

Corporate Wealth Maximization, Takeovers, and The Market for Corporate Control

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Introduction

The recent storm of hostile corporate takeovers in the US, UK, Canada, and Australia could lead to the misleading conclusion that such activities will soon spread to other capital markets, particularly in Western Europe, as a part of the restructuring process that is currently gaining momentum. The purpose of this article is to explain why hostile takeovers are unlikely to play an important role in this restructuring process, whereas friendly mergers and strategic alliances may be heavily employed. Our conclusion is based on what we see as a sharp dichotomy between the existing Anglo-American capital markets and the non-Anglo-American markets.

Our main hypothesis is that the Anglo-American markets are driven by a philosophy best described in the academic literature as the »Stockholder Wealth Maximization« model (SWM), whereas the non-Anglo-American markets are functioning in a manner best described in the academic literature as the »Corporate Wealth Maximization« model (CWM).

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Introduction

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Our secondary hypothesis is that the Anglo-American markets can operate in the SWM model mode because of the discipline imposed by the one-share-one-vote norm and the lack of any completely effective takeover defenses. On the other hand, the non-Anglo-American markets are not characterized by the one-share-one-vote norm and they have historically developed an impressive array of takeover defenses.

Regardless of our observed dichotomy between the way national equity markets function in practice, it should be noted that the theoretical basis for all markets for corporate control has its roots in classical economic theory. The theory held that land, labor, and capital are the scarce economic resources. Factor markets determine the price of each according to the law of supply and demand. Entrepreneurs (owner-managers) have the right and the motivation to combine the scarce factors of production with a goal of maximizing the profit of the firm.

During the nineteenth and twentieth centuries classical economic theory had to be modified to reflect new realities. Ownership and management had become increasingly separated with the development of public equity markets and large corporations. Instead of the owner-management function being combined, managers became another scarce factor of production whose price is determined in its own factor market. Ownership also became a separate factor with a price determined in its own factor market (equity markets). Finally, technology became still another scarce resource, not necessarily imbedded in either managers or owners, with the price of technology determined by its own separate factor market.

The big question today is which of these separate factors has the right, ability and motivation to combine the other factors of production and who should be the principal beneficiaries? Should it be the owners, managers, technologists, labor or some other stakeholder? At this point in time it appears that the Anglo-American markets are leaning toward the owners being the principal beneficiaries, with the managers acting as the owners' agents (SWM model). In the non-Anglo-American markets, the owners are considered to be only one of a number of stakeholders who are collectively the beneficiaries, and managers are not considered to be the agents of any one stakeholder group (CWM model).

This article is divided into five parts. First we describe the main assumptions of the CWM model. Second, we describe the main assumptions of the SWM model. Third, we analyse how the two models have historically led to a conflict in corporate strategy. Fourth, we analyse the tactics that are used in the non-Anglo-American equity markets to ensure the preservation of the CWM model of corporate control. Fifth, we speculate about future developments in the market for corporate control in the non-Anglo-American markets.

The Corporate Wealth Maximization Model

Although the CWM model is most descriptive of the way companies are managed in non-Anglo-American markets, strangely enough the CWM model has been best explained by Gordon Donaldson and Jay W. Lorsch in two books published in 1983 and 1984, using a sample of 12 large, mature, U.S.-based industrial firms over a period of 10 or more years.¹ They introduce the concept of »managing corporate wealth« to describe the way in which management of the sample firms develop statements of corporate mission, establish detailed operational goals, plan a balance between financing capacity and their growth aspirations, and monitor their performance. The authors identify a goal of »corporate wealth maximization« being pursued by all 12 sample firms rather than the goal of stockholder wealth maximization which is prescribed in modern finance theory. However, some of these same firms today may be modifying their behavior as a result of hostile takeovers of even the largest firms such as RJR Nabisco.

Although the Donaldson and Lorsch study was based on a sample of U.S. firms, their CWM model is a very good description of how corporate control is exercised in most Continental Western European countries as well as Japan. It may also still be valid for some portion of the firms located in the Anglo-American markets (the United States, United Kingdom, Canada, Australia and New Zealand)

Choice of Organization Goals in the CWM model

In the CWM model the goal setting process starts with top management defining a corporate mission or purpose. Although usually couched in general terms, the corporate mission identifies those business opportunities which the firm will pursue, and those it will not pursue. The choice depends in part on management's perception of where the firm's comparative advantages should be. The corporate mission statement is then typically made operational by a strategic five year plan with more specific goals, including ones related to financial management, but also including product market and other nonfinancial goals.

Management's choice of goals is constrained by the need to satisfy various important »constituencies«, an observation which is consistent with the behavioral theory of the firm espoused by many organization theorists.² The main constituencies identified by Donaldson and Lorsch are: »the capital market of lenders and shareholders; the product

1. Donaldson and Lorsch, 1983 and Donaldson, 1984.

2. The pioneering work on the behavioral theory of the firm was done in the 1950's and 1960's by Herbert Simon, Richard Cyert, James March and others at Carnegie-Mellon University. A good summary of their work can be found in Cyert and March, 1963.

market, which includes suppliers and host communities as well as customers; the organization itself, with particular emphasis on the managerial, technical, and supervisory personnel who are the key career employees; and society or the public at large.³ Since there are multiple constituencies there must be multiple goals. Some of these are couched in familiar quantified financial terms. Other goals are nonfinancial and sometimes qualitative rather than quantitative statements.

Management Goals in the CWM Model

Management's choice of specific goals is strongly influenced by four motives: 1) organizational survival; 2) managerial independence; 3) organisational self-sufficiency; and 4) managerial self-fulfillment.

The most important of these is organizational survival. This means the firm is growing profitably in the long run even if it must diversify into new product markets to maintain its momentum, i.e., it justifies becoming a conglomerate. It also means that incumbent management remains in charge and is able to leave its imprint on the organization's future direction.

Managerial independence means that management can make decisions without the threat of binding interference from external constituencies such as the lenders, suppliers, government regulators, and even dissident stockholders or directors. It is assumed that stockholders know managements's strategic and operational plans and choose to purchase, hold or sell shares based on that information. It is important to note that the stockholders do not choose goals or strategies for the firm in the CWM model, nor is it assumed that management is an »agent« of the stockholders.

Organizational self-sufficiency means the ability to manage potential conflicts among the objectives of the various constituencies. It implies an ability to do without the full support of one or more constituencies such as lenders or stockholders.

Managerial self-fulfillment means the desire by management to succeed in what they view as a hostile and keenly competitive environment. Success is not what has sometimes been referred to as »managerial welfare maximization« or »risk minimization«. Management's measure of success is synonymous with the organization's measure of success. Since management selects the corporate mission and specific goals the extent to which the organization achieves these is the measure of management's success. In a sense the organization is an extension of management and they stand or fall together.

In evaluating organizational and thus managerial performance both financial and nonfinancial goals are considered. Many goals are stated in relative rather than absolute

3. Donaldson, 1984, p. 25.

terms. For example, the organization wants to have the largest market share in each of its three product markets, an employee turnover rate lower than the industry average, a return on equity greater than the industry average, and an increase in its financial reserves. The first three goals are relative to competitors and the last one a comparison with itself over time.

None of the 12 firms in the sample studied by Donaldson and Lorsch had specific goals related to stock price. In all cases management did not believe a good predictive model of stock valuation exists, and even if it did too many of the variables would be beyond management's control. Management's commitment to its stockholders was to generate growing earnings and dividends over the long run with as much certainty as is possible given the mission statement and goals. Risk was viewed more in the context of product market variability than quarter to quarter variations in earnings or market price per share. None of the firms was concerned about risk as perceived by portfolio managers. Therefore investments were not constrained by a need to exceed a risk-adjusted rate of return calculated by using the capital asset pricing model, arbitrage pricing theory, or any other model devised by financial theorists.

Corporate Wealth Maximization in the CWM Model

Having selected the corporate mission and specific goals, the key to achieving the desired results lies in management's ability to accumulate »corporate purchasing power« or »wealth«. Donaldson and Lorsch state, »To assure survival, self-sufficiency and success, these top managers strive continuously to conserve and augment corporate wealth. Thus they have a natural inclination to amass resources, including the financial resources that give them a significant measure of independence from the capital market constituency. ... In general, therefore, these ultimate objectives are consistent with the traditional economic view that top managers seek the maximization of wealth: the more wealth, the greater the assurance of the means of survival and all that this implies competitively.«⁴

»Corporate wealth« is defined in both a broad context and a narrower one more closely akin to financial management. The broader definition states, »... our definition of wealth takes in corporate wealth in its entirety — that is the technical, market and human resources under management's direct control as well as the firm's financial resources. Consequently, it goes beyond the wealth measured by conventional financial reports to include the firm's market position as well as the knowledge and skill of its employees in technology, manufacturing processes, marketing and administration of the enterprise.«⁵

4. Donaldson and Lorsch, 1983, p. 162.

5. Donaldson and Lorsch, 1983, pp. 162-163.

The narrower financial-oriented definition states, »Corporate wealth is *that wealth over which management has effective control* and which is an assured source of funds, at least within the limits of meaningful strategic planning. In practical terms it is cash, credit, and other corporate purchasing power by which management commands goods and services. Thus it is wealth vital to the organization's survival, wealth which the enterprise cannot or will not do without, because it is essential to its business mission.«⁶

The Shareholder Wealth Maximization Model

The SWM model, which is virtually the only model analysed in the finance literature, stands in sharp contrast to the CWM model. Instead of satisfying a multiple set of goals as in the CWM model, the single goal of the firm should be to maximize the return to shareholders for a given level of risk, or conversely, minimize the risk to shareholders for a given rate of return. Risk is defined as the added risk the firm's shares brings to an already diversified portfolio, rather than the total risk (operational and financial) of the firm itself. This is based on the assumption that the shareholders can eliminate all random type risks, except the risk of overall stock market movements, through portfolio diversification. International portfolio diversification is the ultimate method of this type of risk reduction. Thus unlike the CWM model, the total variability of a firm's cash flows, income, or sales matters only to the degree to which it causes returns to be correlated with movements in the stock market itself.

In the SWM model the share price is assumed always to be correct because it captures all the expectations of return and risk as perceived by investors. Furthermore, the stock market is efficient in that all past and new information is quickly reflected in a share's price. As a result relative share prices are the best allocators of capital in the macro economy.

Instead of management choosing and balancing multiple goals, as in the CWM model, management is limited to being the agent of the shareholders alone (Agency Theory). Shareholders contract with management to maximize shareholder wealth. They accomplish this purpose by placing both positive and negative inducements in the contract with management. For example, granting stock options is a positive inducement. Firing management is the ultimate negative inducement.

The historical corporate strategy conflict between CWM and SWM models in the Anglo-American markets

The CWM model preceded the SWM model in theory and in practice in both the Anglo-American markets and other markets. It was not until the path-breaking article by

6. Donaldson, 1984, p. 22.

Modigliani and Miller in 1958 that academic attention began to focus on maximizing stockholder wealth.⁷ Portfolio theory itself only began in 1959 with the pioneering work of Markowitz, followed by Sharpe (1963).⁸ Agency theory developed in the 1970's.⁹ Therefore the earliest clash between the CWM and SWM models began in the late 1960's and intensified in the 1970's and 1980's.

During the 1960's the CWM model justified the popular strategy for large firms to diversify by acquiring other firms in different industries through an exchange of stock or by cash purchase. The resulting conglomerates enjoyed high price-earnings ratios and rapid rates of growth due mainly to their acquisitions. The acquisition strategy literally created market value when a conglomerate with a high price-earnings ratio exchanged shares with a firm with a low price-earnings ratio. The rationale behind this was that these mergers created synergy and improved economies of scale. The slogan at that time was that »2 + 2 = 5«, meaning that the sum of the whole (merged firm) was greater than the sum of the individual parts (pre-merged firms).

The worldwide stock market crash of 1969 hit the conglomerate stocks much worse than other stocks. Disenchantment with conglomerates led to much lower price-earnings ratios, which in turn made it uneconomical to acquire other firms through an exchange of shares. Without acquisitions the conglomerates experienced low rates of growth which, of course, reinforced their low price-earnings ratios.

During the 1970's portfolio theory finally caught on in the investment world. The SWM model had experienced rapid development in the academic world during the 1960's and by 1970 financial theorists were recommending to practitioners that shareholders can diversify their own portfolios in the securities markets more optimally than conglomerates can do it for them. Therefore conglomerates created no extra stock market value. In fact, it was preferable for a firm to specialize in its core business, thus becoming a »pure play« for investors wishing to diversify. Needless to say, the managers of firms which were following a CWM model strategy resisted the call to break up the conglomerates. During the 1980's the SWM model in its agency theory form supported the attempt by shareholders to force management to break up the conglomerates. Corporate raiders became the catalyst to organize widely spread shareholders in this effort. The new slogan might be called »4 - 2 = 3«, since market value can be created by divestment just as it was previously created by mergers.

Corporate restructuring in this manner was aided by the simultaneous development of a »junk bond« market and a class of speculators known as »arbitrageurs«. Junk bonds

7. Modigliani and Miller, 1958.

8. Markowitz, 1959, Sharpe, 1963 and Sharpe, 1964.

9. Ross, 1973 and Jensen and Meckling, 1976.

are high yield bonds, subordinated to other debt and underwritten by investment bankers as part of a takeover or restructuring financing package. They fill the gap between bank financing of working capital and preferred or common stock. The arbitrageurs are investors who are gambling that when a takeover attempt is announced it will be realized, perhaps at an even higher stock price as other bidders enter the chase. If the takeover bid fails the arbitrageurs are stuck with high priced stock that they may have trouble liquidating at a profit.

The conflict between managers operating within a CWM model framework and investors operating within a SWM model framework led to creation of numerous takeover tactics. Some of the better known defenses are: 1) going private through leveraged buy-outs; 2) finding a »white knight«; 3) creating a »poison pill«; 4) granting »golden parachutes« to existing management; 5) changing a firm's corporate charter to require qualified voting on mergers and staggered elections for the board of directors; 6) accusing the takeover entity with anti-trust law violations or a breach of the securities laws; 7) paying »greenmail«; and 8) proposing a plan for voluntary restructuring to be carried out by existing management.

Those investors who espouse the SWM model have responded by lobbying successfully for enforcement of the »one-share-one-vote« rule, which is traditional in the Anglo-American markets but not necessarily typical of other markets. They have also attacked, through the court system and via legislative initiatives at both the state and federal levels, all the other special defenses, particularly poison pills, golden parachutes, and greenmail.

Takeover defenses in non-Anglo-American markets

In most national markets, outside of the Anglo-American markets, the CWM model continues to be the best description of the way firms operate. Although some well publicized hostile takeovers have been attempted, such as the unsuccessful bid for Société Générale de Belgique by Carlo de Benedetti, the conditions which make hostile takeovers possible in the Anglo-American markets do not yet exist in the other national markets. Of course, friendly mergers and strategic alliances are very common today in these markets, particularly as companies try to restructure themselves to take advantage of the anticipated post-1992 single EEC internal market.

In order to illustrate why the CWM model predominates in most non Anglo-American markets, and why hostile takeovers are not likely to change this situation, we will now summarize conditions which exist in six typical European markets and Japan. Exhibit 1 is a summary of the status of hostile takeover defenses in Denmark, France, the Netherlands, Norway, Switzerland, West Germany, and Japan. The data for Exhibit 1 resulted from a combination of personal knowledge by the authors, interviews with

Exhibit 1: A Survey of Takeover Defenses in Seven Non-Anglo-American Countries

Type of Takeover Defenses	Countries in the Survey in which the Defense is Used
1. Dual classes of voting stock	Denmark, France, the Netherlands, Norway, West Germany, and Switzerland.
2. Restrictions on the number	West Germany and Switzerland
3. Restrictions on foreign ownerships of shares	France, Japan, Norway, and Switzerland
4. Provisions in the corporate charter which might require a supermajority vote on a takeover bid	Japan, Switzerland, and West Germany
5. Selling a special issue of voting shares or convertible preferred to »stable« or »friendly« investors	France, Japan, the Netherlands, Norway, Switzerland, and West Germany
6. Finding a »white knight«	France, the Netherlands, Norway, and Switzerland
7. Control by a foundation	Denmark, the Netherlands, and Switzerland
8. Forming a strategic alliance and/or having interlocking boards of directors	France, Japan, the Netherlands, Norway, and West Germany
9. Relying on a network of close personal relationships, i.e., belonging to »the establishment«	Denmark, France, Japan, the Netherlands, Norway, Switzerland, and West Germany
10. Government regulations controlling competition and monopolies	France, the Netherlands, and West Germany

Note: The seven countries which are included in the survey are: Denmark, France, Japan, the Netherlands, Norway, Switzerland, and West Germany.

investment bankers in each of the markets surveyed, and written materials provided by bankers, lawyers, accountants, and regulators in the various markets.

Some Common Hostile Takeover Defenses

As can be seen in Exhibit 1, each national market has a unique array of hostile takeover defenses, but underlying these features are certain conditions which are present in nearly all the non-Anglo-American markets. These can be summarized as follows:

(1) Banks and insurance companies can and do invest heavily in corporate equities. They are often the controlling shareholders taken collectively.

(2) In many of these markets the typical corporate leverage ratio is quite high by US/UK standards. Most of the debt is provided by the banks, leaving little room for issuing any corporate bonds in the market.

(3) The lack of any significant corporate bond market, except Eurobonds, means that there is also no precedent for a junk bond market. In fact, it could be said that normal bank loans are actually taking the place of junk bonds in the typical corporate financial structure, since debt ratios are often in the 65-85% range (debt/total capitalization). In other words, many national capital markets provide »junk bank debt« at reasonable interest rates!

(4) The one-share-one vote rule often does not apply as is evident in Exhibit 1.

(5) Personal relationships between investors, creditors, management, and government officials are much closer than is typically the case in the Anglo-American markets. This leads to a more loyal and stable investor base and often effects long run investment decisions. No class of investors similar to arbitrageurs exist. They would starve!

(6) Stock ownership by individuals has historically not been widespread in the non Anglo-American markets. Institutional investors are totally dominant in publicly-owned companies.

(7) The privately-owned corporate sector is relatively more important in the Continental West European markets than in the Anglo-American markets.

(8) Government regulation of sensitive industries reduces the number of companies open for takeovers, especially by foreign firms. Sensitive industries are typically those related to defense, banking, insurance, newspapers, television, telecommunications, shipping and, aviation.

(9) Lack of a history of hostile takeovers has lulled many governments into feeling that public regulation of takeovers is not needed. Therefore, self-regulation is used but this often allows companies virtually unlimited freedom to dream up takeover defenses with only a modicum of protection for individual investor rights.

(10) Historically, merchant bankers and stockbrokers have not enjoyed the same degree of respect that they do in the Anglo-American markets. The top graduates of European universities and business schools do not compete for investment careers to the same extent as similar graduates might do in the US.

(11) It is evident from Exhibit 1 that some of the traditional takeover defenses which are used in the Anglo-American markets are missing from the non-Anglo-American markets. These include greenmail, golden parachutes, poison pills, and leveraged buyouts.

In the remainder of this section we will explain Exhibit 1 in more detail by expanding on each of the seven markets surveyed.

Denmark

A number of large, important firms in Denmark, such as Novo-Nordisk, have two classes of voting stock. Each A share typically has up to ten votes compared to one vote for each B share. The A shares are usually held by heirs of the founders or by a foundation. This foundation is independent in principle but often loyal to heirs, management, or other vested interests.

In the past Danish banks needed special permission by Danish regulatory authorities to have permanent holdings of shares in other companies. This very much limited the banks' role as equity investors. In the future, as part of the liberalisation of Danish financial regulations and EEC harmonization, Danish banks will be granted general permission to act freely as equity investors.

There is a continued preference by the large Danish pension funds for investing in Danish securities even if they must forego the benefits of international portfolio diversification. The pension funds and other institutional investors rarely interfere with management, thus allowing the CWM model to function. Close personal relationships exist between portfolio managers, bankers, management, and government officials.

Fund managers are not formally reviewed by professional evaluators since such services do not exist in Denmark. To the extent that funds are evaluated in the press, it is usually based on rate of return regardless of the amount of risk incurred. Portfolio management services are usually purchased based on reputation or tradition rather than a careful evaluation of actual performance. As a result, fund and portfolio managers are not under intense pressure to perform in the short run and therefore have the luxury of taking a long view of investment. This is consistent with the CWM model.

Typically, mergers and strategic alliances in one form or another are management and/or board initiated. Recently, groups of institutional investors have also initiated alliances among companies in which they are investors. Hostile takeover attempts are very rare and as a rule have failed.

France

Although French companies are typically managed along the lines of the CWM model, takeover defenses are less developed than in the rest of the countries described here. Therefore, there have been some recent takeover attempts, but most of them so far have failed. However, laws that would regulate takeovers are presently being discussed in France and the government is carefully monitoring impending EEC initiatives in this area. The main existing regulation requires disclosure of share holdings at various thresholds.

Dual classes of voting stock are both legal and in use in French companies. For example, stocks with double voting rights exist in Taittinger, LVMH, and Guyenne et Gascogne. The typical case for disproportionate voting rights involves a family-owned firm that goes partially public.

Foreign ownership of companies in sensitive industries requires government approval. This is particularly true of companies in banking, insurance, investment banking, health care, communications, newspapers, television, and companies which have been nationalized and recently privatized again. The fact that the government owns or controls most of the important financial institutions means that any leveraged buyouts, foreign or domestic, relying on the French capital market would certainly need government approval.

The main takeover defenses in France rely on close personal relationships within the »business establishment«. For example, French firms have issued warrants to friendly, stable shareholders. The warrants would only be exercised in the event of a hostile takeover bid. It is also common to seek out a »white knight«. This defense has been used in recent years by such notable companies as Moët Hennessy, Midi and Telemecanique. Strategic alliances are also becoming more popular such as one between CGE and Société Générale, and another between Bouygues, Suez, and Crédit Lyonnais.

Japan

The CWM model is probably best illustrated in Japan where unfriendly takeovers are almost unthinkable.¹⁰ This is due to the close personal and business relationships which exist, as well as a desire by Japanese society to live in harmony with each other and with nature.

As is well known, many of the most important firms in Japan are members of large industrial groups known as »keretsu«. A typical group would include a large bank, a trading company, and a number of industrial and service companies. A significant share of the group's economic activities is with each other, as customers and suppliers, and cross-ownership of common stock is the norm. Thus each firm owns some shares in each of the other firms, including the bank and trading company. These closely-held shares are almost never sold since that would signal a desire to drop out of the group's other economic activities. As a result, controlling interest in each member of the group is by the collective group members, even though the other shares are traded in Japan's public equity market, which is now the largest in the world.

10. In December 1988 Japan experienced its first large unfriendly takeover. Koshin, an investment group, gained control of Kokusai Kogyo, an aerial survey group worth about \$ 1.65 billion. (Source: *Financial Times*, December 13, 1988, p. 1).

In addition to being key members of *Keretsu*, the banks and insurance companies are collectively major shareholders in almost all of the listed companies in Japan. Although any one bank is limited to 5% of the equity in a firm, and any one insurance company is limited to 10%, together these financial institutions typically have voting control and are considered to be very stable shareholders. Furthermore, any takeover bid would have to be handled by securities firms, who would not cooperate on a hostile bid because of the damage to their reputation and possible conflict with the banks and insurance companies.

Since there have been almost no hostile takeover bids in Japan, other defense strategies have not been needed or tested. However, it has been suggested that it would be possible, in the event of a hostile bid, to change a firm's corporate charter to allow issue of preferred stock convertible into common and sell it to the existing stable shareholders.¹¹ It would also be possible to require a qualified voting majority to change directors, approve a merger, or transfer marketing rights. Virtually any other defense at the board of directors level would be possible since virtually no government regulations exist which cover hostile takeovers. There simply has been no need for such control.

With respect to hostile takeover bids from foreigners, all of the above defenses should be more than adequate protection, but just in case they are needed, still more defenses could be used. For example, the Minister of Finance can recommend, through the Foreign Exchange Law, that foreign investors modify or stop investing in Japanese companies in such cases as: 1) national defense needs; 2) adverse influence on related business in Japan; and 3) when the Foreign Exchange Law requires approval from the government. An example of the Japanese closing ranks against a take over, especially one originated from abroad, was the 1989 abortive attempt by Boone Pickens to take over Koito.

The Netherlands

Dutch firms are managed in the manner described by the CWM model. This is especially appropriate in the Netherlands because of strong concern for the welfare of all stakeholder groups, not just the shareholders. This is reflected in national rules which offer extraordinary protection to workers in case of proposed plant closures. It can also be observed in the use of two boards, one of which is a »supervisory board«, and the other is a »board of managing directors«. The supervisory board contains members representing

11. Interview with Mr. Yoshio Ninomiya, Deputy General Manager, Corporate Strategy and Services Department, The Nomura Securities Co., Ltd., Tokyo, Japan.

12. Same as footnote 11.

both shareholder and other stakeholder groups. Typically, both boards would need to approve any merger, and especially a hostile takeover bid.

There are so many takeover defenses available that it would be exceptional to experience a successful hostile takeover. Dual classes of voting stock and certificates are common (CSM, Heineken, and Royal Dutch Shell). In some cases firms have certificates that can be suddenly converted to voting shares if needed (Unilever). Another Dutch defensive feature is to issue voting preferred stock and/or »priority« shares, both of which are held by stable (friendly) investors or white knights. A unique Dutch institution called »Winterpalace« is a combination of Amro-Bank and two big Dutch pension funds. Winterpalace can be requested to act as a white knight by firms faced with a hostile takeover bid. Through negotiations it is determined what should be done with the shares acquired by Winterpalace and what fee the firm will pay for the white knight's service!

Similar to Denmark, a foundation may be established to hold the controlling »certified« shares of a company, with the objective of guarding the interests of all stakeholder groups. The board of the foundation must be composed of at least 50% independent members. Examples of such a setup are Amro-Bank, Bührmann-Tetterode, and Elsevier.

As in other European countries the Dutch are beginning to form strategic alliances both inside the country and externally. In addition to such formal arrangements, the network of personal contacts can also make a difference if needed for defensive purposes.

Norway

The situation in Norway is most similar to Denmark. The use of two classes of voting stock is common. For example, Norsk Data A/S has issued non-voting B-shares, which are primarily held by foreigners and the public. The A-shares have all the votes and are held by the founders and institutional investors. Unlike Denmark but similar to Sweden, there are also restrictions on the percentage of voting stock in publicly-listed firms which can be held by foreigners. Normally, foreigners can hold up to one third of the voting stock in industrial firms, 40% in shipping firms, and 25% in banks and insurance firms. This is in the process of being liberalized.

Strategic alliances are also characteristic of the Norwegian scene. Most of the strategic alliances, however, are not motivated by takeover defense strategy but rather by the need to guarantee commercial relationships with partners located within the EEC, since Norway is not a member of the EEC.

Similar to Denmark, the Norwegian business establishment enjoy close personal relationships with each other as well as with members of the investment, banking, and government communities. Many of the key players have gone to school together, live in close proximity, and have worked in more than one Norwegian enterprise.

White knight, poison pill, and golden parachute defenses are not common but have been used in exceptional circumstances such as the 1985 takeover attempt on Kosmos. These defenses are not legally banned but there have been very few hostile takeover attempts to test whether they can be used.

In summary, Norwegian management has every reason to feel secure from hostile takeovers and is thus free to pursue a goal of corporate wealth maximization.

Switzerland

The CWM model is the best description of the manner in which Swiss companies are managed. Similar to the situation in most other small European countries, the Swiss have designed a number of effective defenses from hostile takeovers. However, not being a member of the EEC, the Swiss are even more sensitive to takeovers from abroad.

Dual classes of voting stock is the most effective Swiss defence mechanism. The equity composition of many Swiss companies contains bearer shares which are available to foreigners but nonvoting, and registered shares which are only open to Swiss citizens.

In addition to restrictions on foreign ownership, some companies have restrictions on the number of shares which can be voted by anybody, Swiss or foreign citizens. For example, Nestlé has a provision that not more than 3% of its equity capital can be held by any one investor. Ciba-Geigy has the same restriction but with a maximum of 2%.

Other takeover defenses which have been used occasionally by Swiss companies are requiring a qualified majority vote to change a company's capital structure (Sandoz), finding a white knight (La Suisse used Renteanstalt), control by a foundation (Hasler-Ascom), and using a network of personal relationships.

West Germany

In West Germany the banks are allowed to invest significantly in non-banking firms. The three largest banks, in particular, are very influential in corporate governance since they are represented on the boards of directors of many of the most important business firms in West Germany. Moreover these firms raise most of their capital through the banking system rather than through new equity issues or corporate bonds. This close relationship between the banks and their clients allows business firms to enjoy relatively high debt ratios without fear of having their debt called.

As a result of the dominant role played by banks, Germany's securities markets are relatively underdeveloped considering the industrial strength of the country. Many of the most important firms have remained private, or, if public, the shares are closely held by relatively few banks and institutional investors, who are investing for the long run. For example, it has been estimated that at the end of 1987 public limited companies (AG) numbered only 2262 compared to 360,480 private limited companies (GmbH). The public companies had only DM 119.6 billion in capital compared to DM 157.3 billion in the

privat companies.¹³ Of the 2,262 public companies, only 474 had ordinary shares officially quoted or traded at the stock exchange. After eliminating preferred shares, and companies which do not have at least 50% of their stock listed, only 25% of the ordinary capital of public companies is potentially subject to purchase in the open market.

Even those companies which are theoretically exposed to hostile takeover are very often protected by legal defenses.¹⁴ The first legal hurdle is to acquire a simple majority of the votes polled at a general shareholder meeting. This is not as simple as it sounds because, similar to Switzerland, many German companies limit the percent of voting capital which can be voted by any one beneficial investor. For example, no matter how many shares an investor holds, that investor can only vote a maximum of 5% of the total subscribed voting capital in such major companies as Asko, Bayer, Deutsche Bank, Mannesman, and Veba. Similar but higher limits exist for such companies as Hoechst (15%) and VW (20%). In addition some companies have dual classes of stock with different voting rights.

A second major hurdle is the need to achieve a qualified majority for certain key decisions. For example, it typically takes a 75% majority to replace members of the supervisory board (board of directors). It takes a 95% majority to put a company into liquidation.

A third hurdle is the potential enforcement of competition laws by the Federal German Cartel Office (Bundeskartellamt). In general, an association of companies involving more than a 25% stake in each other is forbidden if this has the effect of creating or enhancing a position of market dominance.

The net result of these legal defenses, the lack of a big public market, and the absence of any historic precedents, is that hostile takeovers in Germany can only be accomplished in practice with the support and agreement of the major banks and other financial institutions. It should be noted, however, that numerous friendly mergers have been negotiated and even more are expected in the future as German firms attempt to restructure in preparation for the promised EEC market of 1992. In the meantime, however, virtually all of the companies adhere to the CWM model of corporate management.

The future: EEC harmonization

The biggest potential for change exists in the EEC market. Several pieces of draft legislation are in various stages of preparation. The most important ones have to do with control of mergers and takeovers.

13. All data in this paragraph are from: Schröder Münchmeyer Hengst & Co., »Mergers, Acquisitions and Takeovers - Fuel for the German Stock Market«, Frankfurt, West Germany, April 3, 1989, pp. 7-8.

14. Same as footnote 12. The discussion in this paragraph and the two which follow are a synopsis of this citation.

It appears from the current draft version of the mergers legislation that only the largest cross-border mergers will be considered at all by the EEC Commission.¹⁵ Opposition to a merger at the EEC Commission level will only be based on the degree to which such a merger would severely hamper internal competition, thus losing some of the benefits of the internal market. It is not clear yet how a negative decision by the EEC Commission will be enforced, or if the European Court of Justice will have the final jurisdiction on an appeal.

The takeover legislation is in less advanced form but it appears there may be a two step transition.¹⁶ The first legislation would specify the level of stock ownership at which an investor must disclose his intentions. It appears that 10% ownership will be the level at which this disclosure must occur. Just what is meant by »intentions« is as yet undetermined. Also at question is what role other interested parties, such as labor unions and local government, will play.

A later second phase of legislation would probably deal with the more delicate questions of corporate governance. One big battle will probably be over the one-share-one vote standard which exists in the U.K. but not in most other EEC member countries as described above. In order to gain maximum benefit from freedom of capital movement it is argued that it would be logical for the EEC Commission to recommend adoption of the one-share-one-vote standard by all members. This would, of course, eliminate the ability to have disproportionate voting rights such as A and B shares. It would also probably eliminate limitations on foreign ownership of shares, at least as this applies to other EEC member states. Another practice in jeopardy would be the limit on total number of shares which can be voted by any one investor. It is unclear whether foundation control will be challenged as long as the foundation owns a majority of the shares, assuming one-share-one-vote. Related legislation will also deal with representation for non-stockholder interest groups on the board of directors and other matters which may place limits on unfettered stockholder control of firms.

The counterarguments to this potential future EEC initiative on corporate governance will probably come from the smaller countries in the EEC, such as Denmark and Benelux Countries, and from the newer members with less developed capital markets,

15. The draft legislation is entitled, »Draft Merger Control Regulation: Proposal for a Regulation (EEC) of the Council on the Control of Concentrations between Undertakings«. It was first submitted to the Council of Ministers by the EEC Commission on July 20, 1973. It has been amended February 12, 1982, February 23, 1984, and December 17, 1986. Also Interview with Mr. Helmuth Schröter, EEC Directorate for Competition.

16. Interview with Mr. Herman Niessen, EEC Directorate for Takeovers. The draft directive on takeovers has been published under the title »EEC Directorate General XV Doc. No. 6387 (First Revision). For a summary of EEC takeover legislation and other legal barriers to takeovers in Europe, especially the U.K., see MacLachlan and Mackesy, 1989.

namely Greece, Portugal and Spain. They fear that without some takeover defense, almost all of their best national companies could be swallowed up by takeovers by companies located in the largest and most developed EEC countries.

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