MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS

THIRD EDITION

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PATRICK A. GAUGHAN

JOHN WILEY & SONS, INC.

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PREFACE

The field of mergers and acquisitions continues to experience dramatic growth. Record-breaking megamergers have become commonplace. Indeed, while megamergers used to be mainly an American phenomenon, the current fifth merger wave became a truly international merger period. Starting in the 1990s and continuing into the next decade, some of the largest mergers and acquisitions took place in Europe. This was underscored by the fact that the largest deal of all time was a hostile acquisition of a German company by a British firm.

When the fourth merger wave ended with the start of the 1990–91 recession, it appeared it would be some time before we saw a volume of deals similar to that which we had seen in the 1980s. Ironically, after a short hiatus, a new merger wave took hold—and this one was a worldwide wave. These deals partly came as a result of an expansion of the economy that led companies to consider mergers and acquisitions as the fastest way to grow.

Economic growth was not the only reason for the large volume of deals throughout the world. Deregulation in Europe and the development of a common European economy also played a role. Nations such as Canada and Australia also exhibited a pronounced higher volume of deals. The picture in Asia, however, was different. Here, restructuring and downsizing were more commonplace as the Asian economy remained weak. Companies in Japan and Korea, long protected by their highly regulated economic structures, now had to consider bankruptcy and other forms of restructuring as the means of working out their economic difficulties.

The deals of the fifth merger wave seem to have more of a strategic focus than the transactions of the 1980s. Breakup transactions designed to provide a quick return for the dealmakers are uncommon. Rather, the deals of the 1990s claim to have more of a strategic focus.

In the United States, firms in several industries were consolidated in roll-up transactions, which resulted in more of an oligopolistic market structure. Even though the number of competitors declined, the deal participants often did not appear to gain market power. Instead they sought cost reductions through scale economies and expanded market opportunities. While very popular in the mid-1990s, by the start of 2000 the market soured on these deals.

Many of the methods that applied to deals of prior years are still relevant, but new rules are also in effect. These principles consider the mistakes of prior periods along with the economic and financial conditions that are currently in effect. It is hoped that these new rules will make the mergers of the fifth merger wave sounder and more profitable than those of prior periods.

The focus of this book is decidedly pragmatic. I have attempted to write it in a manner that will be useful to both the business student and the practitioner. Since the world of mergers and acquisitions is clearly interdisciplinary, material from the fields of law and economics is presented along with corporate finance, which is the primary emphasis of the book. The practical skills of finance practitioners have been integrated with the research of the academic world of finance. For example, three chapters are devoted to the valuation of businesses, including the valuation of privately held firms. This is an important topic that usually is ignored by traditional finance references. Much of the finance literature tends to be divided into two camps: practitioners and academicians. Clearly, both groups have made valuable contributions to the field of mergers and acquisitions. This book attempts to interweave these contributions into one comprehensible format.

The increase in mergers and acquisitions activity has given rise to the growth of academic research in this area. This book attempts to synthesize some of the more important and relevant research studies and to present their results in a straightforward and pragmatic manner. Because of the voluminous research in the field, only the findings of the more important studies are highlighted. Issues such as shareholder wealth effects of antitakeover measures have important meanings to investors, who are concerned about how the defensive actions of corporations will affect the value of their investments. This is a good example of how the academic research literature has made important pragmatic contributions that have served to shed light on important policy issues.

I have avoided incorporating theoretical research that has less relevance to those seeking a pragmatic treatment of mergers and acquisitions. However, some theoretical analyses, such as agency theory, can be helpful in explaining some of the incentives for managers to pursue management buyouts. Material from the filed of portfolio theory can help explain some of the risk-reduction benefits that junk bond investors can derive through diversification. These more theoretical discussions, along with others, are presented because they have important relevance to the real world of mergers and acquisitions. The rapidly evolving nature of mergers and acquisitions requires constant updating. Every effort has been made to include recent developments occurring just before the publication date. I wish the reader an enjoyable and profitable trip through the world of mergers and acquisitions.

Patrick A. Gaughan

Part One

BACKGROUND

1

INTRODUCTION

After a short hiatus, mergers and acquisitions had resumed the frantic pace that was established during the fourth merger wave of the 1980s and by the mid-1990s we were in the middle of the fifth merger wave, which featured deal volume that surpassed the level reached in the 1980s. The 1980s represented one of the most intense periods of merger activity in U.S. economic history. This period witnessed the fourth merger wave of the twentieth century. One such wave occurred at the end of the 1960s, with the two prior waves occurring in the 1920s and at the turn of the century.

The fourth wave was unique compared with the three prior waves. It specifically featured the hostile takeover and the corporate raider. In addition, in the 1980s the junk bond market grew into a tool of high finance whereby bidders for corporations obtained access to billions of dollars to finance raids on some of the largest, most established corporations in the United States. This access to capital markets allowed megamerger deals to become a reality. The resurgence of merger and acquisition activity in the 1990s quickly shifted into the fifth merger wave. The intensity of this wave is underscored by the fact that several of the ten largest deals in U.S. history took place in 1998 alone (Table 1.1).

The 1980s featured an unprecedented volume of merger and acquisition activity compared with prior historical periods. Not only did the volume of mergers and acquisitions reach an all-time high in the 1980s (Table 1.2 and Figure 1.1), but also the average price of each acquisition increased steadily (Figure 1.2). Before the 1980s larger U.S. companies had little need to worry about preserving their independence. With the advent of the hostile raid, however, they erected formidable defenses against takeovers and increasingly called on state governments to pass laws to make hostile acquisitions more difficult.

The 1980s also featured the rapid growth and decline of the leveraged buyout (LBO)—the use of debt capital to finance a buyout of the firm's stock. In an LBO, a public company goes private by purchasing its publicly outstanding shares. This financing technique was popular in the mid-1980s but became a less viable alternative toward the end of the decade as the number of good LBO targets declined. The end of the decade also signaled a dramatic decline in the junk bond market as raiders and LBO firms lost some of their access to the financing necessary to complete leveraged transactions.

The falloff in merger and acquisition activity at the beginning of the 1990s reversed in 1992 when the volume of transactions intensified. By 1993 we were once again in the throes of a full-scale merger wave. However, this wave was distinctly different from the wave that preceded it. The deals of the 1990s are not the highly leveraged hostile transactions that were common in the 1980s. Rather, the 1990s feature more strategic mergers that are not motivated

Table 1.1. Ten Largest Worldwide Mergers and Acquisitions

Announced Year	Effective Year	Acquirer	Target	Transaction Value ($ Billions)
Nov. 1999	Jun. 2000	Vodafone AirTouch PLC	Mannesmann AG	$202.8
Jan. 2000	Jan. 2001	America Online Inc.	Time Warner	$164.7
Nov. 1999	Jun. 2000	Pfizer Inc.	Warner-Lambert Co.	$89.2
Dec. 1998	Nov. 1999	Exxon Corp.	Mobil Corp.	$78.9
Jan. 2000	Dec. 2000	Glaxo Wellcome PLC	SmithKline Beecham PLC	$76.0
Apr. 1998	Oct. 1998	Travelers Group Inc.	Citicorp	$72.6
May. 1998	Oct. 1999	SBC Communications Inc	Ameritech Corp.	$62.6
Jan. 2000	May 2000	Shareholders	Nortel Networks Corp.	$61.7
Apr. 1998	Sep. 1998	NationsBank Corp	BankAmerica Corp.	$61.6
Jan. 1999	Jun. 1999	Vodafone Group PLC	AirTouch Communications Inc	$60.3

by short-term profits or dependent on highly leveraged capital structures. The 1990s and 2000s also featured a markedly increased volume of European mergers (Figure 1.3).

This book describes the growth and development of the field of mergers and acquisitions through a historical focus followed by a review of the laws or rules that govern the game of mergers and acquisitions. In addition, the strategy and motives that inspire mergers and acquisitions are examined. The offensive and defensive techniques of hostile acquisitions are also discussed. The vast array of defenses that may be implemented to thwart a hostile bid are then reviewed. Offensive and defensive methods from the viewpoints of both management and shareholder are explored. In addition, the impact on the shareholder wealth is examined through a review of the wealth effects of these different offensive and defensive tactics.

Table 1.2. Net U.S. Merger and Acquisition Announcements, 1963–2000

Year	Number	Percentage Change (%)	Year	Number	Percentage Change (%)
1963	1,361	—	1982	2,346	–2
1964	1,950	43	1983	2,533	8
1965	2,125	9	1984	2,543	1
1966	2,377	12	1985	3,001	18
1967	2,975	25	1986	3,336	11
1968	4,462	50	1987	2,032	–39
1969	6,107	37	1988	2,258	11
1970	5,152	–16	1989	2,366	5
1971	4,608	–11	1990	2,074	–12
1972	4,801	4	1991	1,877	–9
1973	4,040	–16	1992	2,574	37
1974	2,861	–29	1993	2,663	3
1975	2,297	–20	1994	2,997	13
1976	2,276	–1	1995	3,510	17
1977	2,224	–2	1996	5,848	67
1978	2,106	–5	1997	7,800	33
1979	2,128	1	1998	7,809	–1
1980	1,889	–11	1999	9,278	19
1981	2,395	27	2000	9,602	4

Source: Mergerstat Review, 1990 and 2001.

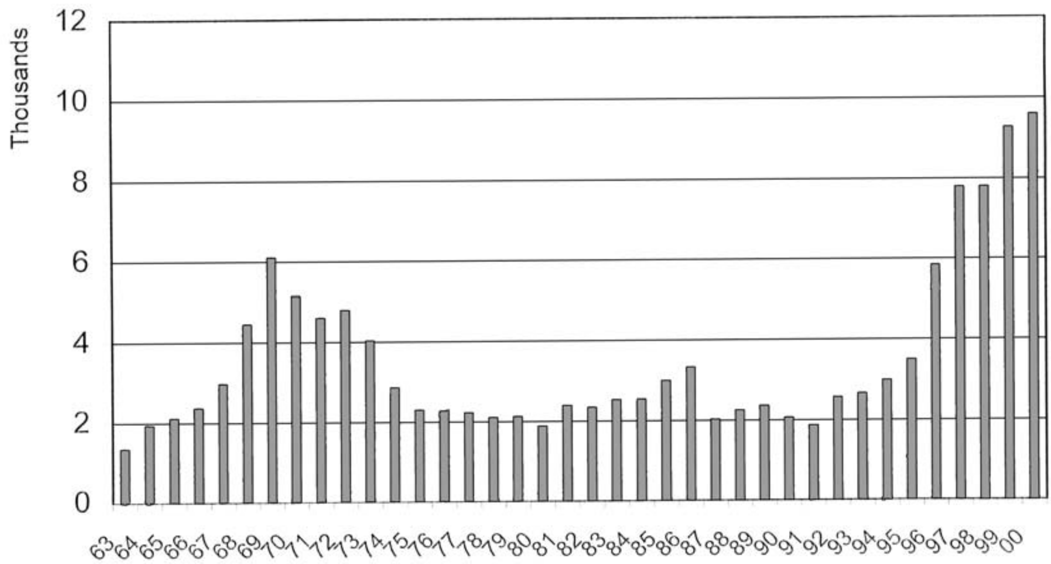

Figure 1.1. Total U.S. mergers and acquisitions announcement, 1963–2000.

Source: Mergerstat Review, 1981, 1991, and 2001.

Also analyzed in detail are the techniques of LBOs: the junk market, which is one of the main sources of LBO financing; and employee stock ownership plans, an important financing technique for certain types of LBOs.

Leveraged transactions may rely on the utilization of tax benefits. Therefore, the various tax issues involved in both leveraged and nonleveraged transactions are reviewed.

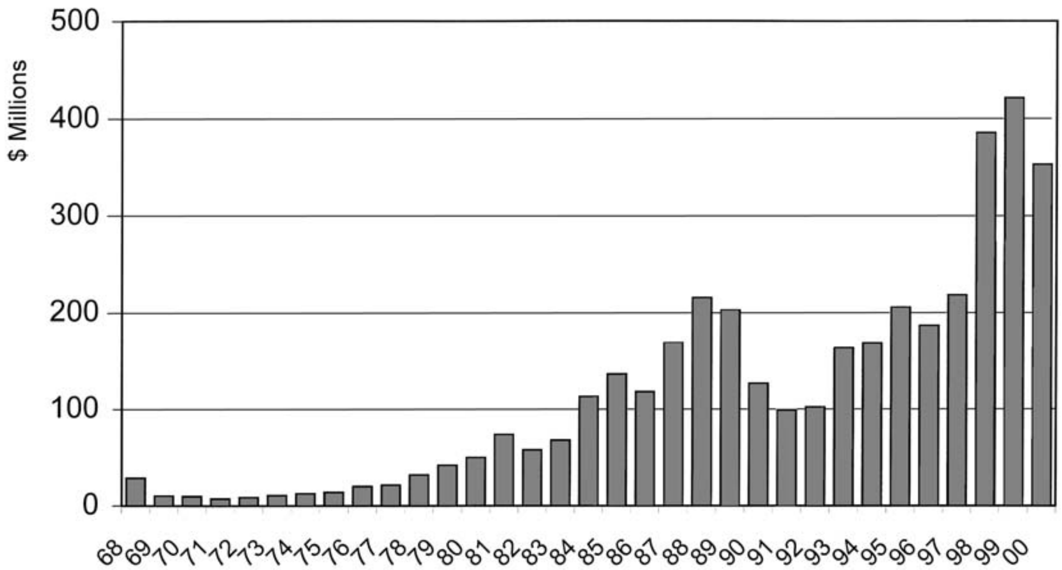

Figure 1.2. Average U.S. purchase price, 1968–2000.

Source: Mergerstat Review, 1981, 1991, and 2001.

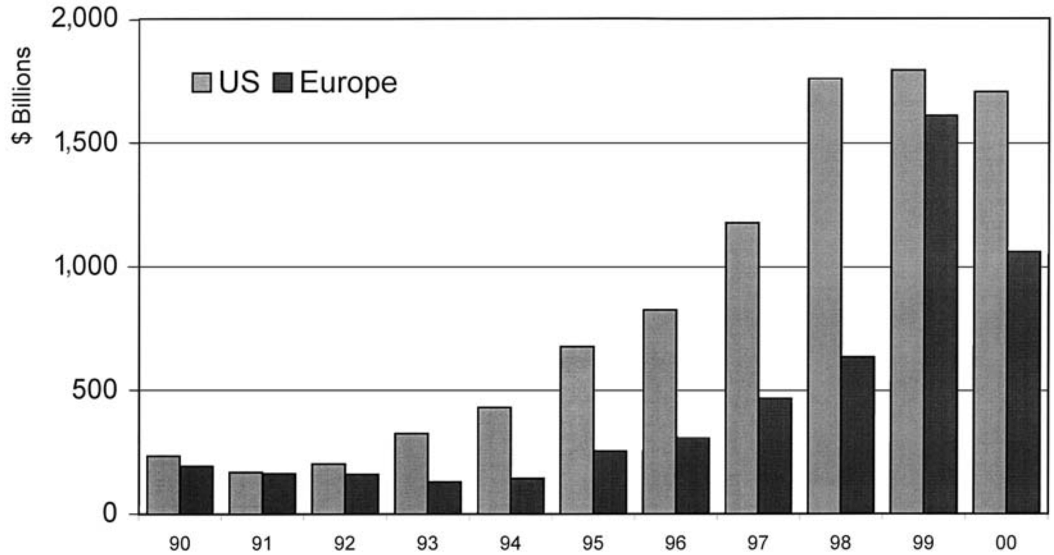

Figure 1.3. U.S. and Europe mergers and acquisitions in dollar value, 1990–2000.

Sources: 1) Bernard Black, The first International Merger Wave, *Miami Law Review,* 54, July 2000, pp. 799–818.
2) Thomson Financial Securities Data.

Corporate restructuring that involves a contraction, as opposed to acquisition-related expansion, is discussed in detail. Various forms of corporate restructuring, including divestitures, spinoffs, and equity carve-outs have become more commonplace in the 1990s as some firms pursued a downsizing strategy while others expanded through mergers and acquisitions. Other firms that were in a more distressed financial condition were forced to use the corporate reorganization process available under the bankruptcy laws. Having covered a thorough background of the field, the rest of the book is dedicated to valuation.

The process of valuation for mergers and acquisitions is covered in three parts:

1. A review of financial analysis to ensure that the reader has a common body of financial knowledge with which to approach the valuation process
2. An application of this financial analysis to valuing publicly held firms
3. An analysis of the methods of valuing privately held businesses

Throughout this book, the material is presented from both a pragmatic and an academic viewpoint. The pragmatic focus utilizes a "how to" approach and a detailed description of the real world of mergers and acquisitions rather than a theoretical treatment. This approach is complemented by a more traditional academic analysis of the relevant research literature in each of the areas described. This dual pragmatic and academic approach will give the reader the benefits of practitioners' experience as well as researchers' work on the frontier of the field. Research that lacks pragmatic value is not reviewed.

DEFINITIONS

A *merger* is a combination of two corporations in which only one corporation survives and the merged corporation goes out of existence. In a merger, the acquiring company assumes the assets and liabilities of the merged company. Sometimes the term *statutory merger* is used to refer to this type of business transaction. A statutory merger differs from a *subsidiary merger,* which is a merger of two companies in which the target company becomes a subsidiary or part of a subsidiary of the parent company. The acquisition by General Motors of Electronic Data Systems, led by its colorful Chief Executive Officer Ross Perot, is an example of a subsidiary merger. In a *reverse subsidiary merger,* a subsidiary of the acquirer is merged into the target.

A merger differs from a *consolidation,* which is a business combination whereby two or more companies join to form an entirely new company. All of the combining companies are dissolved and only the new entity continues to operate. For example, in 1986 the computer manufacturers Burroughs and Sperry combined to form UNISYS. In a consolidation, the original companies cease to exist and their stockholders become stockholders in the new company. One way to look at the differences between a merger and a consolidation is that with a merger $A + B = A$, where company B is merged into company A. In a consolidation, $A + B = C$, where C is an entirely new company. Despite the differences between them, the terms *merger* and *consolidation,* as is true of many of the terms in the mergers and acquisitions field, are sometimes used interchangeably. In general, when the combining firms are approximately the same size, the term *consolidation* applies; when the two firms differ significantly by size, merger is the more appropriate term. In practice, however, this distinction is often blurred, with the term *merger* being broadly applied to combinations that involve firms of both different and similar sizes.

Another term that is broadly used to refer to various types of transactions is *takeover.* This term is more vague and sometimes refers only to hostile transactions; at other times it refers to both friendly and unfriendly mergers.

VALUING A TRANSACTION

The method used by Mergerstat is the most common method relied on to value deals. Enterprise value is defined as the base equity price plus the value of the target's debt (including both short and long term) and preferred stock less its cash. The *base equity price* is the total price less the value of the debt. The buyer is defined as the company with the larger market capitalization or the company that is issuing shares to exchange for the other company's shares in a stock-for-stock transaction.

TYPES OF MERGERS

Mergers are often categorized as horizontal, vertical, or conglomerate mergers. A *horizontal merger* occurs when two competitors combine. For example, in 1994 two defense firms, Northrop and Grumman, combined in a $2.17 billion merger. If a horizontal merger causes the combined firm to experience an increase in market power that will have anticompetitive effects, the merger may be opposed on antitrust grounds. In recent years, however, the government has been somewhat liberal in allowing many horizontal mergers to go unopposed.

Vertical mergers are combinations of companies that have a buyer-seller relationship. For example, in 1993 Merck, the world's largest drug company, acquired Medco Containment Services, Inc., the largest marketer of discount prescription medicines, for $6 billion. The transaction enabled Merck to go from being the largest pharmaceutical company to also being the largest integrated producer and distributor of pharmaceuticals. This transaction was not opposed by antitrust regulators even though the combination clearly resulted in a more powerful firm. Ironically, regulators cited increased competition and lower prices as the anticipated result.

A *conglomerate merger* occurs when the companies are not competitors and do not have a buyer-seller relationship. One example would be Philip Morris, a tobacco company, which acquired General Foods in 1985 for $5.6 billion. Clearly, these companies were in very different lines of business. The advisability of conglomerate acquisitions is discussed in Chapter 4.

REASONS FOR MERGERS AND ACQUISITIONS

As is discussed in Chapter 4, there are several possible motives or reasons that firms might engage in mergers and acquisitions. One of the most common motives is expansion. Acquiring a company in a line of business or geographic area into which the company may want to expand can be a quicker way to expand than internal expansion. An acquisition of a particular company may provide certain synergistic benefits for the acquirer, such as when two lines of business complement one another. However, an acquisition may be part of a diversification program that allows the company to move into other lines of business.

In the pursuit of expansion, firms engaging in mergers and acquisitions cite the pursuit of synergistic gains as one of the reasons for the transaction. Synergy exists when the sum of the parts is more productive and valuable than the individual components. There are many potential sources of synergy and they are discussed in Chapter 4.

Financial factors motivate some mergers and acquisitions. For example, an acquirer's financial analysis may reveal that the target is undervalued. That is, the value of the buyer may be significantly in excess of the market value of the target, even when a premium that is normally associated with changes in control is added to the acquisition price.

Other motives, such as tax motives, also may play a role in an acquisition decision. These motives and others are critically examined in greater detail in Chapter 15.

MERGER FINANCING

Mergers may be paid for in several ways. Transactions may use all cash, all securities, or a combination of cash and securities. Securities transactions may use the stock of the acquirer as well as other securities such as debentures. The stock may be either common stock or preferred stock. They may be registered, meaning they are able to be freely traded on organized exchanges, or they may be restricted, meaning they cannot be offered for public sale, although private transactions among a limited number of buyers, such as institutional investors, are permissible.

Stock transactions may offer the seller certain tax benefits that cash transactions do not provide. However, securities transactions require the parties to agree on the value of the securities. This may create some uncertainty and may give cash an advantage over securities transactions from the seller's point of view. For large deals, all cash compensation may mean that the bidder has to incur debt, which may carry with it unwanted adverse risk consequences. Although such deals were relatively more common in the 1980s, securities transactions became more popular in the 1990s. The various advantages and valuation effects of cash versus securities transactions are discussed in Chapters 13 and 15.

MERGER PROFESSIONALS

When a company decides it wants to acquire or merge with another firm, it typically does so by using the services of outside professionals. These professionals usually include investment bankers, attorneys, accountants, and valuation experts. Investment bankers may provide a variety of services, including helping to select the appropriate target, valuing the target, advising on strategy, and raising the requisite financing to complete the transaction. During the heyday of the fourth merger wave in the 1980s, merger advisory and financing fees were a significant component of the overall profitability of the major investment banks. Table 1.3 shows a ranking of merger and acquisition financial advisors.

Investment banks are often faced with the concern about conflicts between various departments of these large financial institutions, which may play very different roles in the merger process. Investment banks often have arbitrage departments that may accumulate stock in companies that may be taken over. If they purchase shares before the market is convinced that a company will be acquired, they may buy at a price significantly below the eventual takeover price, which usually includes a premium above the price at which that stock had been trading. This process, which is fraught with risks, is known as *risk arbitrage.* If an investment bank is advising a client regarding the possible acquisition of a company, it is imperative that a *Chinese wall* between the arbitrage department and the ad-

Table 1.3. U.S. Financial Advisor Rankings, 1/1/00–12/31/00

Rank	Financial Advisor	Total Invested Capital of Deals Worked ($ Billions)	Total Number of Deals
1	Goldman Sachs & Co.	758.9	187
2	Morgan Stanley Dean Witter	523.1	152
3	Merrill Lynch & Co.	494.6	158
4	Salomon Smith Barney	481.6	153
5	Credit Suisse First Boston	480.0	383
6	Wasserstein Perella Group	262.6	37
7	Chase Manhattan Group Corp.	218.6	115
8	J. P. Morgan & Co.	182.6	85
9	Lehman Brothers	152.5	110
10	UBS Warburg AG	128.0	83

Source: Mergerstat Review, 2001.

Table 1.4. U.S. Legal Advisor Rankings, 1/1/00–12/31/00

Rank	Legal Advisor	Total Invested Capital of Deals Worked ($ Billions)	Total Number of Deals
1	Sullivan & Cromwell	707.6	135
2	Simpson Thacher & Bartlett	700.1	114
3	Skadden Arps Slate Meagher & Flom	572.1	118
4	Dewey Ballantine	419.3	110
5	Morris Nichols Arsht & Tunnell	404.5	76
6	Gleary Gottlieb Steen & Hamilton	358.4	68
7	Cravath Swaine & Moore	338.7	51
8	Wachtell Lipton Rosen & Katz	325.4	98
9	Jones Day Reavis & Pogue	302.2	195
10	Fried Frank Harris Shriver & Jacobson	289.0	68

Source: Mergerstat Review, 2001.

visors working directly with the client be constructed so that the arbitragers do not benefit from the information that the advisors have but that is not yet readily available to the market. To derive financial benefits from this type of *inside information* is a violation of the law. This is discussed further in Chapter 3.

The role of investment banks changed somewhat in the 1990s. The dealmakers who promoted transactions just to generate fees became unpopular. Companies that were engaged in mergers and acquisitions tended to be more involved in the deals and took over some of the responsibilities that had been relegated to investment bankers in the 1980s. More companies directed the activities of their investment bankers as opposed to merely following their instructions as they did in the prior decade.

Given the complex legal environment that surrounds mergers and acquisitions, attorneys also play a key role in a successful acquisition process. Law firms may be even more important in hostile takeovers than in friendly acquisitions because part of the resistance of the target may come through legal maneuvering. Detailed filings with the Securities and Exchange Commission (SEC) may need to be completed under the guidance of legal experts. In both private and public mergers and acquisitions, there is a legal due diligence process that attorneys should be retained to perform. Table 1.4 shows the leading legal merger and acquisition advisors in 2000.

Accountants play an important role in mergers and acquisitions. They have their own accounting due diligence process. In addition, accountants perform various other functions such as preparing pro forma financial statements based on scenarios put forward by management or other professionals.

Still another group of professionals who provide important services in mergers and acquisitions are valuation experts. These individuals may be retained by either a bidder or a target to determine the value of a company. We will see in Chapters 13 and 14 that these values may vary depending on the assumptions employed. Therefore, valuation experts may build a model that incorporates various assumptions, such as revenue growth rate or costs, which may be eliminated after the deal. As these and other assumptions vary, the resulting value derived from the value also may change.

LEVERAGED BUYOUTS

In an LBO a buyer uses debt to finance the acquisition of a company. The term is usually reserved, however, for acquisition of public companies where the acquired company becomes private. This is referred to as *going private* because all of the public equity is purchased, usually by a small group or a single buyer, and the company is no longer traded in securities markets. One version of a leveraged buyout is a *management buyout.* In a management buyout, the buyer of a company, or a division of a company, is the manager of the entity.

Most LBOs are buyouts of small and medium-sized companies or divisions of large companies. However, in what was then the largest transaction of all time, the 1989 $25.1 billion LBO of RJR Nabisco by Kohlberg Kravis & Roberts shook the financial world.

The leveraged buyout business declined after the fourth merger but rebounded somewhat in the fifth wave (Figure 1.4). There are several reasons for this, including the collapse of the junk bond market. These issues are discussed at length in Chapters 7 and 8.

CORPORATE RESTRUCTURING

Users of the term *corporate restructuring* usually are referring to asset selloffs such as *divestitures.* Companies that have acquired other firms or have developed other divisions through activities such as product extensions may decide that these divisions no longer fit into the company's plans. The desire to sell parts of a company may come from poor performance of a division, financial exigency, or a change in the strategic orientation of the company. For example, the company may decide to refocus on its *core* business and sell off noncore subsidiaries. This type of activity increased after the end of the third merger wave

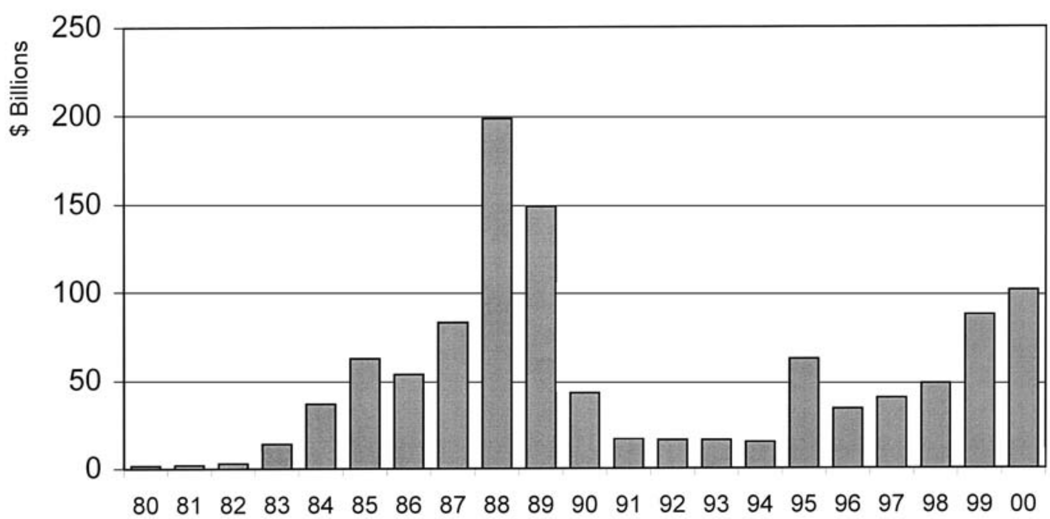

Figure 1.4. The value of worldwide leveraged buyouts in dollar value, 1980–2000.

Source: Thomson Financial Securities Data.

as many companies that engaged in diverse acquisition campaigns to build conglomerates began to question the advisability of these combinations.

There are several forms of corporate selloffs, with divestitures being only one of them. Spinoffs enjoyed increased popularity in the early 1990s, while equity carve-outs provided another way that selloffs could be accomplished. The relative benefits of each of these alternative means of selling off part of a company are discussed in Chapter 10.

Other forms of corporate restructuring are cost and workforce restructuring. In the 1990s we saw many companies engage in *corporate downsizing* as they strove to become more efficient. This was encouraged by several factors, including the 1990–91 recession and the international competitive pressure of the globalization of world markets.

Another form of corporate restructuring is *financial restructuring,* which refers to alterations in the capital structure of the firm, such as adding debt and thereby increasing financial leverage. Although this type of restructuring is important in corporate finance and is often done as part of the financing activities for mergers and acquisitions, it is not treated in this text as a form of corporate restructuring. Rather, the term *restructuring* is reserved for the more physical forms of restructuring such as divestitures.

MERGER NEGOTIATIONS

Most mergers and acquisitions are negotiated in a friendly environment. The process usually begins when the management of one firm contacts the target company's management, often through the investment bankers of each firm. The management of both firms keep the respective boards of directors up-to-date on the progress of the negotiations because mergers usually require the boards' approval. Sometimes this process works smoothly and leads to a quick merger agreement. A good example of this was the 1995 $19 billion acquisition of Capital Cities/ABC Inc. by Walt Disney Co. In spite of the size of this deal, there was a quick meeting of the minds by management of these two firms and a friendly deal was completed relatively quickly. In other instances, friendly negotiations may break down, leading to the termination of the bid or a hostile takeover. An example of a negotiated deal that failed and led to a hostile bid was the 1995 tender offer by Moore Corporation for Wallace Computer Services, Inc. Here negotiations between two archrivals in the business forms and printing business proceeded for five months before they were called off, leading to a $1.3 billion hostile bid.

Except for hostile transactions, mergers usually are the product of a negotiation process between the managements of the merging companies. The bidding firm typically initiates the negotiations when it contacts the target's management to inquire whether the company is for sale and to express its interest in buying the target. This interest may be the product of an extensive search process to find the right acquisition candidates. However, it could be a recent interest that was inspired by the bidder's investment bank approaching it with a proposal that it believes would be a good fit for the bidder. For small-scale acquisitions, this intermediary might be a business broker.

Both the bidder and the target should conduct their own valuation analyses to determine what the target is worth. As is discussed in the valuation chapters, the value of the target for the buyer may be different from the value of that company to the seller. Valuations can differ due to varying uses of the target assets or different opinions on the future growth of the target. If the target believes that it is worth substantially more than what the buyer is willing to pay, a friendly deal may not be possible. If, however, the seller is interested in selling and both parties are able to reach an agreement on price, a deal may be possible. Other important issues, such as financial and regulatory approvals, if necessary, would have to be completed before the negotiation process could lead to a completed transaction.

Disclosure of Merger Negotiations

Before 1988 it was not clear what obligations companies involved in merger negotiations had to disclose their activities. However, in 1988, in the landmark *Basic Inc. v. Levinson* decision, the U.S. Supreme Court made it clear that a denial that negotiations were taking place when the opposite was the case is improper. Companies may not deceive the market by disseminating inaccurate or deceptive information, even when the discussions are preliminary and do not show much promise of coming to fruition.

The Court's position reversed earlier positions that had treated proposals or negotiations as being immaterial. The *Basic v. Levinson* decision does not go so far as to require companies to disclose all plans or internal proposals involving acquisitions. Negotiations between two potential merger partners, however, may not be denied.

The exact timing of the disclosure is still not clear. Given the requirement to disclose, a company's hand may be forced by the pressure of market speculation. It is often difficult to confidentially continue such negotiations and planning for any length of time. Rather than let the information slowly leak, the company has an obligation to conduct an orderly disclosure once it is clear that confidentiality may be at risk or that prior statements the company has made are no longer accurate.

In cases in which there is speculation that a takeover is being planned, significant market movements in stock prices of the companies involved—particularly the target—may occur. Such market movements may give rise to an inquiry from the exchange on which the company trades or from the National Association of Securities Dealers (NASD). Although exchanges have come under criticism for being somewhat lax about enforcing these types of rules, an insufficient response from the companies involved may give rise to disciplinary actions against the companies.

MERGER APPROVAL PROCEDURES

In the United States, each state has a statute that authorizes mergers and acquisitions of corporations. The rules may be different for domestic and foreign corporations. Once the board of directors of each company reaches an agreement, they adopt a resolution approving the deal. This resolution should include the names of the companies involved in the deal and the name of the new company. The resolution should include the financial terms of the deal and other relevant information such as the method that is to be used to convert securities of each company into securities of the surviving corporation. If there are any changes in the articles of incorporation, these should be referenced in the resolution.

At this point the deal is taken to the shareholders for approval. Once approved by the shareholders, the merger plan must be submitted to the relevant state official, usually the secretary of state. The document that contains this plan is called the *articles for merger or consolidation.* Once the state official determines that the proper documentation has been received, it issues a certificate of merger or consolidation.

Securities and Exchange Commission rules require a proxy solicitation to be accompanied by a Schedule 14A. Item 14 of this schedule sets forth the specific information that must be included in a proxy statement when there will be a vote for an approval of a merger, sale of substantial assets, or liquidation or dissolution of the corporation. For a merger, this information must include the terms and reasons for the transaction as well as a description of the accounting treatment and tax consequences of the deal. Financial statements and a statement regarding relevant state and federal regulatory compliance are required. Fairness opinions and other related documents also must be included.

Special Committees of the Board of Directors

The board of directors may choose to form a special committee of the board to evaluate the merger proposal. Directors who might personally benefit from the merger, such as when the buyout proposal contains provisions that management directors may potentially profit from the deal, should not be members of this committee. The more complex the transaction, the more likely that a committee will be appointed. This committee should seek legal counsel to guide it on legal issues such as the fairness of the transaction, the business judgment rule, and numerous other legal issues. This committee, and the board in general, needs to make sure that it carefully considers all relevant aspects of the transaction. A court may later scrutinize the decision-making process, such as what occurred in the *Smith v. Van Gorkom* case, which is discussed in Chapter 13. In that case the court found the directors personally liable because it thought that the decision-making process was inadequate, even though the decision itself was apparently a good one for shareholders.

Fairness Opinions

It is common for the board to retain an outside valuation firm, such as an investment bank or a firm that specializes in valuations, to evaluate the transaction's terms and price. This firm may then render a fairness opinion in which it may state that the offer is in a range that it determines to be accurate. According to one survey, for deals valued at less than $5 billion, the average fairness opinion fee was $600,000, whereas for deals valued at more than $5 billion, the average fairness opinion fee was $4.6 million.[1] These opinions may be somewhat terse and usually are devoid of a detailed financial analysis. Presumably, however, underlying the opinion itself is such a detailed financial analysis. As part of the opinion that is rendered, the evaluator should state what was investigated and verified and what was not. The fees received and any potential conflicts of interest should also be revealed.

1. *The Daily Deal,* February 28, 2001. Source: CommScan/Computsoft Research Ltd., New York.

Upon reaching agreeable terms and receiving board approval, the deal is taken before the shareholders for their approval, which is granted through a vote. The exact percentage necessary for stockholder approval depends on the articles of incorporation, which, in turn, are regulated by the prevailing state corporation laws. Following approval, each firm files the necessary documents with the state authorities in which each firm is incorporated. Once this step is completed and the compensation has changed hands, the deal is completed.

SHORT-FORM MERGER

A short-form merger may take place in situations in which the stockholder approval process is not necessary. Stockholder approval may be bypassed when the corporation's stock is concentrated in the hands of a small group, such as management, which is advocating the merger. Some state laws may allow this group to approve the transaction on its own without soliciting the approval of the other stockholders. The board of directors simply approves the merger by a resolution.

A short-form merger may occur only when the stockholdings of insiders are beyond a certain threshold stipulated in the prevailing state corporation laws. This percentage varies depending on the state in which the company is incorporated, but it usually is in the 90% to 95% range. Under Delaware Law the short form merger percentage is 90%.

FREEZEOUTS AND THE TREATMENT OF MINORITY SHAREHOLDERS

A majority of shareholders must provide their approval before a merger can be completed. A 51% margin is a common majority threshold. When this majority approves the deal, minority shareholders are required to tender their shares, even though they did not vote in favor of the deal. Minority shareholders are said to be *frozen out* of their positions. This majority approval requirement is designed to prevent a *holdout problem,* which may occur when a minority attempts to hold up the completion of a transaction unless they receive compensation over and above the acquisition stock price.

This is not to say that dissenting shareholders are without rights. Those shareholders who believe that their shares are worth significantly more than what the terms of the merger are offering may go to court to pursue their *shareholder appraisal rights.* To successfully pursue these rights, dissenting shareholders must follow the proper procedures. Paramount among these procedures is the requirement that the dissenting shareholder object to the deal within the designated period of time. Then they may demand a cash settlement for the difference between the "fair value" of their shares and the compensation they actually received. Of course, corporations resist these maneuvers because the payment of cash for the value of shares will raise problems relating to the positions of other stockholders. Such suits are very difficult for dissenting shareholders to win. Dissenting shareholders may only file a suit if the corporation does not file suit to have the fair value of the shares determined, after having been notified of the dissenting shareholders' objections. If there is a suit, the court may appoint an appraiser to assist in the determination of the fair value.

PURCHASE OF ASSETS COMPARED WITH PURCHASE OF STOCK

The most common form of merger or acquisition involves purchasing the stock of the merged or acquired concern. An alternative to the stock acquisition is to purchase the target company's assets. In doing so, the acquiring company can limit its acquisitions to those parts of the firm that coincide with the acquirer's needs. When a significant part of the target remains after the asset acquisition, the transaction is only a partial acquisition of the target. When all the target's assets are purchased, the target becomes a corporate shell with only the cash or securities that it received from the acquisition as assets. In these situations, the corporation may choose to pay stockholders a liquidating dividend and dissolve the company. Alternatively, the firm may use its liquid assets to purchase other assets or another company.

ASSUMPTION OF THE SELLER'S LIABILITIES

If the acquirer buys all the target's stock, it assumes the seller's liabilities. The change in stock ownership does not free the new owners of the stock from the seller's liabilities. Most state laws provide this protection, which is sometimes referred to as *successor liability.* One way the acquirer can try to avoid assuming the seller's liabilities is to buy only the assets rather than the stock of the target. In cases in which a buyer purchases a substantial portion of the target's assets, the courts have ruled that the buyer is responsible for the seller's liabilities. This is known as the *trust funds doctrine.* The court may also rule that the transaction is a *de facto* merger—a merger that occurs when the buyer purchases the assets of the target, and, for all intents and purposes, the transaction is treated as a merger.

The issue of successor liability may also apply to other commitments of the firm, such as union contracts. The National Labor Relations Board's position on this issue is that collective bargaining agreements are still in effect after acquisitions.

ADVANTAGES OF ASSET ACQUISITIONS

One of the advantages of an asset acquisition, as opposed to a stock acquisition, is that the bidder may not have to gain the approval of its shareholders. Such approval usually is only necessary when the assets of the target are purchased using shares of the bidder and when the bidder does not already have sufficient shares authorized to complete the transaction. If there are not sufficient shares authorized, the bidder may have to take the necessary steps, which may include amending the articles of incorporation, to gain approval. This is very different from the position of the target company where their shareholders may have to approve the sale of a substantial amount of the company's assets. The necessary shareholder approval percentage is usually the same as for stock acquisitions.

ASSET SELLOFFS

When a corporation chooses to sell off all its assets to another company, it becomes a corporate shell with cash and/or securities as its sole assets. The firm may then decide to distribute the cash to its stockholders as a liquidating dividend and go out of existence. The proceeds of the assets sale may also be distributed through a *cash repurchase tender offer.* That is, the firm makes a tender offer for its own shares using the proceeds of the asset sale to pay for shares. The firm may also choose to continue to do business and use its liquid assets to purchase other assets or companies.

Firms that choose to remain in existence without assets are subject to the Investment Company Act of 1940. This law, one of a series of securities laws passed in the wake of the Great Depression and the associated stock market crash of 1929, applies when 100 or more stockholders remain after the sale of the assets. It requires that investment companies register with the SEC and adhere to its regulations applying to investment companies. The law also establishes standards that regulate investment companies. Specifically, it covers:

- Promotion of the investment company's activities
- Reporting requirements
- Pricing of securities for sale to the public
- Issuance of prospectuses for sales of securities
- Allocation of assets within the investment company's portfolio

If a company that sells off all its assets chooses to invest the proceeds of the asset sale in Treasury bills, these investments are not regulated by the act.

There are two kinds of investment companies: *open-end investment companies* and *closed-end investment companies.* Open-end investment companies, commonly referred to as mutual funds, issue shares that are equal to the value of the fund divided by the number of shares that are bought, after taking into account the costs of running the fund. The number of shares in a mutual fund increases or decreases depending on the number of new shares sold or the redemption of shares already issued.

Closed-end investment companies generally do not issue new shares after the initial issuance. The value of these shares is determined by the value of the investments that are made using the proceeds of the initial share offering.

REVERSE MERGERS

A reverse merger is a merger in which a private company may go public by merging with an already public company that often is inactive or a corporate shell. The combined company may then issue securities and may not have to incur all of the costs and scrutiny that normally would be associated with an initial public offering. The private company then has greatly enhanced liquidity for its equity. Another advantage is that the process can take place quickly. In addition, the private company's shares are publicly traded after the deal, and that can be more attractive to other targets that the bidder may be pursuing. Most reverse mergers involve smaller companies that are looking for a less expensive way of going public.

An example of a recent reverse merger was the March 2001 $229 million reverse merger involving Ariel Corporation and Mayan Network Corp. Under this deal, Mayan acquired Ariel. Mayan shareholders owned 90% of the combined company, while Ariel shareholders owned the remaining 10%. One unusual aspect of this reverse merger was its size, as most such deals involve smaller firms. The deal presented benefits for both companies because it allowed Mayan, a company that only recently had signed up its first two customers, to tap public markets, while giving Ariel, whose stock price and financing were weak, an opportunity to improve its financial condition.[2]

HOLDING COMPANIES

Rather than a merger or an acquisition, the acquiring company may choose to purchase only a portion of the target's stock and act as a *holding company,* which is a company that owns sufficient stock to have a controlling interest in the target. Holding companies trace their origins back to 1889, when New Jersey became the first state to pass a law that allowed corporations to be formed for the express purpose of owning stock in other corporations.

If an acquirer buys 100% of the target, the company is known as a *wholly owned subsidiary.* However, it is not necessary to own all of a company's stock to exert control over it. In fact, even a 51% interest may not be necessary to allow a buyer to control a target. For companies with a widely distributed equity base, effective working control can be established with as little as 10% to 20% of the outstanding common stock.

Advantages

Holding companies have certain advantages that may make this form of control transaction preferable to an outright acquisition. Some of these advantages are:

- *Lower cost.* With a holding company structure, an acquirer can attain control of a target for a much smaller investment than would be necessary in a 100% stock acquisition. Obviously, a smaller number of shares to be purchased permits a lower total purchase price to be set. In addition, because fewer shares are demanded in the market, there is less upward price pressure on the firm's stock and the cost per share may be lower. The acquirer may attempt to minimize the upward price pressure by gradually buying shares over an extended period of time.
- *No control premium.* Because 51% of the shares were not purchased, the control premium that is normally associated with 51% to 100% stock acquisitions would not have to be paid.
- *Control with fractional ownership.* As noted, working control may be established with less than 51% of the target company's shares. This may allow the controlling company to exert certain influence over the target in a manner that will further the controlling company's objectives.
- *Approval not required.* To the extent that it is allowable under federal and state laws, a holding company may simply purchase shares in a target without having to solicit the approval of the target company's shareholders. As is discussed in Chapter 3, this has become more difficult to accomplish because various laws make it difficult for the holding company to achieve such control if serious shareholder opposition exists.

2. Danny Forsten, "Mayan Snares Ariel in $229 Million Reverse Merger," *The Daily Deal,* 30 March 2001, p. 1.

Disadvantages

Holding companies also have certain disadvantages that make this type of transaction attractive only under certain circumstances. Some of these disadvantages are:

- *Multiple taxation.* The holding company structure adds another layer to the corporate structure. Normally, stockholder income is subject to double taxation. Income is taxed at the corporate level, and some of the remaining income may then be distributed to stockholders in the form of dividends. Stockholders are then taxed individually on this dividend income.

  Holding companies receive dividend income from a company that has already been taxed at the corporate level. This income may then be taxed at the holding company level before it is distributed to stockholders. This amounts to *triple taxation* of corporate income. However, if the holding company owns 80% or more of a subsidiary's voting equity, the Internal Revenue Service allows filing of consolidated returns in which the dividends received from the parent company are not taxed. When the ownership interest is less than 80%, returns cannot be consolidated, but between 70% and 80% of the dividends are not subject to taxation.
- *Antitrust problems.* A holding company combination may face some of the same antitrust concerns with which an outright acquisition is faced. If the regulatory authorities do find the holding company structure anticompetitive, however, it is comparatively easy to require the holding company to divest itself of its holdings in the target. Given the ease with which this can be accomplished, the regulatory authorities may be more quick to require this compared with a more integrated corporate structure.
- *Lack of 100% ownership.* Although the fact that a holding company can be formed without a 100% share purchase may be a source of cost savings, it leaves the holding company with other outside shareholders who will have some controlling influence in the company. This may lead to disagreements over the direction of the company.

JOINT VENTURES

Another type of business combination is a *joint venture.* In a joint venture, companies can enter into an agreement to provide certain resources toward the achievement of a particular business goal. For example, one company could provide financing while another firm contributes physical assets or technological expertise. The venture would realize certain returns, and they would be shared among the venture partners according to a prearranged formula.

In recent years a number of international joint ventures have taken place in the automobile industry. United States companies have entered into agreements with Japanese manufacturers to take advantage of certain comparative advantages these firms might enjoy, such as technological advantages and quality controls. Some of the ventures provided for the establishment of manufacturing facilities in the United States to produce automobiles to be sold in the U.S. market under American manufacturers' brand names. The goal was to enable American manufacturers to produce cars that offered some of the beneficial features of Japanese cars, such as quality, durability, and fuel economy, without having to invest the significant resources to develop this technology and manufacturing know-how. The Japanese manufacturers would also be able to take advantage of the American manufacturers' brand names, distribution network, and other marketing advantages that American manufacturers enjoyed, such as good financing subsidiaries. In addition, the agreements using U.S. manufacturing facilities and U.S. workers would allow Japanese manufacturers to avoid trade restrictions that might affect them if they were to sell directly to the U.S. market. One example of such an arrangement was the joint venture between Chrysler Motors and Mitsubishi Motors, in which the companies agreed to jointly manufacture automobiles in Bloomington, Illinois.

Another example that illustrates the combination of the characteristics of a joint venture and a holding company is the 1995 relationship formed between Packard Bell and NEC, in which NEC purchased a 20% stake in the closely held Packard Bell for $170 million. In addition to providing Packard Bell with needed cash, the companies agreed to supply components to each other and to make joint purchases of computer parts and engage in joint product development. The companies also agreed to the mutual use of each firm's marketing channels.

CASE STUDY: COKE AND PROCTER & GAMBLE $4.2 BILLION JOINT VENTURE

On February 20, 2001, two giant consumer products companies, Coke and Procter & Gamble, established a separate company as a joint venture. The company would develop and market juices and snacks. It would combine the international distribution system of Coke with Procter & Gamble's development expertise. The corporate structure of the venture is a limited liability company in which each venture partner owns 50%. Each company would contribute certain major consumer brands. Coke adds its Minute Maid juice unit along with its Fruitopia, Hi-C, and Five Alive drinks. Procter & Gamble would bring its Sunny Delight and Pringles. The new company would have 4,000 employees and would market 40 brands.

The venture combines the strengths of each company. Coke has an extremely broad global distribution system that Procter & Gamble lacks. Procter & Gamble, however, has impressive abilities to develop new consumer products such as nutritional beverages. Although Coke has world-renowned brands and a great distribution system, it had seen its sales slow and sought to develop new products—especially noncarbonated drinks. Procter & Gamble excels in this capability.

The combination would give a boost to certain successful Procter & Gamble products such as the Pringles line of potato chips. Procter & Gamble believed that they could greatly enhance the sales of Pringles by selling it through the Coke distribution system. For example, on a worldwide basis, Pringles was reported to be in one-tenth of the outlets that Coke is in.[a]

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a. Nikhil Deogun and Betsy McKay, "Coke and P&G Plan to Create $4.2 Billion Juice and Snack Company," *Wall Street Journal,* 21 February 2001, p. B1.

The joint venture with Procter & Gamble was an alternative that Coke's management pursued after its board of directors had recently vetoed a proposed acquisition of Quaker Oats that they thought was too expensive. The union between Coke and Procter & Gamble helps close the gap with Pepsi in the juice market and snack market—both of which Pepsi is very strong in. Pepsi owns the dominant Tropicana juice brand along with Frito-Lay snack foods. The joint venture with Procter & Gamble now gives Coke major brands in these two areas.

STRATEGIC ALLIANCES

An alternative to a joint venture is a *strategic alliance.* A strategic alliance is a more flexible concept than a joint venture and refers to a myriad of arrangements between firms whereby they work together for varying periods of time to accomplish a specific goal. Through such alliances links can be readily established and easily disbanded. An organizational entity usually is not created with a strategic alliance, whereas it often is in a joint venture. This may be an advantage because the potential agency costs associated with the managers of the joint venture are not incurred. The added flexibility of strategic alliances may be of special benefit to growing firms because it allows them to quickly establish links when they are needed. These links can often accomplish goals that may require a significant investment and financial resources. This is another reason growing firms, such as high technology companies, may find this alternative of particular benefit. One example of a high-tech development alliance was NCR's 1990 agreement with Seagate Technology to jointly develop high-performance storage systems.[3] An example of a high-tech marketing agreement was the alliance between 3Com Corporation and Sync Research, in which 3Com Corporation would provide marketing assistance to Sync Research's products.

The downside of alliances is the greater potential for opportunistic behavior by the partners. Companies that share business strategy and business secrets may put these valuable intangible assets at greater risks than what might occur in a more integrated organizational structure.

Given the usual loose nature of alliances, there is a tendency to have posturing by the partners so that they create a need for each other. This may involve sharing only essential information when necessary. The partners will continue to cooperate only as long as there is a benefit from the association. If the partners can show each other that there are benefits from a continued association into the future, there is an incentive for greater cooperation.

3. SuHan Chan, John S. Kensinger, Arthur Keown, and John Martin, "Do Strategic Alliances Create Value," *Journal of Financial Economics* 46, no. 2 (November 1997), pp. 199–222.

CASE STUDY: CISCO-SOFTBANK ALLIANCE

In January 2001, Cisco announced a three-part agreement in which Cisco, a U.S. maker of Internet switching equipment, announced that it was buying a 1% stake in Softbank for $200 million, while also repurchasing most of Softbank's interest in Cisco's Japanese unit for a reported $275 million. In addition, Cisco announced that it would invest over $1 billion in an Asian venture fund that will be managed by Softbank.

This deal is an expansion of a relationship between Cisco and Softbank that dates back to 1994, when Softbank bought a 12% interest in Cisco's Japanese unit. Softbank also helped Cisco with its penetration of the Japanese market. The new deal is designed to take advantage of the strengths and resources of the respective companies. Cisco brings not only its vast Internet prowess but also substantial financial resources. Softbank brings its knowledge of the Asian Internet business. The cash resources that Cisco "brings to the table" help offset Softbank's reported shortage of such resources. Cisco, on the other hand, sees the deal as a way to expand the Asian market for its products and services. Given that Cisco has had a long-term relationship with Softbank, its comfort level was higher than that which it might have had with a company with whom it did not enjoy such as relationship. The financial resources of Cisco also came at a time when the stock price of Softbank had fallen significantly.

REFERENCES

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2

HISTORY OF MERGERS

Five periods of high merger activity, often called merger waves, have taken place in the history of the United States. These periods were characterized by cyclic activity, that is, high levels of mergers followed by periods of relatively fewer mergers. The first four waves occurred between 1897 and 1904, 1916 and 1929, 1965 and 1969, and 1984 and 1989. Merger activity declined at the end of the 1980s but resumed again in the early 1990s to begin the current fifth merger wave. The various merger waves provoked major changes in the structure of American business. They were instrumental in transforming American industry from a collection of small and medium-sized businesses to the current form, which includes thousands of multinational corporations.

This chapter focuses more closely on the later merger periods because they are, of course, more relevant to recent trends in the world of mergers. This is particularly the case starting with the fourth and fifth merger waves.

THE FIRST WAVE, 1897–1904

The first merger wave occurred after the Depression of 1883, peaked between 1898 and 1902, and ended in 1904 (Table 2.1 and Figure 2.1). Although these mergers affected all major mining and manufacturing industries, certain industries clearly demonstrated a higher incidence of merger activity.[1] According to a National Bureau of Economic Research study by Professor Ralph Nelson, eight industries—primary metals, food products, petroleum products, chemicals, transportation equipment, fabricated metal products, machinery, and bituminous coal—experienced the greatest merger activity. These industries accounted for approximately two-thirds of all mergers during this period.

The mergers of the fourth wave were predominantly horizontal combinations (Table 2.2 and Figure 2.2). The many horizontal mergers and industry consolidations of this era often resulted in a near monopolistic market structure. For this reason, this merger period is known for its role in creating large monopolies. This period is also associated with the first billion dollar megamerger deal when U.S. Steel, founded by J. P. Morgan, later joined with Carnegie Steel, founded by Andrew Carnegie, and combined with its other major rivals.

1. Ralph Nelson, *Merger Movements in American Industry: 1895–1956* (Princeton, N.J.: Princeton University Press, 1959).

Table 2.1. Mergers, 1897–1904

Year	Number of Mergers
1897	69
1898	303
1899	1,208
1900	340
1901	423
1902	379
1903	142
1904	79

Source: Merrill Lynch Business Brokerage and Valuation, *Mergerstat Review,* 1989.

The resulting steel giant merged 785 separate firms. At one time U.S. Steel accounted for as much as 75% of the United States' steel-making capacity.

Besides USX Corporation (formerly U.S. Steel), some of today's great industrial giants originated in the first merger wave. These include DuPont Inc., Standard Oil, General Electric, Eastman Kodak, American Tobacco Inc., and Navistar International (formerly International Harvester). While these companies are major corporations today with large market shares, some were truly dominant firms by the end of the first merger wave. For example, U.S. Steel was not the only corporation to dominate its market. American Tobacco enjoyed a 90% market share, and Standard Oil, owned by J. D. Rockefeller, commanded 85% of its market.

In the first merger movement, there were 300 major combinations covering many industrial areas and controlling 40% of the nation's manufacturing capital. Nelson estimates that in excess of 3,000 companies disappeared during this period as a result of mergers.

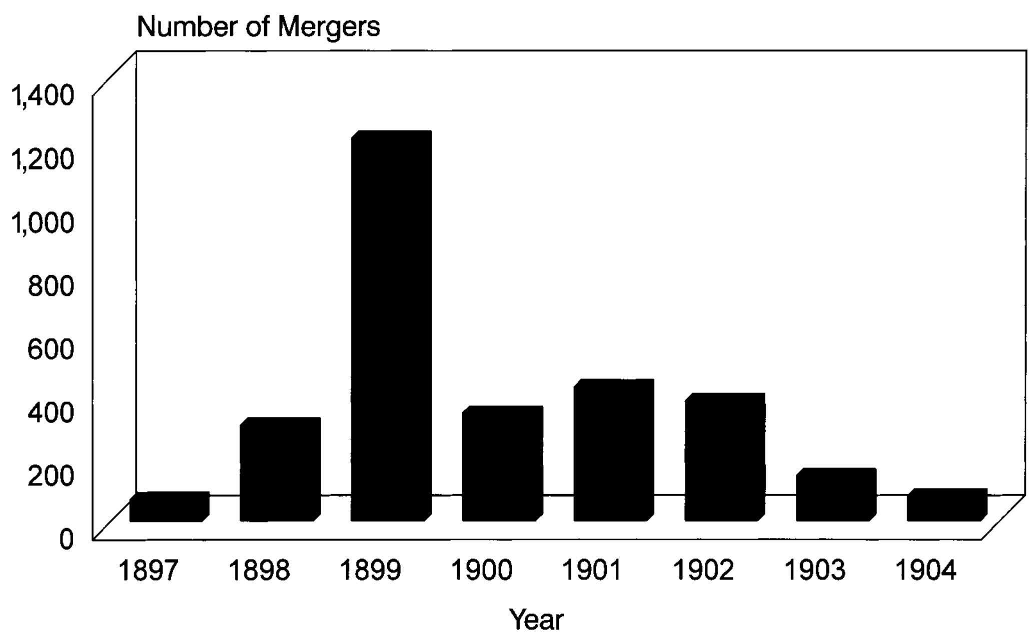

Figure 2.1. Mergers of the first wave, 1897–1904.

Table 2.2. Mergers by Types, 1895–1904

Type of Merger	Percentage (%)
Horizontal	78.3
Vertical	12.0
Horizontal and Vertical	9.7
Total	100.0

Source: Neil Fligstein, *The Transformation of Corporate Control* (Cambridge, Mass.: Harvard University Press, 1990), p. 72.

By 1909 the 100 largest industrial corporations controlled nearly 18% of the assets of all industrial corporations. Even the enactment of the Sherman Antitrust Act (1890) did not impede this period of intense activity. The Justice Department was largely responsible for the limited impact of the Sherman Act. During the period of major consolidation of the early 1900s, the Justice Department, charged with enforcing the act, was understaffed and unable to aggressively pursue antitrust enforcement. The agency's activities were directed more toward labor unions. Therefore, the pace of horizontal mergers and industry consolidations continued unabated without any meaningful antitrust restrictions.

By the end of the first great merger wave, a marked increase in the degree of concentration was evident in American industry. The number of firms in some industries, such as the steel industry, declined dramatically, and in some areas only one firm survived. It is ironic that monopolistic industries formed in light of the passage of the Sherman Act. However, in addition to the Justice Department's lack of resources, the courts initially were unwilling to literally interpret the antimonopoly provisions of the act. For example, in 1895 the U.S. Supreme Court ruled that the American Sugar Refining Company was not a monopoly that did not restrain trade.[2] The courts initially saw the law's focus to be on regulating stock-

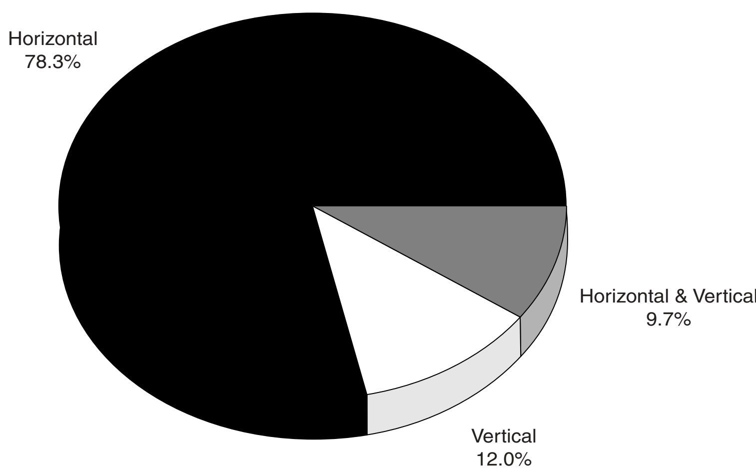

Figure 2.2. Mergers of the first wave by type.

Source: Nelson 1959 and Neil Fligstein, *The Transformation of Corporate Control* (Cambridge, Mass.: Harvard University Press, 1990), p. 72.

2. Joseph R. Conlin, *The American Past* (Fort Worth, Tex.: Harcourt Press, 1997), p. 500.

holder trusts, in which investors would invest funds in a firm and entrust their stock certificates with directors who would ensure that they received dividends for their "trust certificates." For this reason, the law was not applied to hinder the formation of monopolies in several industries in the first merger wave.

The trusts were formed by dominant business leaders, such as J. P. Morgan of the House of Morgan and John D. Rockefeller of Standard Oil and National City Bank, as a response to the poor performance of many of the nation's businesses as they struggled with the weak economic climate. They saw the structure of many industries, which included many small and inefficient companies, as part of the reason for this poor performance. They used the voting powers entrusted to them to force multiple mergers in certain industries in an effort to reduce the level of competition and to allow the surviving companies to enjoy certain economies of scale. The end result was that certain trusts, such as the American Cottonseed Oil Trust and the National Lead Trust, dominated their respective industries. Morgan Bank, in turn, controlled First National Bank, the National Bank of Commerce, the First National Bank of Chicago, Liberty National Bank, Chase National Bank, Hanover National Bank, and the Astor National Bank.[3]

In addition to lax enforcement of federal antitrust laws, other legal reasons explain why the first merger wave thrived. For example, in some states, corporation laws were gradually relaxed. In particular, corporations became better able to secure capital, hold stock in other corporations, and expand their lines of business operations, thereby creating a fertile environment for firms to contemplate mergers. Greater access to capital made it easier for firms to raise the necessary financing to carry out an acquisition, and relaxed rules controlling the stockholdings of corporations allowed firms to acquire the stock in other firms with the purpose of acquiring them.

Not all states liberalized corporate laws. As a result, the pace of mergers and acquisitions was greater in some states than in others. New Jersey, in which the passage of the New Jersey Holding Company Act of 1888 helped liberalize state corporation laws, was the leading state in mergers and acquisitions, followed by New York and Delaware. This act pressured other states to enact similar legislation rather than see firms move to reincorporate in New Jersey. Many firms, however, did choose to incorporate in New Jersey, which explains the wide variety of New Jersey firms that participated in the first merger wave. This trend declined dramatically by 1915, when the differences in state corporation laws became less significant.

The development of the U.S. transportation system was another of the major factors that initiated the first merger wave. Following the Civil War, the establishment of a major railway system helped create national rather than regional markets that firms could potentially serve. Transcontinental railroads, such as the Union Pacific–Central Pacific, which was completed in 1869, linked the western United States with the rest of the country. Many firms, no longer viewing market potential as being limited by narrowly defined market boundaries, expanded to take advantage of a now broader-based market. Companies, now facing competition from distant rivals, chose to merge with local competitors to maintain their market share. Changes in the national transportation system made supplying distant markets both easier and less expensive. The cost of rail freight transportation fell at an av-

3. Nell Irvin Painter, *Standing at Armageddon: The United States, 1877–1919* (New York: W.W. Norton & Company, 1987), pp. 178–179.