manufactured a small number of long-lived standardized products employing a production process designed to maximize scale economies is giving way to one in which the market demands a vastly larger array of specialized products, that have dramatically shorter product cycles, and whose manufacture demands a different kind of production process and industrial organization.[58] Internationalization of both the product and capital markets has accelerated.[59] Each of these changes has triggered responses in the corporate governance and political environments which, in turn, have fed back into the economic environment. It may have been difficult for natural ecologists to recognize the pervasiveness of change in ecosystems whose cycles are long-lasting and therefore difficult to observe. For those of us interested in the ecology of social systems, the insight that the natural condition of ecosystems is change not equilibrium has the characteristic of elegance. Once said, its accuracy is obvious. There is no stable equilibrium.

The task now is the instrumental application of that insight to guide regulatory efforts in the political environment whose goal is to improve the performance of organizations in the economic environment by altering the terms of the corporate governance environment. Recognition of the pervasiveness of change suggests the mutability principle. In an environment characterized by constant and unpredictable change, the quality necessary for evolutionary success is mutability—an organism's ability to alter its structure to adapt to new conditions. What we should seek is not the optimum governance regime for the environmental conditions we currently observe. Regulation that enshrines existing governance structures by creating transaction cost barriers to organizational change is a poor candidate for improving long-term economic performance. The mutability principle counsels in favor of changes in the corporate governance environment that facilitate prompt and low cost organizational responses to changes in the economic environment. This principle suggests a very different approach to regulatory reform of corporate governance than, at least to an outsider, appears to animate the European Community's current efforts to harmonize takeover law.

58. *See* Paul Milgrom & John Roberts, *The Economics of Modern Manufacturing: Technology, Strategy and Organization*, 80 Am. Econ. Rev. 511 (1990); Michael J. Piore, Corporate Reform in American Manufacturing and the Challenge to Economic Theory (Massachusetts Institute of Technology Working Paper No. 533, 1989). For a comparison between American and Japanese industrial organization along these dimensions, see Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. Econ. Literature 1 (1990).

59. *See, e.g.*, Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. Fin. Serv. Res. 349 (1990) (analyzing the extent and composition of internalization in the world's equity securities market in the 1980s).

IV. Harmonization of European Takeover Law and the Mutability Principle

At present, the Commission of the European Communities' Amended Proposal for a Thirteenth Council Directive on Company Law, Concerning Takeover and Other General Bids[60] (the "Thirteenth Directive"), constitutes the principal effort at harmonizing European takeover law. Focusing most intently on hostile bids, the document specifies the required terms of a takeover bid and the manner in which the bidding process must be conducted. Most controversially, it also severely restricts target management's ability to take defensive action after a bid has been made. Much more limited restrictions were placed on defenses usually adopted prior to a bid, such as dual class common stock or a ceiling on the number of shares that can be voted by a single shareholder. Current thoughts on pre-bid defensive behavior seem to be reflected in the Commission's Proposal for a Regulation on the Statute for a European Company,[61] which would not affect existing firms and would leave companies that elect to be governed by its provisions a great deal of freedom to adopt pre-bid defensive barriers,[62] and in the second amendment to the proposed Fifth Directive on the Structure of Public Limited Companies.[63]

These efforts seem motivated by the desire to alter the European corporate governance environment to encourage a corporate acquisition response to perceived changes in the economic environment that are believed to have changed the efficient boundary of the firm. A recent study of obstacles to takeover bids in the European Community undertaken on behalf of the Commission concludes that facilitating takeovers

60. 1991 O.J. (C 240) 7. The amended directive superseded the Commission's earlier proposal of January, 1989. *See* Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1989 O.J. (C 64) 8. For commentary on the previous draft, see Jeffrey P. Greenbaum, *Tender Offers in the European Community: The Playing Field Shrinks*, 22 Vand. J. Transnat'l L. 923 (1989); Dieter Hahn, *Takeover Rules in the European Community: An Economic Analysis of Proposed Takeover Guidelines and Already Issued Disclosure Rules*, 10 Int'l Rev. L. & Econ. 131 (1990).

61. *See* Statute for a European Company, E.C. Bull. Supp. May, 1989. The distinction between pre- and post-bid defensive action is ambiguous with respect to the operation of the poison pill. Although nothing in the Thirteenth Directive prevents a potential target company from adopting a poison pill plan prior to receipt of a takeover bid, the plan is implemented after the bid by issuing preferred stock. Article 8(1)(a) of the Thirteenth Directive effectively disables poison pill plans by requiring shareholder approval to issue any securities while a takeover bid is pending. For a discussion of the history of the *Societas Europaea* project, see Richard M. Buxbaum & Klaus J. Hopt, Legal Harmonization and the Business Enterprise 244-46 (1988).

62. The regulation would apply only to holding companies resulting from a merger among companies from different member states, or to the formation of a joint subsidiary by companies from different member states, in either case only if the parties elect its application. *See* Statute for a European Company, *supra* note 61, at Article 2. With respect to the defensive freedom left to electing companies, Article 92 would bar dual class common stock but leave companies free to limit the maximum number of shares that could be voted by a single shareholder. *See id.* at Article 92.

63. Second Amendment to the Proposal for a Fifth Directive, 1991 O.J. (C 7) 5.

within the European Community is required to enable "EC companies to build the necessary scale in their new 'home market' [which] is in many industries essential to assure EC industry competitiveness in an increasingly global environment."[64] Similarly, the preface to the proposal for a Statute for a European Company lists the Statute's first purpose as "enabl[ing] businesses to carry out cross-frontier restructurings by means of an international assets merger rather than merely by means of a takeover bid."[65] In general, both proposals seem to be concerned with the fact that economic changes have increased the efficient scale of enterprise. The announced goal is to facilitate an equilibrating response by easing certain barriers to corporate acquisitions.[66]

The Thirteenth Directive and the Statute for a European Company seem to reflect an uneasy balance between the two conflicting poles within the European corporate governance environment. On the one hand, the British governance model places the power to transfer control of a corporation with its shareholders much more effectively than currently is the case in the United States. Under General Principle 7 of the City Code on Takeovers and Mergers, target companies are essentially prohibited from taking defensive action once a bid is made.[67] As a result, target management's decision not to participate in a friendly acquisition can be appealed to the shareholders by means of a hostile bid. The British model is clearly reflected in Article 8 of the Thirteenth Directive which, in the words of the explanatory memorandum accompanying the directive, "require[s] the board of the offeree company to refrain from adopting defensive measures without the authorization of the general meeting of shareholders."[68]

In contrast, the German model is commonly taken to fix control in management, subject to ongoing monitoring by large banks.[69] In Germany, it is difficult for control to be accumulated or transferred through the market because of the combination of: (1) a two-tiered board system that insulates operating management from prompt displacement; (2) bearer shares that serve to give the large banks voting power that far exceeds their not insubstantial direct equity holdings; and (3) limits on

64. Booz°Allen Acquisition Services, Executive Summary, Study on Obstacles to Takeover Bids in the European Community 12 (1989).

65. Statute for a European Company, *supra* note 61, at 7.

66. *See* Company Law Committee, the Law Society, Amendments to the Fifth Directive, Memorandum No. 253 (Apr. 1991), describing the amendments as "intended to remove barriers to takeovers." *Id.* at 1.

67. General Principle 7 is amplified by Rule 21, which explicitly prohibits a target company from issuing new shares, disposing of material amounts of assets, or entering into contracts other than in the ordinary course of business.

68. Explanatory Memorandum accompanying Thirteenth Directive, at 7.

69. *See, e.g.*, John Cable, *Capital Market Information and Industrial Performance: The Role of West German Banks*, 95 Econ. J. 118 (1985); Theodor Baums, Banks and Corporate Control (Program in Law and Economics, School of Law, University of California at Berkeley Working Paper No. 91-1, 1991).

the maximum number of shares a single shareholder can vote.[70] While the Statute for a European Company does not itself erect barriers to control transfer, by its terms and limited application it allows those Community members with corporate governance systems following the German model to retain them.

The first step in understanding this harmonization effort from an ecological perspective is to recognize that its most important characteristic is not a preference for the British or the German model, but an orientation towards replicating one or a combination of existing systems. If the critical characteristic of the ecological system in which EC companies will compete in the future is constant and pervasive change, then the orientation of the harmonization effort must be forward-looking. This, in turn, suggests an ecological approach to harmonization premised on the mutability principle. While this is not the place to work out the details of such an approach, I will show that the mutability principle provides a premise on which one could be built. In particular, the mutability principle counsels in favor of a distinction between technical and structural barriers to takeovers and counsels against a distinction between technical barriers created before and after a bid is made. Less conceptually, the mutability principle also provides a means to distinguish between two types of deviation from the principle of one share-one vote, namely dual class common stock, in which one class has superior voting rights, and capped voting, in which a cap is set on the maximum number of votes that can be cast by a shareholder, regardless of the number of shares owned.

A. *An Ecological Perspective on Harmonization of Takeover Law: Choosing the Mutability Principle, Not the British or German Approaches*

The one clear element of the current effort to harmonize European takeovers is that the task is perceived to be selecting the "correct" takeover regime for member state corporations from among a short list of historically delimited possibilities. This ordinarily involves a choice between the British model, the German model, or some amalgam of the two, such as the combination of the Thirteenth Directive (which reflects the British model for post-bid defensive tactics) and the Statute for a European Company (which reflects the German model for pre-bid tactics). For example, the Booz•Allen report to the Commission states: "We believe the Commission should attempt to develop a 'European Model' for takeovers with the aim of combining the best of both the UK (or U.S.) and the West German (or Japanese) models."[71] But the central

70. *See, e.g.*, 2 Coopers & Lybrand, Barriers to Takeovers in the European Community, Germany ch. (1990) (study commissioned by Great Britain Department of Trade and Industry); Julian Franks & Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 10 Econ. Pol'y 189 (1990).

71. Booz•Allen, *supra* note 64, at 56. Franks & Mayer criticize the Commission's preference for the British model, but nonetheless treat the choice as limited to two candi-

insight of an ecological perspective is that the dominant characteristic of ecological systems is constant and pervasive change. There is simply no reason to believe that the post-war success of the British or German (or the Japanese or American) models in those countries assures their success in a future in which internationalization proceeds at an ever-increasing rate, product markets change with unprecedented rapidity, and the explosion in information technology provides an ever more effective lubricant for the entire process. Indeed, there is simply no reason to believe that we are capable of designing a fool-proof model. A healthy respect for hubris dictates substantial skepticism of our ability to anticipate the shape of, and the proper response to, future change. And, as Buxbaum and Hopt have stressed, the "petrification" of directives makes the costs of being wrong high indeed.[72] Once in place, directives are unlikely to be changed.

In addition to treating the task as one of choosing between the British and German models, the current approach to harmonization also seems to build on a second, equally debatable, simplifying premise. It assumes that limiting the choice to one or another model not only imposes conformity both geographically across the European Community and, given the likelihood of petrification, across time, but also assumes that all firms are the same and imposes conformity across types of firms. Emerging empirical research suggests that different economic activities may be best carried out in different organizational forms. For example, cutting edge research and development may be better suited to small entrepreneurial firms, while implementation of such efforts may be best suited to large mature organizations.[73] Firms that make substantial investments in research and development are dramatically different from firms that are not research and development intensive.[74] Similarly, firms that seek protection from takeover by means of a management buyout appear to be

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dates: "[T]here can be no presumption that the UK takeover market is superior to the bank-dominated capital market of Germany." Franks & Mayer, *supra* note 70, at 194.

72. Buxbaum & Hopt, *supra* note 61, at 243.

> Because Community directives require a long process of negotiation and compromise, there is a great danger that once a directive is enacted it will be practically impossible to amend or rescind. Any modification or repeal of a Community measure would certainly not be easier than its enactment. On the contrary, modifications of existing directives would receive little priority in relation to further harmonization proposals, and would probably even be opposed as adverse to the harmonization process in general.

Id.

73. *See* George J. Benston, Conglomerate Mergers: Causes, Consequences, and Remedies 19-26 (1980); Oliver E. Williamson, Markets and Hierarchies 198-207 (1975); Ronald N. Yeaple, Are Small R&D Organizations More Productive? (Center for Manufacturing & Operations Management, Simon Graduate School of Business Administration, University of Rochester Working Paper No. CMOM 87-04 1987).

74. *See* Bronwyn H. Hall, The Impact of Corporate Restructuring on Industrial Research and Development, Brookings Papers on Economic Activity - Microeconomics 1990, at 85; Bronwyn H. Hall, Corporate Restructuring and Investment Horizons (National Bureau of Economic Research Working Paper No. 3794, 1991).

qualitatively different from those who seek protection by means of issuing a second class of super-voting stock to a control group.[75] Precisely because economic change may affect each firm differently, harmonization efforts should accommodate variations among firms and activities.[76]

That leaves us with mutability as a principle on which to premise the harmonization effort. When the only condition of the future we can predict with confidence is pervasive change, and when such change can be expected to affect different firms and industries differently, examining existing regulatory regimes for barriers that serve to impede a firm's ability to respond quickly and effectively to technological change is our only effective strategy. From this perspective, efforts at harmonizing European takeover law should seek to minimize barriers that impede the transmission of economic change to the firm and barriers to organizational mutability, rather than selecting, at the supranational level, a single regime to apply to all firms.

B. *Implications of the Mutability Principle: Distinguishing Between Technical and Structural Barriers to Takeovers*

In discussing barriers to takeovers within the European Community, it has become commonplace to distinguish between technical and structural barriers.[77] Technical barriers are part of the formal apparatus of the corporate governance environment. They are erected by statutes and statutorily authorized company regulations that allocate power between various participants in the business enterprise, such as shareholders, management, labor and, in some member states, the national government. In addition to the familiar panoply of defenses erected by a target company after receipt of a bid, and addressed by the Thirteenth Directive, the company laws of many member states also authorize a range of

75. *See* Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807 (1987); Kenneth Lehn et al., *Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyouts*, 27 J. Fin. Econ. 557 (1990).

76. Franks & Mayer make a similar point. Stressing the different characteristics of the British and German models, the authors note that "[w]here the balance [between models] lies will depend on the circumstances of individual firms and economies. Fast growing firms will opt for arrangements that promote dynamic over static efficiency. More mature firms will emphasize the advantage of corporate efficiency." Franks & Mayer, *supra* note 70, at 215.

77. *See* Booz•Allen, *supra* note 64; Coopers & Lybrand, *supra* note 70; Simon MacLachlan & William Mackesy, *Acquisitions of Companies in Europe—Practicability, Disclosure, and Regulation: An Overview*, 23 Int'l Law. 373 (1989); *The Regulations Governing Mergers & Acquisitions Across the European Community*, Int'l Fin. L. Rev. (Josephine Carr ed., Supp. March, 1989); Section on Business Law, International Bar Ass'n for Int'l Capital Markets Group, *Constraints on Cross Border Takeovers and Mergers—A Catalogue of Disharmony*, 19 Int'l Bus. Law. 49 (1991); Benito Arrunada, Market vs. Regulation in the Market for Corporate Control: Interactions between Takeovers and Industrial Policy in Spain (Program in Law and Economics, Harvard Law School Discussion Paper No. 66, 1989). Some authors have characterized the distinction as one between regulatory and institutional barriers. *See* Franks & Mayer, *supra* note 70, at 192.

techniques that effectively discourage a bid from being made in the first place. For example, voting rights can be manipulated to provide protection. In a number of countries, company regulations can specify the maximum number of votes that can be cast by a single shareholder.[78] Similarly, in some countries different classes of shares can be given different numbers of votes per share, thereby allowing voting control to be placed in the hands of a select group regardless of the size of their equity holdings.[79]

Management organization also creates technical barriers to takeovers. In Germany, the company's operations are placed in the hands of a managing board appointed for a five-year term by a supervisory board composed of up to 50% labor representatives, whose members can be removed only by a 75% vote of shareholders.[80] Thus, operating management is protected against displacement by an acquiror for up to five years following acquisition of voting control. At the extreme, the supervisory board of public limited companies in the Netherlands are apparently self-perpetuating, allowing shareholders the right to make suggestions as to new supervisory board members, but with the power of actual selection remaining with the supervisory board itself.[81]

Finally, rules governing shareholder voting procedure serve to restrict challenges to management through the electoral process. In Germany, for example, the pervasiveness of bearer shares which shift voting power to the depositories in which they are held, and the barriers to a beneficial owner actually voting bearer shares lodged with a depository or directing the depository how to vote, appear to make it impossible to wage a United States style proxy fight.[82]

Structural barriers, in contrast, simply reflect the effect of existing conditions in the economic environment, albeit facilitated and reinforced by conditions in the corporate governance and political environments. They

78. *See, e.g.*, 2 Coopers & Lybrand, *supra* note 70 (reviewing voting restrictions on a country by country basis).

79. In the Netherlands, for example, "protective" shares representing up to 50% of outstanding stock can be issued to a friendly foundation when danger of a takeover is present. *See* J.M.M. Maeijer, *Dutch Law Relating to Hostile Takeovers and the Protection Against Them, in* Defensive Measures Against Hostile Takeovers in the Common Market 173, 182-83 (J.M.M. Maeijer & Koen Geens eds., 1990).

80. Franks & Mayer, *supra* note 70, at 206.

81. 2 Coopers & Lybrand, *supra* note 65, Netherlands ch. at 29, 37-38 (1989). This governance structure also has a correspondent in the United States—the standard governance structure used by non-profit corporations. "In the typical [U.S.] nonprofit corporation, members of the board of directors are elected by the corporation's voting members who, in turn, are defined as the members of the board." Ronald J. Gilson, *Just Say No to Whom?*, 25 Wake Forest L. Rev. 121, 122 (1990). However, U.S. law recognizes the absence of any organizational constraint on management behavior, and typically subjects the conduct of non-profit corporations to ongoing scrutiny by the state attorney general. *See id.* at 122-23.

82. *See* Johannes Kondgen, Duties of Banks in Voting Their Clients' Stock 3-7 (paper presented at Conference on Comparative Corporate Governance, University of Osnabruck, July, 1992) (unpublished manuscript on file with the *Fordham Law Review*).

include such circumstances as the concentration of ownership in families and small groups, the influence of large universal banks, and the reliance on debt as opposed to equity financing.

The mutability principle suggests a critical difference between technical and structural barriers to takeovers. An ecological perspective on harmonizing takeover law has as its focus the interaction between the economic, corporate governance and political environments. Corporate acquisitions generally, and hostile takeovers in particular, function as a mechanism by which the efficient boundary of the firm equilibrates following a technological change. Technical barriers raise the transaction costs of the equilibration process, thereby ossifying the existing boundaries of firms and protecting them from the need to respond to a changed economic environment.

Structural barriers, in contrast, lack such an instrumental purpose. Italy provides a good example. It is reported that of the 200 Italian companies listed on a stock exchange, only seven have more than 50% of their common stock in the hands of the public. Of these, five are effectively controlled by families. Thus, even in the absence of technical barriers, only two companies in the entire Italian economy are even theoretically subject to a hostile takeover.[83] Such concentration is facilitated by a much heavier emphasis on debt, as opposed to equity, financing in continental Europe than in either the United States or Great Britain. For example, stock market capitalization as a percentage of gross domestic product was 98.1% in the United Kingdom, but no more than 20% in France, Germany or Italy.[84] The relative importance of bank financing thus helps explain both the importance of banks in the German corporate governance environment and the continued concentration of equity holdings.

Concentrated patterns of ownership represent not a barrier to equilibration, but simply the existing condition of the economic environment. Just as the peculiar history of the American economic and political envi-

83. 2 Coopers & Lybrand, *supra* note 70, Italy ch. at 12-14. The phenomenon of extensive family control of public companies appears to be widespread. The Coopers & Lybrand report estimates that over half of the 200 largest French companies are family controlled. These holdings, together with government holdings in newly privatized companies, protect a substantial portion of the French economy. *See id.*, France ch. at 15. Extreme concentration of family ownership is also reported in Spain. In Germany, only 465 public limited liability companies have their shares quoted on a stock exchange and, of these, a large number are said to be part of a group. *See* Marcus Lutter & Brigitte Lammers, *Hostile Takeovers: Possibilities and Limitations According to German Law, in* Defensive Measures Against Hostile Takeovers, *supra* note 79, at 113. Cable, *supra* note 64, provides more detailed data. One family held a majority of the stock of 14 of the top 100 German companies, and between 25-50% of an additional four companies. Because large individual and family holdings increase as firm size decreases, and because of the frequency of large corporate cross holdings, Cable believed that the data on family ownership of the 100 largest companies understated the extent of concentrated holdings in German corporations. *See id.* at 120-21.

84. 2 Coopers & Lybrand, *supra* note 70, France ch. at 12.

ronments led to an emphasis on local banking and dispersed and now reaggregating shareholdings,[85] so the economic and political environments of European Community member states other than Great Britain, led to bank-dominated finance. Similarly, the pervasiveness of concentrated family ownership, especially with respect to successful first-generation companies founded following World War II, reflect a member state's pattern of economic growth and the life cycle of the particular company. These conditions will change in response to changes in the economic environment. As founders of significant numbers of post-war family companies reach retirement age concentration of ownership will dissipate. In fact, the weakening of the dominant position of the German banks may already have begun. The development of international capital markets has provided an alternative source of funds with a resulting decrease in the percentage of the capital of large German corporations provided by bank credits and loans—from 16.9% in 1974 to 6.6% in 1984.[86] There is

85. For a discussion of American banking regulation, see Coffee, *supra* note 44; Grundfest, *supra* note 44; Roe, *supra* note 44.

86. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277, 1304, n.108 (1991); Josef Esser, *Bank Power in West Germany Revised*, 13 W. Eur. Pol. 17, 23 (1990). Further evidence of change in the German bank centered system is reflected in the drop in bank equity holdings that parallels the drop in lending. From 1976 to 1986, the percentage of German companies in which the large banks held in the aggregate more than 10% of the equity dropped from 129 to 86. *See* Esser, *supra*, at 25.

A similar process appears to be underway in Japan, the other system typically grouped with Germany as bank centered. Carl Kester identifies three phenomena that have dramatically reduced the centrality of bank finance in the Japanese system. *See* W. Carl Kester, Japanese Takeovers 187-217 (1991). First, as in Germany, the internationalization of the Japanese capital market and the development of a commercial paper market provided alternatives to traditional bank finances. *See id.* at 188. By 1985, some one-half of Japanese company securities issuances were overseas. *See id.* Second, the success of Japanese companies in the international marketplace resulted in an enormous buildup of internal financial resources. The period from 1978 to 1987 marked a significant deleveraging of Japanese companies, the net debt-to-equity ratio falling from 1.7 in 1978 to slightly negative by 1987. *See id.* at 191-93. Third, Kester reports a sharp drop in the equity holdings of main banks in their client companies. The six largest banks hold less than the 5% legal maximum in their keiretsu companies, and the trend is steadily down, on average falling from 4.4% in 1975 to 3.7% in 1986. *See id.* at 207.

The result of these three phenomena suggest a significant change in the level of bank monitoring in Japan—that characteristic commonly treated as the distinguishing feature of Japanese corporate governance. Kester reports that all but one of the companies in his sample stated that their corporate plans and investments were closely examined by their banks during the 1950 to 1980 period, but that "*none* reported being subjected to such scrutiny today." *Id.* at 197. Kester concludes that Japanese financial institutions "are losing their ability to monitor client companies closely and intervene as needed to correct problems, both heretofore critical safeguards in the Japanese corporate governance system." *Id.* at 217. Other commentators confirm the phenomenon. *See* James C. Abegglen et al., The Japanese Corporation 189 (1985); J. Mark Ramsayer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. Legal Stud. 91, 98 (1991); Paul Sheard, *Japanese Corporate Finance and Behavior: Recent Developments and the Impact of Deregulation*, *in* Japanese Financial Markets and the Role of the Yen 55, 62 (Colin R. McKenzie & Michael Stutchbury eds., forthcoming 1992). The pattern reflects little reason to pursue harmonization of the European economic environment.

Recognition that so-called structural barriers are an outcome rather than a cause serves to highlight the ecological importance of technical barriers in the corporate governance environment. Technical barriers perpetuate preexisting outcomes in the economic environment when change otherwise would have shifted the efficient boundary of the firm. Thus, the focus of any effort at harmonization of takeover law should be on technical barriers that insulate a firm from the pressure to adapt to technological change. Once the firm is left exposed to technological changes, the existing equilibrium in the economic environment will shift when such change warrants it.

C. *Implications of the Mutability Principle: Eliminating the Distinction Between Pre-Bid and Post-Bid Technical Barriers*

Current harmonization efforts draw a sharp distinction between pre-bid and post-bid technical barriers. The Thirteenth Directive's prohibition of defensive tactics in response to a bid would effectively dismantle post-bid technical barriers. The proposed Statute for a European Company, however, would leave pre-bid technical barriers, like management structure and share voting restrictions, largely in place. This distinction is understandable from an historical perspective. It merely reflects the familiar difference between company law and takeover law.[87] Application of the mutability principle, however, renders this distinction irrelevant. Focusing only on post-bid technical barriers would leave companies free to adopt governance devices that effectively block a hostile offer from ever being made and thereby insulate the firm from the pressure of changes in the economic environment, unless transmitted through internal, voluntary mechanisms. The lesson of the American experience in the 1980s, however, indicates that internal monitoring has predictable limitations. It is effective when a particular company underperforms within its respective industry. A ready performance measure—comparison with competitors—signals the need for action as well as the specific type of action required. Such action, while distasteful, does not require a reconceptualization of the company's very purpose. In contrast, hostile takeovers seemed necessary when technological change affected an entire industry. Insiders simply had more difficulty making a paradigm shift.

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the argument in this Essay—change in the economic environment engenders change in the corporate governance environment.

87. It is the bid that triggers the operation of takeover regulatory regimes like the City Code in Great Britain and the Williams Act in the United States. Even the common law of corporations draws a parallel distinction between defensive responses and pre-bid structural devices. For example, the Delaware Supreme Court treated the adoption of a poison pill plan as an event of little moment, reserving careful scrutiny for the post-offer decision as to whether to redeem the pill. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356-57 (Del. 1985).

It is precisely when internal monitoring is least likely to work that prebid technical barriers to external change will be invoked. Both existing management and current workers may have a short-term interest in preserving the status quo; resisting change gets some participants to retirement and, in all events, puts off the day of reckoning for all.[88] But the effect is only to shift the costs of change to the future and, most likely, to increase them.

Thus, the mutability principle suggests eliminating the technical barriers to change represented by the pre-offer obstacles that the Thirteenth Directive does not address. This does not mean, however, that all restrictive management or voting arrangements should be eliminated. The critical element required by the mutability principle is that the effects of economic change be visited on those who have the power to cause the organization to adapt. Technical barriers that nonetheless leave decisionmakers exposed to the changing economic environment do not offend the mutability principle.

This distinction can be illustrated by the difference between a dual class voting arrangement in a company going public for the first time and a system of capped voting. The former involves a company's initial public offering with the dominant shareholder assuring continued control by offering to the public only low-voting or non-voting stock.[89] The latter involves placing a limit on the maximum number of votes that can be cast by a single shareholder, regardless of the number of shares actually owned. From the perspective of mutability, the two arrangements have quite opposite implications. The dual class voting arrangement on an initial public offering is unobjectionable. An owner/decisionmaker—a party that has both the decisionmaking authority to cause the firm to respond to economic change and, because it also bears significant economic risk, the incentive to act—existed before the dual class public offering. Because an owner/decisionmaker remains after the initial offering, the economic impact of change will continue to be visited on the corporate decisionmaker and the mutability principle is unimpaired.

88. John Coffee has thoughtfully developed the potential for self-protective coalitions of management and labor in the face of economic change. *See* John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 Geo. L.J. 1495, 1523-28 (1990). The conduct of Eastern Airlines prior to its takeover by Continental provides an extreme example of such a value reducing coalition. There the job protective interests of management and the machinists union coincided in a particularly revealing way. The machinists represented the baggage handlers who, because of prior contracts, earned dramatically more—perhaps three to four times—than the minimum wage that their jobs would have commanded on the open market. From the baggage handlers' perspective, delaying any change worked to their advantage because it prolonged the period during which they would receive above market wages even at the expense of the airline's failure. Indeed, because minimum wage jobs would always be available, delay was preferable to a resolution that might have saved the airline. *See* Robert N. Ashcroft, The Death of Eastern Airlines: A Catastrophic Failure of Negotiations (May, 1991) (unpublished manuscript, on file with the *Fordham Law Review*).

89. *See* Gilson, *supra* note 75, at 827-29.

Conversely, a capped voting arrangement has a very different impact. Rather than attempting to retain control in an owner/decisionmaker, a capped voting scheme functions to assure that no owner/decisionmaker can exist. Control cannot be centralized in anyone. The result, and presumably the goal, is to assure that control rests with management while shareholders bear the impact of economic change. From this perspective, imagine the German governance system if the current decrease in the importance of bank lending continues[90] with the predictable effect of reducing bank influence, and capped voting schemes prevent anyone else from accumulating an ownership position large enough to allow significant monitoring. By separating decisionmaking authority from riskbearing, capped voting serves to buffer the organization from the pressure to adapt to economic change. Such a result violates the mutability principle.

The proposed Statute for a European Company distinguishes between dual class and capped voting regimes, but unfortunately appears to get it backwards. Article 52(3) of the Statute prohibits dual class voting while Article 92(3) authorizes capped voting.[91] A simple application of the mutability principle would dictate the reverse—prohibiting capped voting and authorizing dual class voting.[92]

V. Objections to the Mutability Principle

While one can imagine a number of objections to a mutability-based approach to harmonization, two in particular warrant consideration here. The first asserts that, in the end, harmonization according to the mutability principle results in no more than an unrestricted invitation to hostile takeovers, what the President of the French Republic, Francois Mitterand, has called "gangsterism and the law of the strongest,"[93] and the CEO of Deutsche Bank, A. Herrhausen, has referred to as the "blunders of American capitalism."[94] The second objection, which in many respects is a particularization of the first, asserts the importance of what is said to be a special cost of hostile takeovers—the destruction of implicit contract regimes. While the core of this objection is the same as the first—that the mutability principle leads to a corporate governance environment dominated by hostile takeovers—it warrants independent

90. *See supra* notes 76-82 and accompanying text.

91. *See* Statute for a European Company, *supra* note 61, at Articles 52(3), 92(3).

92. The recent amendment to the Proposed Fifth Directive concerning the structure of limited companies and the powers and obligations of their organs, *supra* note 58, is a step in the right direction. Prior to the amendment, Article 33(2), like the proposed Statute for a European Company, prohibited dual class voting but authorized capped voting. The amendment continues the prohibition of dual class voting, but at least prohibits capped voting. Presumably the Proposed Statute for a European Company will be amended to conform to the amended proposed Fifth Directive.

93. Ernst-Ludwig Von Thadden, *On the Efficiency of the Market for Corporate Control*, 43 KYKLOS 635, 635 (1990) (citing Le Monde, Feb. 14, 1989).

94. *Id.* (citing Frankfurter Allgemeine Zeitung, Dec. 23, 1988).

attention because it has been raised explicitly in the harmonization debate.[95]

A. *Is the Mutability Principle Merely the British Model in Disguise?*

A critic of the mutability principle might well conclude that the rhetoric of an ecological approach, while different from the standard arguments in favor of the disciplining value of an active market for corporate control, yields the same prescription: the British model of unlimited hostile takeovers. The objection is understandable. It is easy to assume that eliminating technical barriers to hostile takeovers inevitably results in a corporate governance environment dominated by hostile takeovers.

The confusion results from mistaking a process for an outcome. In the model developed in Section I, corporate acquisitions are an equilibrating mechanism that shifts the efficient boundary of the firm in response to technological change.[96] A hostile takeover is a special type of acquisition

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95. *See* Franks & Mayer, *supra* note 70. A third objection to the mutability principle is much more general. Harmonization of company law, as opposed to capital market law, is simply said to be of minimal importance. *See* Buxbaum & Hopt, *supra* note 61, at 196-204; C. Timmerman, *Methods and Tools for Integration*, *in* European Business Law 130 (Richard M. Buxbaum et al. eds., 1991). As a result, harmonization of takeover law and the mutability principle are hardly worth the effort.

While a detailed response to an objection at this level of generality is far beyond the scope of this Essay, a number of brief responses are possible, the last of which persuades me of the wisdom of the effort. First, a race to the bottom argument for harmonization, which has power in the United States because of the perverse effect of competition for charters over terms concerning which managers and shareholders have different interests, seems much less persuasive in Europe. Because of the general application in Europe of the headquarters approach to designating which state's laws govern a corporation's internal affairs, as opposed to the state of incorporation approach dominant in the United States, change in applicable law is more costly in Europe. *See* Buxbaum & Hopt, *supra* note 61, at 226-28.

Second, the need for harmonization of takeover law has been urged as necessary to assure a "level playing field"; it should not be possible for German firms to launch hostile bids for British firms while British firms are blocked from responding in kind. *See, e.g.*, European Business Law, *supra*, at 375-78 (remarks of G. Fitchew). However, in the absence of an economic justification for hostile takeovers, the reciprocity claim seems much more of a political justification for harmonization. *Cf.* Buxbaum & Hopt, *supra* note 61, at 198 (arguing that harmonization is not necessarily a political decision). I have no inclination to argue that the mutability principle is responsive to a political agenda for harmonization.

I am persuaded, however, that there exists an economic justification for harmonization of takeover law on the mutability principle. The point of the mutability principle is to assure an economic system that can successfully cope with an environment of pervasive change. In a world in which blocks of trading partners are important, the health of the European economy is affected by the economic health of its individual components. From this perspective, harmonization on the basis of the mutability principle is necessary to capture a public good—prosperity—that the short term self interest of important local political actors—management and labor—may otherwise dissipate. To be sure, one can take issue with this justification for harmonization, but then the issue is simply whether the mutability principle makes sense—precisely where we were before the argument that harmonization was unimportant was raised.

96. *See supra* notes 7-14 and accompanying text.

necessary when the acquiring company and the target disagree over the location of the new efficient boundary.[97] Eliminating barriers to the operation of the equilibrating mechanism does not cause hostile takeovers. Technological change occasions corporate acquisitions and the empirical evidence in the United States strongly suggests that only certain types of technological change result in hostile takeovers. In particular, hostile takeovers seem to be associated with changes affecting the structure of an entire industry, where effective internal monitoring is made difficult both by the absence of a strong signal of poor performance and the incentive for those who stand to lose by the necessary restructuring to protect themselves by forming coalitions.[98]

Moreover, limits to hostile takeovers are more pervasive than either the discussion of technical or structural barriers thus far has indicated. As recent surveys of takeover barriers have stressed,[99] cultural differences also affect the incidence of hostile takeovers. Suppose that a family-controlled company is confronted with a technological change, the rational response to which is selling the business. Suppose further that the culture of the country in which the company operates treats management as owing equal obligations to shareholders, labor and the public.[100] If the family owners have internalized that culture and if hostile takeovers are costly, then the family will presumably accept a lower price to sell the business to a "responsible" buyer with the price difference being outweighed by the culturally-dictated nonpecuniary utility associated with responsible ownership. If the buyer is privately held, or if the price discount for social responsibility does not exceed the costs of a hostile takeover of the new buyer, no hostile takeover will result, even if barriers to takeovers are eliminated. Cultural and institutional characteristics of individual member states will not disappear with the advent of harmonization. Put differently, the structure of organization in any country is likely to be path dependent—to depend upon the conditions in the economic and political environment at the time that technical barriers to takeovers are removed.[101] Thus, whether harmonization that takes the form of dismantling technical barriers to takeovers results in a significant number of takeovers depends on the nature of the technological changes

97. *See supra* note 12 and accompanying text.

98. *See* Coffee, *supra* note 44, at 1329-1336. A recent example comes to mind. Both labor and management resisted efforts by Carl Icahn to take over USX. Icahn proposed to spin off USX's oil operations from its steel operations, claiming that the market penalized the firm's conglomerate structure. The steelworkers union joined management in opposing Icahn's effort because the assets of the oil operations provided valuable security for the steelworkers' otherwise unfunded pension benefits. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863, 905 n.146 (1991).

99. *See, e.g.*, Booz•Allen, *supra* note 64; Coopers & Lybrand, *supra* note 70.

100. *See, e.g.*, Coopers & Lybrand, *supra* note 70, Netherlands ch. at 29-30.

101. *See, e.g.*, James J. Heckman, *Identifying the Hand of Past: Distinguishing State Dependence from Heterogeneity*, 81 Am. Econ. Rev., May, 1991, at 75 (Papers & Proceedings).

and the particular institutions and economies of the respective countries. This is precisely the difference between harmonization premised on the mutability principle and harmonization premised on a selection from among a limited number of existing models. The former seeks uniformity in process; the latter seeks uniformity in outcome.

B. *Hostile Takeovers as a Threat to Implicit Contract Regimes*

A recent argument raised against hostile takeovers treats them as opportunistic breaches of implicit contracts between the corporation and workers.[102] Because the terms of such implicit contracts, namely continuity of employment, cannot be specified explicitly except at great expense and with loss of flexibility, a corporate governance environment that facilitates takeovers deprives companies of the benefit of this type of contracting. In the context of the harmonization debate, Franks and Mayer argue that the balance between the disciplinary benefits of hostile takeovers and their costs in disrupting implicit contracting is indeterminant, therefore leaving unclear the desirability of harmonization along either the British or German models.[103] The implicit contract argument against takeovers and harmonization can be approached both analytically and empirically. Evaluation of the analytic component of the argument is at best indeterminant because the terms of the implicit contract of interest with respect to hostile takeovers are unobservable. Evaluation of the empirical component of the argument, however, suggests that hostile takeovers either do not play a significant role in situations where implicit contracts are important, or that they are not breached by acquirors in situations where they are important.

Labor economists originally developed the concept of implicit contract to explain observed anomalies in the labor market, principally the downward inflexibility of wage rates.[104] In this literature, voluntary relations, the terms of which are not governed by a detailed written document, are called implicit contracts. The simple intuition is that the terms of the bargain are reflected implicitly in the substance of the continuing voluntary interaction between the parties. The difficulty with the application of implicit contract analysis in the context of hostile takeovers, in contrast to its original application, is that the terms of the implicit contract cannot be specified beyond those which are observed. In the hostile takeover context, the particular term of the contract, which is crucial to the argument, simply cannot be observed.

102. *See* Charles R. Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 Am. Econ. Rev. 155 (1986); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* Corporate Takeovers: Causes and Consequences 33 (Alan J. Auerbach ed., 1988).

103. *See* Franks & Mayer, *supra* note 70.

104. *See* Sherwin Rosen, *Implicit Contracts: A Survey*, 23 J. Econ. Literature 1144 (1985). Rosen credits Costas Azariadis, *Implicit Contracts and Underemployment Equilibria*, 83 J. Pol. Econ. 1183 (1975), with coining the term. *See id.* at 1144.

For example, imagine a claim that American companies have an implicit contract with employees providing in general for long-term employment. The contract claim is based on the observation that, despite the legal doctrine of employment at will,[105] employees without explicit contracts typically experience long-term employment with a single employer.[106] What, however, is the implicit contract concerning employer response to technological change? Have we observed long-term employment in the United States during the post-World War II period because the implicit contract provides for continued employment despite technological change, or have we observed long-term employment even though the implicit contract allows for discharge in response to technological change, because there has been little technological change in basic industries? Thus, because we cannot observe the critical term of the implicit contract, we also cannot determine whether a takeover that alters employment levels violates an implicit contract.[107]

The empirical component of the implicit contract argument fares even worse. If takeovers serve to breach implicit contracts with labor, we should observe either wage cuts or employment reductions following takeovers. With respect to wage cuts, Shleifer and Summers[108] report "one famous case"[109]—Carl Icahn's acquisition of TWA—in which wage

105. The employment-at-will doctrine specifies that, in the absence of an explicit employment contract, an employee can be terminated at any time without cause. *See, e.g.*, Andrew D. Hill, "Wrongful Discharge" and the Derogation of the At-Will Employment Doctrine (University of Pennsylvania Labor Relations and Public Policy Series No. 31, 1987) (discussing abrogation of traditional employment at will doctrine).

106. *See* Robert E. Hall, *The Importance of Lifetime Jobs in the U.S. Economy*, 72 Am. Econ. Rev. 716 (1982).

107. Consider the following example. Prior to deregulation, an implicit contract existed between United States airlines and their unions that wage increases would not be seriously contested because their cost could be passed on to consumers through CAB approved fare increases. Deregulation changed that world. New non-union airlines entered the market with lower labor costs and charged correspondingly lower fares. The wage structures of established airlines put them at a significant competitive disadvantage. What did the pre-deregulation implicit contract say about the airlines' right to make post-deregulation changes in the wage structure by, for example, moving to a two-tier wage structure? In such circumstances, implicit contract analysis cannot be very helpful. For an interesting case study in the labor relations of airline deregulation, see Ashcroft, *supra* note 85; *see also* Stacey Kole et al., Deregulation and the Governance of Airlines (University of Pittsburgh Working Paper, April, 1992) (unpublished manuscript, on file with the *Fordham Law Review*) (presenting a careful study of how deregulation, by increasing the consequences of managerial decisions for firm value, affected the governance of airlines).

One might still argue that, as a matter of public policy, workers (or others) should be protected from unexpected changes in regulation or technology. For example, one might argue that an appropriate response to a Kaldor-Hicks efficient change is to enforce the hypothetical payment to losers. But then the argument is no longer one of implicit contract, but of transition. Louis Kaplow convincingly argues that transitional relief—protecting individuals from the effects of changes in regulatory policy or economic conditions—is generally inefficient. *See* Louis Kaplow, *An Economic Analysis of Legal Transition*, 99 Harv. L. Rev. 511 (1986).

108. Shleifer & Summers, *supra* note 102, at 35.

109. Bhagat et al., *supra* note 13, at 6.

reductions loomed large. However, Bhagat, Shleifer, and Vishny, after considering a sample of hostile takeovers, conclude that compensation cuts of existing workers are not a significant motivation for takeovers.[110] With respect to employment reductions, the data suggest little in the way of reduction in blue collar employment. Some reduction in white collar employment does appear, but even this result is associated with acquisitions generally, rather than hostile acquisitions in particular.[111] Finally, a recent study of 286 plant closings between 1980 and 1984 reported that "few of the plant-closing announcements in our sample were made by firms that were targets of takeovers attempts."[112]

From an ecological perspective, this result is hardly surprising. Recall that the nature of the change in the economic environment influences the acquisition technique observed in the corporate governance environment. An acquiror has no incentive to alter implicit contracts that remain efficient. If a hostile takeover really would dissipate a valuable corporate asset, namely trust and reputation, why would an acquiror pay more for the target after the loss of this asset than the target was valued by the market in the hands of previous management? In settings where a hostile takeover would somehow unavoidably destroy important implicit contracts, we would expect to see only friendly transactions.

Thus, harmonization premised on the mutability principle should not threaten existing implicit contract regimes. Again, the flaw in the argument is to confuse the availability of one aspect of an equilibrating process with the outcome of that process. There is no reason to believe that the availability of hostile takeovers would lead to their dominating the European corporate governance environment.

CONCLUSION

A careful reader will have noticed that my argument supporting the mutability principle as a basis on which to structure harmonization of European takeover law suffers from an important ecological defect. In developing the concept of the political ecology of takeovers, I described the interaction of three environments: economic, corporate governance and political. And while I considered the political environment in

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110. *See id.*

111. *See id.* at 7. Bhide, *supra* note 13, at 48, finds that the redistribution effects of hostile takeovers "borders on the trivial." Indeed, Lichtenberg & Siegel report an increase in blue collar employment following takeovers, somewhat reversing a pre-takeover decline. *See* Frank R. Lichtenberg & Donald Seigel, *The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel*, 33 J.L. & Econ. 383, 387 (1990); *see also* Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. Fin. Econ. 217, 241 (1989) (reporting consistent results).

112. Donald W. Blackwell et al., *Plant-Closing Decisions and the Market Value of the Firm*, 26 J. Fin. Econ. 277, 287 (1990). *See also* Joseph A. Grundfest, Job Loss and Takeovers, Address to the University of Toledo College of Law, Third Annual Colloquium on Corporate Law and Social Policy (Mar. 11, 1988) (transcript on file with the *Fordham Law Review*) (refuting connection between takeovers and job loss).

describing the political ecology of takeovers in the United States, that dimension of the analysis has been entirely absent from my discussion of the application of the mutability principle to European harmonization, a central flaw given the familiar comment that harmonization is largely a political process about which economic arguments are as often rationalizations as they are motives.[113]

Indeed, I expect the American observers of the intersection of the corporate governance and political environments would justifiably question the political feasibility of harmonizing American takeover law around the mutability principle. The recent efforts of representatives of large U.S. corporations to block Securities and Exchange Commission proposals to increase access to the proxy process is only the most recent effort to protect existing management positions against economic change.[114]

My neglect of the European political environment in assessing approaches to harmonization stems from caution born of distance. As only a foreign observer of the process, I am left to suggest the mode of analysis and leave to others with institutional knowledge of the political dimension to determine its feasibility. While it is personally troubling that the political environment might block harmonization around the mutability principle in the United States, for present purposes, it is not analytically disconcerting. That the United States does it badly is no reason for Europe to follow suit, as the current effort at harmonization itself demonstrates.

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113. *See* Fitchew, *Political Choices* in European Business Law, *supra* note 95, at 1.

114. *See* Stephen Labaton, *U.S. Pressed by Business Over S.E.C.*, N.Y. Times, Oct. 18, 1991, at D1. ("One of the nation's most powerful corporate interest groups, the Business Roundtable, has been meeting with senior Administration officials to bypass the Securities and Exchange Commission in trying to prevent new rules for corporate shareholder battles.").