The Case for Facilitating Competing Tender Offers: A Last (?) Reply

LUCIAN ARYE BEBCHUK
Harvard Law School

Several years ago, Easterbrook and Fischel (1981, 1982) argued that the facilitation of competing tender offers is undesirable. They suggested that, in order to encourage prospective bidders' search for targets, it is desirable to minimize the premiums paid to target shareholders. On this view, impeding competing bids is desirable because it would sharply reduce takeover premiums. Indeed, because a target's dispersed shareholders are under pressure to tender, impeding rival bids would lead to very low premiums indeed.[1]

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1. The pressure to tender and its consequences are analyzed in detail in Bebchuk (1985a, 1985b, 1986).

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In two articles (Bebchuk, 1982a, 1982b), I advanced a position opposite to that of Easterbrook and Fischel. I questioned the existence and magnitude of the negative effect that facilitating competing bids was argued to have on search. I also pointed out that facilitating such bids produces some significant benefits. A similar proauctioneering position was also taken at that time by Gilson (1981, 1982).

The primary implication of this theoretical disagreement concerns the regulation of offerors. Time is crucial for competing bids, and the Williams Act, which the proauctioneering view endorses, provides time by prescribing a mandatory delay period. Those who hold the antiauctioneering view would have us repeal the Williams Act: they would like us to return to a regime of Saturday-Night-Special bids (hereinafter referred to as SNS bids)—that is, offers that are open for a very brief period, with no withdrawal rights and on a first-come-first-served basis.

The second implication of the debate concerns the role of a target's management. Easterbrook, Fischel, Gilson, and I all agreed that management should be prohibited from obstructing existing bids. Easterbrook and Fischel's view, however, led them to advocate total passivity for target managements, while Gilson and I supported allowing management to provide information to potential bidders in order to solicit rival bids.

The choice, then, is between two regimes. Under a no-auctioneering regime, the first bidder, facing no threat of competing bids and subjecting the shareholders to the pressure of a SNS raid, would be able to acquire the target for a very low, minimal premium over the pre-bid market price. Under an auctioneering regime, in contrast, the acquirer would generally be the bidder that is willing to pay more than what rival bidders would be willing to pay.

Alan Schwartz has now subjected the issue to a systematic reexamination, and he is adding his voice to that of Easterbook and Fischel (Schwartz, 1986a). As I explain below, however, Schwartz's analysis does not adequately address the arguments that I made in favor of auctioneering, and it consequently does not strengthen the antiauctioneering case.

1. THE EFFECT OF AUCTIONEERING ON SEARCH

Much of the debate has been concerned with the effect that facilitating competing bids will have on the number of beneficial acquisitions. Schwartz seeks to contribute to an understanding of this issue by developing a formal model of the search conducted by prospective acquirers. This formal model provides a rigorous demonstration of the proposition that an increase in the rewards for acquirers' search increases investment in search, and that auctions therefore reduce the level of this search. But this proposition does little to resolve the issue; it has never been disputed by any participant in the debate.

While I agreed in my earlier articles that, in comparison to the no-

auctioneering regime, auctioneering reduces prospective acquirers' investment in search, I argued (1) that the effect of auctioneering on prospective acquirers' search might be desirable rather than undesirable, and that, even if the effect is undesirable, it is far from clear that its magnitude is substantial; and (2) that auctioneering has a beneficial effect on the level of search by potential targets. Schwartz does not adequately address my arguments with respect to (1) and ignores my arguments with respect to (2).

1.1. The Effect of Auctioneering on Acquirers' Search

1.1.1. Acquirers' Search in an Auctioneering Regime

To examine the effect of auctioneering on acquirers' search, it might be best to start by recognizing that auctioneering is perfectly consistent with inducing a substantial level of such search. At present, when competing bids are facilitated, there is a considerable amount of such search because searchers receive substantial rewards. For one thing, prior to making a bid, a searcher can and commonly does make undisclosed purchases of the target's stock. Under the present formulation of the Williams Act, the searcher can buy up to 5 percent of the target's shares without disclosing the purchases. Whether or not the searcher ultimately acquires the target, the searcher will usually make a substantial profit on its pre-bid purchases.[2] The evidence indicates that the gain that a searcher can make on its pre-bid purchases often approaches 2 to 3 percent of the target's value.

In addition to making a profit on pre-bid purchases, searchers gain in other ways. In particular, even in an auctioneering regime, a searcher that acquires an identified target would often not have to pay as much as its valuation of the target. Of course, the searcher would have to pay at least the competitive price—that is, the price that other potential buyers would be willing to pay. The searcher, however, might place a higher value on the target's assets than do other potential buyers: buyers often vary significantly in the amount of efficiency gains (whether from "synergy" or from improved management) that they can produce by acquiring the target. In such a case, the searcher usually captures a substantial fraction of those gains from the acquisition that other buyers would be unable to produce.

The existing rewards for search appear to be substantial relative to search

2. If the searcher acquires the target, then its pre-bid purchases will enable it to save the bid premium on the stock it already owns. If another buyer acquires the target, the searcher will earn on its stock the acquisition premium paid by that buyer. And if the target's shareholders reject all available bids, then the searcher will still make a substantial gain, because in such a case the market price of the independent target's shares will probably be higher than the pre-bid price for which the searcher bought its shares.

costs. Because prospective buyers often lack appropriate in-house resources, the search is frequently conducted for them by investment bankers. In such cases, the search costs are a fraction of the investment bankers' total fees—fees which, in turn, are often less than 1 percent of the target's value.

While the existing level of acquirers' search is thus substantial, it is important to recognize that an auctioneering regime is consistent with even much more search by acquirers than now takes place. The rewards for search could be substantially increased by raising the statutory limit on the amount of the target's shares that a searcher can purchase without being required to disclose its purchases. As long as the searcher is required to stay below the threshold of effective control, an increase in the disclosure threshold would be consistent with an auctioneering regime. Thus, since the existing disclosure threshold of 5 percent falls far below any reasonable specification of the effective control threshold, the existing, substantial rewards for search could be greatly enhanced without sacrificing the benefits (to be described) of an auctioneering regime. Those concerned about the current level of acquirers' search should therefore, before advocating the drastic measure of repealing auctioneering, first push for—and see the consequences of—an increase in the statutory disclosure threshold.

1.1.2. ACQUIRERS' SEARCH IN THE NO-AUCTIONEERING REGIME

While auctioneering is consistent with a very substantial level of search, adopting the no-auctioneering regime would of course further increase the search by prospective acquirers. It is far from clear, however, that this increase in acquirers' search would be desirable, for the increase would overshoot the socially optimal level of that activity.

Like any other potentially beneficial activity, search is desirable only up to some point. Presumably we would not want to have most of the country's work force engaged in search for takeover targets. Specifically, search is socially desirable only to the extent that the social gains from it exceed its social costs; that is, the level of search is optimized at the point where the social benefit from an incremental unit of search is equal to its social cost. Because searchers bear the full costs of their search, a socially optimal level of search would be induced if and only if searchers expect to receive exactly—no less but also no more than—the social benefits of their activity.

Schwartz's valid concern is that an auctioneering regime does not always provide searchers with the full social benefits of their activity. Searchers that identify a target whose acquisition would produce efficiency gains generally cannot capture all of these efficiency gains but only part of them; consequently, acquirers' search for such potential efficiency gains is at a suboptimal level.

There is, however, another valid concern—that adopting the no-auc-

tioneering regime would produce socially excessive incentives to search. Under that regime, searchers would be able to acquire a target for a minimal premium over the target's prebid market value. Thus, searchers that identify a target whose acquisition would produce efficiency gains would capture the full value of these efficiency gains. Thus far, all is well. But the problem is that, in addition to such efficiency gains, searchers would also make some substantial private gains that would not fully reflect social gains.

Most importantly, searchers would make substantial gains from "foreknowledge-motivated" takeovers—takeovers motivated by the searchers' possession of private information suggesting that the target is currently undervalued by the market.[3] Searchers would consequently invest considerable resources in "foreknowledge-motivated" search—search aimed at identifying targets whose shares are currently undervalued. When undervalued targets would be identified, they would be acquired through an SNS raid with a minimal premium—and the searcher would thus capture the full gap between the target's true value and its pre-bid market value.

Foreknowledge-motivated takeovers, to be sure, are not entirely devoid of social value. When a searcher discovers and acquires an undervalued target, the acquisition process might lead the market to "correct" (at least partially) its valuation of the target. While this adjustment would eventually take place anyway, accelerating it is socially beneficial (as it might in the meantime provide better signals to investment decisions). The crucial point is, however, that the social value of this adjustment in valuation is smaller—and presumably much smaller—than the amount of the undervaluation. For example, suppose that a searcher discovers a target that has a true value of three billion dollars and acquires it for a minimal premium over its market price of two billion. Even assuming that the takeover would fully and immediately correct the market's valuation of the target's assets (which, as discussed below, might not happen), the social value of this correction would be presumably much smaller than one billion; for one billion would be the social value of the acquisition that would increase the target's real value by one billion (rather than merely alert the market to the existence of such a value).

Some have argued that many current takeovers are foreknowledge-motivated (see, for example, Lowenstein), while others have suggested that current takeovers cannot be well explained by such a motive (see, for example, Bradley, Desai, and Kim). It is thus important to emphasize that my argument in no way depends on the existing incidence of foreknowledge-

3. Tax savings are another type of private gains that do not reflect social gains. While tax savings produced by an acquisition do increase the combined wealth of the acquirer's and the target's shareholders, they do not of course represent social gains but simply come at the expense of tax revenues. As I pointed out in my earlier articles, while tax savings are unlikely to be the dominant motive for acquisitions, they are likely to motivate some acquisitions and to be present in a significant number of others.

motivated takeovers. As I will later explain, the existing auctioneering regime discourages foreknowledge-motivated takeovers much more than it discourages takeovers motivated by the prospect of efficiency gains. I therefore do not wish, nor do I need, to make any assertion about the current incidence of foreknowledge-motivated takeovers. I only claim that, *if* the no-auctioneering regime is adopted, there will be a substantial and excessive incidence of such foreknowledge-motivated acquisitions. This proposition directly follows from the observation that under that regime there would be very considerable profits to be made from looking for and making such acquisitions.

It is worth noting that, whether or not foreknowledge-motivated takeovers occur under the existing auctioneering regime, there is no doubt that a substantial foreknowledge-motivated search does currently take place. Arbitrageurs and other market professionals currently expend considerable resources to acquire private information that will enable them to identify companies that are likely to be undervalued by the market. At present, however, since SNS bids are not possible, these searchers derive their profits mainly by purchasing on the market the shares of undervalued companies. Indeed, such share purchases of market professionals eventually drive prices up toward true values, and they are indeed one of the main mechanisms that contribute to the relative efficiency of market prices (see, for example, Gilson and Kraakman, 1984).

It is unclear how the existing level of foreknowledge-motivated search compares with the desirable level of such search. The existing level might be excessive, because, as just explained, the social benefits produced by such search are significantly smaller than the identified gaps between the true value and market value of undervalued targets. The existing level might also not be excessive, however, since foreknowledge-motivated searchers can currently capture only a fraction of the gaps that they identify. Whether the current level is excessive or suboptimal, however, clearly the level of foreknowledge-motivated search under the no-auctioneering regime would be excessive; for in that regime searchers' gains would be virtually equal to the value of the identifed gaps between true and market values, and these gains would substantially exceed the social benefits from the searchers' activity.

Schwartz suggests that foreknowledge-motivated takeovers would not take place even in the no-auctioneering regime, and he provides several reasons for holding such a view. First, he doubts that any prospective bidder could ever acquire a piece of favorable information about a target that is not already fully reflected in the market price of the target's stock. Any favorable private information that a bidder could acquire, Schwartz says, is presumably known to the target's management; the management, interested in enhancing share value, would have presumably already revealed it to the market, and the market price therefore must already reflect it.

Schwartz's view implies that market prices reflect not only all publicly available information but also all private, including insider, information.[4] This claim is stronger than that which is usually made even by strong supporters of the efficient capital markets hypothesis. The version of the hypothesis that has significant academic support (and significant though not unambiguous empirical support) is that market prices fully reflect all publicly available information—but not necessarily all private information held by anyone (whether insider or outsider).

Indeed, it is generally believed that market prices do not fully reflect all such private information. Inside information, for example, is believed not to be fully reflected in market prices, because, for one thing, managers cannot continuously reveal their information in a costless and credible way. The view that at any time some private information is not fully reflected in prices and might thus enable its possessor to make profits is strongly supported by both theory and evidence. On a theoretical level, if prices reflected all private information, then no profits could be ever made from the possession of private information, and the acquisition of information would come to a halt. As to the evidence, it suffices to note that insider trading was found to provide insiders with significant abnormal returns (see, for example, Jaffe), indicating that inside information is not fully reflected in prices.

Alternatively, Schwartz argues that, even if a target happens to be temporarily undervalued and is identified as such by a prospective bidder, the bidder would be unable to acquire it for less than its true value. Whatever the reasons for the target's undervaluation, Schwartz says, this undervaluation would be eliminated once a bid is made. The target's managers would then have a strong incentive to convey the target's true value to the market. The market price would consequently go up to the true value, Schwartz suggests, and the bidder would be therefore unable to acquire the target for less than its true value.

It appears doubtful that management could always credibly convey the target's true value in the very brief period left to it by a SNS bid. For one thing, the verification, digestion and evaluation of information takes time; that is after all one of the main reasons why a delay period is so crucial for competing bids. Let us assume for a moment, however, that management could indeed respond to a foreknowledge-motivated SNS bid by convincingly reporting the target's true value. It is far from clear that this response would prevent the bid from succeeding.

As already noted, in the face of a SNS bid, the target's shareholders would

4. Although Schwartz's explicit assumption is only that managers will reveal to the market all *favorable* inside information, it can be shown that, if managers can and do credibly reveal all favorable information, then all insider information, good and bad, will become known to the market. See Ross (1979: 184–88).

be under considerable pressure to tender (and, given the likely first-come-first-served structure of the bid, under pressure to tender as early as possible). Consequently, shareholders would likely tender their shares and the bid would likely succeed even if shareholders believe management's announcements that the target's value is high and that rejecting the bid would be thus value-maximizing. Indeed, once the SNS bid is launched, the market price would be unlikely to reflect subsequent revisions in the shareholder's estimates of the target's independent value; the market price would likely be affected by the looming presence of the bid and the expectations of a takeover, and consequently it might well be capped by the bid price (see Bebchuk, 1985a: 1727–29; Bebchuk, 1985b: 34–35).[5]

Finally, Schwartz suggests that, even assuming that under the no-auctioneering regime a bidder would be able to acquire an undervalued target for less than its true value, the bidder would be unable to profit from such a foreknowledge-motivated takeover (and therefore would presumably not attempt it in the first place). As just discussed, Schwartz believes (mistakenly) that acquiring an undervalued target for less than its true value would be possible only if, subsequent to the bid, the target's management fails to convince investors that the target has been thus far undervalued. If management fails to change the market's valuation of the target's assets, Schwartz asks, how would the acquirer succeed in doing so? Following the takeover, Schwartz reasons, the market would continue to undervalue the target's assets and the takeover would consequently fail to produce an appreciation of the acquirer's stock.

But, even assuming that the market would initially continue to undervalue the target's assets (and thus also the combined assets of the target and the acquirer), this undervaluation would not permanently persist. Clearly, even if the target were to remain independent, its true economic value would eventually be revealed. Indeed, when a bidder is said to possess private information that a target is undervalued, the meaning of this statement is that the bidder's private information suggests that the market's current valuation of the target's assets is lower than the valuation that the market is expected to attach to these assets at some future date. Of course, following a foreknowledge-motivated takeover, the acquirer would try (often with some success) to accelerate the upward revision in the market's valuation of the target's assets. But even if the full adjustment takes time it would eventually occur, and there

5. Indeed, Schwartz's analysis itself assumes that shareholders would not be always capable of rejecting a Saturday-Night-Special raid even if doing so would be their value-maximizing course of action. Schwartz assumes that under the no-auctioneering regime acquisition premiums would be significantly lower than under the auctioneering regime, where mandatory delay is provided. But if shareholders are able to reject SNS bids when that would be value-maximizing, then the no-auctioneering regime would not have the effect of reducing premiums: for then shareholders would reject the SNS bids in every case in which it appears that they would be able to receive subsequently a higher offer from a rival bidder.

can be thus no doubt that acquiring an undervalued target through a minimal-premium SNS bid would be a very good investment indeed.

In sum, it can be confidently concluded that under the no-auctioneering regime there would be, alongside the substantial incidence of efficiency-motivated takeovers, also a substantial incidence of foreknowledge-motivated takeovers. The latter would enable searchers to capture the gap between the true value and market value of identified undervalued targets. And these gains would induce a very considerable and *socially excessive* level of foreknowledge-motivated search.[6]

6. In a rejoinder that follows below, Schwartz criticizes the analysis above and continues to deny that foreknowledge-motivated search and takeovers would take place under the no-auctioneering regime. In particular, he makes several claims (Schwartz, 1986b:272–74).

(i) Schwartz continues to maintain that all private information (and not only all public information) is bound to be fully reflected in market prices immediately—or, at most, within a few hours—after it becomes known to some private party. Schwartz continues to assume that all private information about a target is known by the target's management, that the management can always pass this information to the market in a convincing, credible and costless way, and that the management will always do so immediately or, at most, after the few hours that would be needed for the managers to trade on the basis of the information. As I just emphasized, however, this view is totally inconsistent with the received economic theory. It is generally accepted among financial economists that market prices do not and indeed cannot reflect all private information (see, e.g., Grossman and Stiglitz, 1980), in part because management cannot credibly and costlessly pass all of its private information (see, e.g., Ross, 1979).

(ii) Schwartz quotes what I said in another context in another paper (see Bebchuk, 1985b: 38), and asserts that the point I made there suggests the unlikelihood of foreknowledge-motivated takeovers. I said in that paper that, even under the Williams Act, competition among acquirers is not perfect. While a bid below a target's value will often trigger a higher rival bid, this is not always bound to occur. A potential rival bidder, I said, might be sometimes discouraged from bidding by the presence of uncertainty concerning the target's value, by the transaction costs involved, or by the prospect that a bid would trigger a bidding contest that would drive the price up and thereby eliminate or curtail the potential for profit. Schwartz claims that the problems I noted would prevent foreknowledge-motivated bids from taking place.

The problems that I noted, however, in no way warrant such a prediction. To start with, even under the Williams Act, the noted problems do not prevent all or most rival bids. After all, current competition among acquirers is real and viable. What I suggested was that these problems exist and have significance in a nontrivial fraction of cases, thus making the competition among acquirers less than perfect. Moreover, these problems would affect potential SNS bidders under the no-auctioneering regime even less than they affect potential rival bidders under the Williams Act regime. These problems might have more of a chilling effect on a potential rival bidder that faces an initial premium bid because the rival bidder would have to offer more than this initial bid and, furthermore, it might have to pay a higher price yet if the initial bidder raises its bid. These problems would naturally have little chilling effect on a potential bidder that, under the no-auctioneering regime, would be able to acquire the target for a minimal premium. In sum, these problems would not prevent foreknowledge-motivated takeovers from occurring under the no-auctioneering regime.

(iii) Finally, Schwartz puts on me the burden of proving that foreknowledge-motivated takeovers would occur under the no-auctioneering regime. He says that "it is not enough" to raise the possibility of an increase in foreknowledge-motivated search, because such an outcome seems much less likely (in light of his criticism of my analysis) than other outcomes. But, as I just explained, his criticism provides no basis for viewing this outcome as unlikely. In any event, the burden that Schwartz suggests I must now carry is that of showing that my prediction rests on plausible assumptions. This burden is clearly discharged by my analysis. My prediction follows from the assumption that searchers seek to maximize profits and from the observation that the no-auctioneering regime would significantly increase the profits that searchers could make from

1.1.3. EVALUATING THE EFFECT OF AUCTIONEERING ON ACQUIRERS' SEARCH

Neither the auctioneering regime that I support nor the no-auctioneering regime advocated by Schwartz is likely to produce a socially optimal level of search. On the one hand, the no-auctioneering regime would clearly produce an excessive level of search; in particular, it would produce substantially more foreknowledge-motivated search than is socially desirable. On the other hand, in an auctioneering regime, the level of search for targets whose acquisition would produce efficiency gains, though substantial, is still likely to be suboptimal.

It follows that the effect that adopting the no-auctioneering regime would have on prospective acquirers' search might or might not be desirable. Would we be better off having the excessive search of the no-auctioneerng regime or the possibly suboptimal search of an auctioneering regime? We do not have enough empirical information, of course, to provide a definite answer.

In evaluating the desirability of the auctioneering regime's effect on acquirers' search, however, there is an important feature of the regime that should be borne in mind. The auctioneering regime has a different effect on foreknowledge-motivated search than it has on efficiency-motivated search: the regime reduces the rewards for the former more sharply than it reduces the rewards for the latter. When the motivation for acquiring the target is the current undervaluation of the target's stock, the value of the target is presumably the same for all potential buyers. Consequently, under the auctioneering regime, the first bidder cannot hope to purchase the target for significantly less than its valuation of the target. In contrast, when the motivation for acquiring the target is the prospect of realizing efficiency gains, prospective acquirers might vary considerably in the amount of efficiency gains that they can produce and thus in the value that they attach to the target. Consequently, in such a case, the identifying searcher might well expect that, if it ends up acquiring the target, it is likely to pay significantly less than its valuation of the target and to be thus left with a significant surplus. Hence, the auctioneering regime discourages foreknowledge-motivated search more strongly than it discourages efficiency-motivated search. It follows that adopting the no-auctioneering regime would encourage efficiency-motivated search less than it would boost foreknowledge-motivated search.

Finally, the foregoing evaluation of the effect of auctioneering on acquirers' search suggests that, even if this effect is undesirable, it is far from clear that its magnitude is significant.

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identifying undervalued targets. Indeed, the prediction that, by increasing the return on foreknowledge-motivated search, the no-auctioneering regime would increase that search rests on the same logic and theoretical assumptions on which rests the prediction, which Schwartz and I share, that, by increasing the return on search for efficiency-enhancing acquisitions, the no-auctioneering regime would increase that search.

1.2. The Effect of Auctioneering on Targets' Search

Even assuming that adopting a no-auctioneering regime would have a desirable effect on the search by potential acquirers, the overall effect of the regime on the number of beneficial acquisitions might be negative, for the regime would have an undesirable effect on the search by potential targets.

Corporate acquisitions result not only from search by potential buyers for a target but also from search by potential sellers for a buyer. If acquisition of a company can produce efficiency gains, its management may look for an appropriate buyer and try to negotiate an acquisition.

Now, a no-auctioneering regime would sharply reduce premiums not only in hostile takeovers but also in negotiated acquisitions. Premiums in such acquisitions are negotiated against the background of a possible unfriendly tender offer by the prospective acquirer. And the no-auctioneering regime would greatly strengthen the prospective acquirer's negotiating position: the acquirer would have no reason to pay more than the low premium it would have to spend to acquire the target through an unfriendly offer.

Because the no-auctioneering regime would curtail the premiums in negotiated acquisitions, it would all but eliminate the potential target's incentives to search and would thus greatly diminish the number of seller-initiated beneficial acquisitions. This reduction in potential targets' search would be clearly undesirable, because such search is presumably never motivated by an underevaluation of the target's stock.[7]

7. In his rejoinder below, Schwartz criticizes the above analysis on several grounds and denies that the auctioneering regime has a desirable effect on targets' search (Schwartz, 1986b: 274–76.

(i) Schwartz questions whether search by targets actually occurs. He says that in models developed by search theorists there is usually no search by both buyers and sellers—either buyers search or sellers search but not both. These models lead him to believe that "joint search" is unlikely to take place.

Schwartz's skepticism concerning the existence of search by targets, however, is unwarranted. In many models that use the assumption that search is conducted only by one side of the market, the assumption is employed solely because of analytical convenience rather than a belief that this is the way the world works. In other models that employ the assumption, it is substantively justified because one side of the market lacks relevant information or faces prohibitive search costs. In our context, however, economic reasoning clearly suggests that, under the auctioneering regime, search for combinations that would produce synergistic gains takes place by both targets and acquirers. The managers of many potential targets might possess information suggesting that the acquisition of their company would produce synergy. Under the auctioneering regime, a synergy-producing acquisition of a target is expected to benefit the target's shareholders. And since target managers are at least partly interested in maximizing the target's value, they will often, when they see a potential for synergy, look for a potential buyer.

(ii) Schwartz questions whether, assuming that search by targets does take place, the no-auctioneering regime would decrease its level. My prediction that this would happen, he says, is inconsistent with the existence of friendly mergers before the enactment of the Williams Act.

My prediction is rooted in a simple and plausible model. Because the no-auctioneering regime would reduce the share of acquisition gains that targets would capture, it would decrease the return to targets' search and thereby discourage that search. My prediction is thus based on the same logic that underlies the prediction, which both Schwartz and I share, that the no-auctioneering regime would increase acquirers' search by raising the return to such search.

The existence of friendly mergers before the enactment of the Williams Act does not justify

2. OTHER EFFECTS OF AUCTIONEERING

After questioning the argument that auctioneering has a substantial negative effect on search, my earlier articles went on to describe three efficient effects

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rejecting the highly plausible prediction that the no-auctioneering regime would decrease targets' search. For one thing, the friendly mergers in the pre-Williams period could have resulted from acquirers' search. Moreover, in that period many potential acquirers were reluctant to use hostile tender offers; consequently, the absence in that period of a mandatory delay did not discourage targets from approaching potential buyers as much as it would discourage them today. Therefore, Schwartz is not justified in drawing inferences from the pre-Williams period regarding the effect that adopting the no-auctioneering regime now would have on targets' search. Indeed, if Schwartz is prepared to draw such inferences from that period, then he will have to reject his prediction that the no-auctioneering regime would encourage acquirers' search; for he will then have to view this prediction as inconsistent with the fact that in the 1950s there were almost no hostile takeovers.

(iii) Finally, Schwartz argues that, even assuming that the no-auctioneering regime would eliminate targets' search, this undesirable effect would in all likelihood be outweighed by the regime's desirable effect of increasing acquirers' search. Schwartz seems to believe (1) that optimal levels of search for synergistic gains would be induced if buyers capture all the created synergistic gains (and are thus the only ones to search) or at least (2) that we would get closer to the optimal search for synergy by giving all the created gains to acquirers (as the no-auctioneering regime would do) than by splitting the gains between acquirers and sellers (as the auctioneering regime does). Both beliefs have no basis in economic theory.

The no-auctioneering regime, in which only acquirers would search, is unlikely to induce optimal levels of search for synergy. Some targets presumably have important relevant information that no buyer possesses. Therefore, the first-best level of search presumably includes at least some search by targets.

More generally, no feasible regime is likely to induce the first-best levels of search for synergy. The first-best levels would obtain when both buyers and sellers search up to the point where the marginal social benefit of their search is equal to the marginal social cost. These levels would be induced if both buyers and sellers could expect to capture the full synergistic gains produced by acquisitions in which they would participate. But it is impossible, of course, to give the full gains to both buyers and sellers. Consequently, in every feasible regime, some sellers or buyers would be unable to expect to capture the full synergistic gains that they would identify and would therefore search too little.

Since no feasible way of distributing synergistic gains would induce the first-best levels of search for synergy, the desirable distribution is that which would bring us closest to the first-best. This distribution depends of course on the shape of the functions (on which we know very little) that describe how the marginal effectiveness of buyers' and sellers' search varies with their investment in search. Therefore, there is no reason to accept Schwartz's belief that in all likelihood the desirable distribution is (in economic terminology) the "corner solution" of giving all the created synergistic gains to buyers.

It is easy to see that distributing all the gains to buyers need not be superior to splitting them. Suppose that the effectiveness of both buyers' and sellers' search steeply declines with its level. In such a case, little search by both sellers and buyers would be clearly preferable to a lot of search by buyers and no search by sellers. And since every splitting of gains would induce some search by both sides of the market, it would be superior to distributing all the gains to buyers and thereby inducing no search by sellers. Indeed, it can be shown that, as long as the marginal effectiveness of both buyers' and sellers' search is declining, the optimal distribution is in all likelihood some form of splitting of gains; for in this likely case it is desirable to induce at least some search by both buyers and sellers. (Of course, this optimal splitting need not overlap with the one that the auctioneering regime produces).

In sum, there is no reason to accept Schwartz's belief that the no-auctioneering regime's undesirable effect of eliminating targets' search for synergy would be outweighed by its desirable effect of increasing acquirers' search for synergy. This prediction is no more plausible than the opposite one.

that auctioneering has: (1) allocating target assets to their most valuable uses; (2) improving the information underlying acquisition decisions; and (3) providing incentives to efficient investment in given companies. Schwartz disputes my view with respect to effect (1) and ignores effects (2) and (3).

2.1. Allocating Target Assets to Their Most Valuable Uses

In a world without transaction costs, so taught us Coase (1960), assets would always promptly reach—through one or many contractual transactions—the party that can use them most efficiently and therefore values them most highly. In such a world, legal rules would be irrelevant to attaining efficient allocation of assets: such allocation would promptly result no matter what the initial allocation is. In our imperfect world, however, friction unfortunately exists. For this world, the lesson of the Coase Theorem is that legal rules might serve a beneficial role of facilitating a relatively direct assignment of assets to their most valuable uses, thus avoiding the frictional and imperfect process of transfer and resale.

Such a role, I argued in my earlier articles, is served by the auctioneering regime. Acquirers might significantly vary in the value that they attach to a given target's assets: the magnitude of synergistic gains clearly depends on the "fit" between the acquirer and the target, and acquirers may well differ in their ability to improve the target's management. An auctioneering regime ensures that a target will be acquired by the buyer that is the highest-valuing user of its assets. In contrast, under the no-auctioneering regime, the target would be always acquired by the first bidder—which might or might not be the highest-valuing user.

Schwartz disputes this point and relies on the possibility of a resale—if the first bidder acquires the target but is not the highest-valuing user, then it might resell the target's assets to the highest-valuing user. Schwartz suggests that (1) this resale is virtually certain and involves little friction; and (2) the auctioneering regime, in any event, is likely to produce more friction than relying on a series of resales.

2.1.1. Friction in the Resale Process

It is doubtful that, in the circumstances under consideration, a resale by the first bidder is virtually certain and involves little friction. This resale process is presumably no more perfect than the common process of one proprietor's negotiating to sell assets to another proprietor; and, ever since the Coase Theorem, law and economics scholarship has devoted much attention to examining how legal rules could be designed to avoid reliance on such sales. For example, like any other negotiated sale, a resale by the first bidder might not take place due to strategic behavior—the parties might not reach agreement concerning the division of the gains from the resale; as game

theorists have taught us, such a deadlock is quite possible in situations (like the one under consideration) where each of the parties is uncertain as to the other's valuation of the object to be sold. This problem does not exist, of course, in an auctioneering regime. Another problem that might be worth noting with respect to the resale scenario is that it might involve a significant delay; for one thing, after the first bidder gains control it might well prefer not to attempt a resale right away but rather effect a takeout first (which takes time), so as to be in the position to sell the whole target rather than a controlling interest in it.[8]

2.1.2. Friction in the Auctioneering Regime

I disagree with Schwartz's claim that the auctioneering regime is likely to involve more friction than a regime of resales. To assess this claim one should consider the two ways in which the auctioneering regime ensures an efficient allocation of target assets.

Uncontested bids. It is important to recognize that the auctioneering regime performs its allocational role not only in those cases where an auction actually takes place but also in the more numerous cases where no bidding contest occurs. For the auctioneering regime substantially increases the likelihood that the first bidder for a given target will be the acquirer to which the target's assets are most valuable.

Suppose, for example, that an investment banker studies a target on its own initiative (as often happens), planning to interest a potential buyer later in the idea of an acquisition. Since bankers' fees are contingent on the success of the acquisition attempt, the auctioneering regime provides the banker with a strong incentive to look for the highest-valuing user: the banker will realize that buyers other than the highest-valuing user will likely fail to acquire the target. In contrast, under the no-auctioneering regime the first bidder would usually succeed in acquiring the target, and the banker's incentive to look for the highest-valuing user would be thus sharply reduced.[9]

8. In my earlier articles I noted among the problems of the resale process that it might be distorted by a preference that the acquirer's managers might have for expanding (or not reducing) the size of their company. Schwartz correctly points out that managerial preference for size might also distort the outcome of auctions, and that it therefore does not provide a good reason for preferring the auctioneering regime. I accept this point and am grateful to Schwartz for pointing it out.

9. In his rejoinder below, Schwartz denies that the auctioneering regime would increase the banker's incentive to look for the highest-valuing user (Schwartz, 1986b:276). He notes that even under the no-auctioneering regime the banker would have some incentive to look for the highest-valuing user, because the banker's information would be somewhat more valuable to the highest-valuing user than to another buyer. Consequently, Schwartz argues, it is difficult to see how the auctioneering regime could materially enhance the banker's incentive to look for the highest-valuing user.

Now, I have not claimed that under the no-auctioneering regime the banker would have no incentive whatsoever to look for the highest-valuing user. Rather, my claim is that this incentive is much greater under the auctioneering regime. Consider the difference between the value of the

Or suppose that a target is identified by a searcher, say, Carl Ichan, that currently gains mainly by making profits on the initial stakes that it acquires in identified targets. Under the auctineering regime, Ichan will purchase a block of the target's stock, attract the market's attention to the target, induce a bid by the highest-valuing user, and thus earn the takeover premium on its block. In contrast, under the no-auctioneering regime, Ichan would not seek to induce a bid from the highest-valuing user. Rather, Ichan would launch an immediate Saturday-Night-Special Raid, acquire the target for a minimal premium, and then resell the target to the highest-valuing user; in this way, Ichan would be able to earn a substantial premium not on a limited block but on all of the target's stock.

The foregoing analysis is supported by the evidence that in the existing auctioneering regime most tender offers are not contested (see, for example, Bradley, 1980). Thus, there are probably many cases at present where the first bidder is the highest-valuing user only because of the existing auctioneering rules. In these cases, the auctioneering regime produces an efficient allocation of target assets without any transaction costs being incurred beyond the unavoidable costs of the first bid. The no-auctioneering regime would thus necessarily add friction in these many cases, no matter how limited the friction involved in a resale.

Contested bids. The above analysis suggests that, overall, the auctioneering regime is likely to minimize the friction involved in moving assets to their most valuable uses even if actual contests, which occur in a minority of the cases, were as costly as Schwartz thinks they are. Nonetheless, it is worth noting that having auctions is not as costly as that.

Schwartz thinks that a Williams Act auction is bound to be quite costly because it "is conducted by target managers, who have an incentive to cause the auction to fail altogether, or to use it to bargain with bidders about the security of their own jobs" (p. 244). Under the auctioneering regime that I advocate, however, management would be prohibited from obstructing bids and it would therefore be unable either to make the auction fail altogether or otherwise to abuse the time provided by the auctioneering regime. The point is that the costs of auctions should not be judged by the example of past bidding contests. Most of the friction and waste that accompanied these contests resulted from obstructive defensive tactics (and bidders' responses to them), and banning such tactics would thus eliminate these costs. The only

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banker's information to the highest-valuing user and the value of this information to another buyer. Clearly, this difference in the information's value to the two buyers is much greater under the auctioneering regime than it would be under the no-auctioneering regime. For under the auctioneering regime a bidder other than the highest-valuing user would have little chance of acquiring the target, while under the no-auctioneering regime such a bidder would have a very good chance of doing so. Thus, the auctioneering regime materially enhances the gain to the banker from identifying the highest-valuing user—and thus also the banker's incentive to look for that buyer.

costs that are intrinsic to the operation of an auctioneering regime are the costs of making competing bids, and these are a small price to pay for ensuring an efficient allocation of target assets.

2.2. Improving the Information Underlying Acquisition Decisions

A prospective acquirer that has imperfect information about a target might err in estimating the efficiency gains that acquiring the target would produce; the acquirer might mistakenly believe that efficiency gains would result even though that particular acquisition would produce no efficiency gains or even efficiency losses. The auctioneering regime improves the information that underlies acquisition decisions, and it thus reduces the likelihood of such an erroneous, inefficient acquisition.

Under an auctioneering regime, a prospective buyer that identifies a potential target might well approach its management, initiate acquisition negotiations, and request certain information about the target. When management agrees to negotiate and provides the requested information, the acquirer is likely to receive nonpublic information that it could not otherwise obtain and that will make the acquirer better able to evaluate whether an acquisition will be beneficial.

Under the no-auctioneering regime, in contrast, a prospective buyer that identifies what seems to be a promising target would avoid approaching the target's management and would instead launch an immediate unsolicited bid. Approaching management always creates the risk that it would start bringing in rival bidders. Under the no-auctioneering regime, the prospective buyer would be unwilling to bear this risk because it would have the opportunity to launch an SNS bid and thereby eliminate the possibilty of competing bids.

2.3. Providing Incentives to Efficient Investment in Given Companies

When the ownership of a given property does not enable the owner to capture the full social gains resulting from the property, investment in this property will be suboptimal. This familiar point implies, in particular, that, to induce an optimal level of investment in a given company, potential investors in the company must expect to fully capture the social gains that will result from their investment.

Now, the gains produced by an acquisition of a target are attributable not only to the preceding search but also to the target's existence, and thus to individuals' prior decisions to establish the target and invest in it. Thus, by ensuring competitive acquisition prices, an auctioneering regime provides target shareholders with a larger share of the gains that are attributable to the target's existence.

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outweigh its possibly negative effect on prospective acquirers' search. Yet, on policy questions of this kind, a conclusive proof in favor of any position is very rare indeed, and society must usually choose on the basis of the best judgment that can be formed. In light of the preceding conclusions, my own judgment is that impeding competing bids would likely be undesirable, and that we should therefore not return to a regime of Saturday-Night-Special raids.[10]

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10. In his rejoinder Schwartz chooses not to address most of the elements of my analysis. Instead, he makes a sweeping criticism of the quality of the analysis in my reply. He asserts that my analysis is of an "older," "obsolete," and "lawyerlike" kind, that it thus differs from the systematic and careful analysis of "modern law and economics scholarship," and that it is therefore not "entitled to credibility."

To substantiate his assertions, Schwartz chooses three elements of my analysis as examples and criticizes them. I added footnotes 6, 7, and 9 to examine this specific criticism. As I explain in these footnotes, the points criticized by Schwartz are a direct application of received economic theory and reasoning. Consequently, his criticism not only does not show any methodological difference between my work and "modern law and economics scholarship," but is also unwarranted on the merits.

As to Schwartz's general assertions concerning the nature of my analysis, I was frankly quite puzzled by them. While I understand that someone could form a different judgment as to how the various factors involved balance overall (as did Easterbrook and Fischel), I cannot see what could lead Schwartz to characterize my analysis as being different from and inferior to that of "modern law and economics scholarship." I therefore leave it to the reader to judge the general nature and quality of my analysis.