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Introduction to Mergers and Acquisitions

The field of mergers and acquisitions (M&As) has greatly expanded over the past quarter of a century. While M&As used to be somewhat more of a U.S. business phenomena, this changed significantly in the 1990s, and now M&As are more commonly used by corporations throughout the world to expand and pursue other corporate goals. This was very much the case in the latest merger wave of the 1990s and early 2000s, where the numbers of deals in Europe were comparable to those in the United States. In addition, other markets, such as the Asian economies, also saw much M&A activity as well as other forms of corporate restructuring. Restructuring, sell-offs, and acquisitions become more common in Asia, where countries such as Japan and South Korea began the slow process of deregulating their economies in an effort to deal with economic declines experienced during that period.

In this book we will analyze how mergers and acquisitions can be used to further a corporation's goals. However, we will focus mainly on how M&As can be misused and why this occurs so often. We will

see that flawed mergers and failed acquisitions are quite common and are not restricted to one time period. We will see that while we have had three merger booms in the United States over the past four decades, every decade featured many prominent merger failures. One characteristic of these failures is their similarity. It might seem reasonable that if several corporations had made certain prominent merger errors, then the rest of the corporate world would learn from such mistakes and not repeat them. This seems not to be the case. It is ironic, but we seem to be making some of the same merger mistakes—decade after decade. In this book we will discuss these errors and try to trace their source.

Before we begin such discussions, it is useful to establish a background in the field. For this reason we will have an initial discussion of the field of M&As that starts off with basic terminology and then goes on to provide an overview. We will start this review by highlighting some of the main laws that govern M&As in the United States. It is beyond the bounds of this book to provide a full review of the major laws in Europe and Asia. Fortunately, many of these are covered elsewhere.

Following our review of the regulatory framework of M&As, we will discuss some of the basic economics of M&As as well as provide an overview of the basic reasons why companies merge or acquire other companies. We will generally introduce these reasons in this chapter, but we will devote Chapter 2 to this issue.

In this initial chapter on M&As, we will also review leveraged transactions and buyouts. The role of debt financing, and the junk bond market in particular, and the private equity business will be covered along with the trends in leveraged deals. We will see that these were more popular in some time periods than in others. In the most recent merger wave, for example, we saw fewer of the larger leveraged buyouts than what we saw in the 1980s when M&As were booming to unprecedented levels.

Finally, we will review the trends in number of dollar value of M&As. We will do this from a historical perspective that focuses on the different merger waves we have had in the United States, but also elsewhere—where relevant. As part of this review, we will point out the differences between the merger waves. Each is distinct and reflects the changing economy in the United States.

BACKGROUND AND TERMINOLOGY

A *merger* is a combination of two corporations in which only one corporation survives. The merged corporation typically ceases to exist. The acquirer gets the assets of the target but it must also assume its liabilities. Sometimes we have a combination of two companies that are of similar sizes and where both of the companies cease to exist following the deal and an entirely new company is created. This occurred in 1986 when UNISYS was formed through the combination of Burroughs and Sperry. However, in most cases, we have one surviving corporate entity and the other, a company we often refer to as the *target*, ceases to officially exist. This raises an important issue on the compilation of M&A statistics. Companies that compile data on merger statistics, such as those that are published in *Merger-stat Review*, usually treat the smaller company in a merger as the target and the larger one as the buyer even when they may report the deal as a merger between two companies.

Readers of literature of M&A will quickly notice that some terms are used differently in different contexts. This is actually not unique to M&As but generally applies to the use of the English language. Mergers and acquisitions are no different, although perhaps it is true to a greater extent in this field. One example is the term *takeover*. When one company acquires another, we could refer to this as a takeover. However, more often than not, when the term *takeover* is used, it refers to a hostile situation. This is where one company is attempting to acquire another against the will of the target company's management and board. This often is done through the use of a *tender offer*. We will discuss hostile takeovers and tender offers a little later in this chapter. Before doing that, let's continue with our general discussion of the terminology in the field of M&As.

MERGER PROCESS

Most M&As are friendly deals in which two companies negotiate the terms of the deal. Depending on the size of the deal, this usually involves communications between senior management of the two companies, in which they try to work out the pricing and other terms of the deal. For public companies, once the terms of the deal have

been agreed upon, they are presented to shareholders of the target company for their approval. Larger deals may sometimes require the approval of the shareholders of both companies. Once shareholders approve the deal, the process moves forward to a closing. Public companies have to do public filings for major corporate events, and the sale of the company is obviously one such event that warrants such a filing by the target.

In hostile deals, the takeover process is different. A different set of communications takes place between the target and bidder. Instead of direct contact, we have an odd communications process that involves attorneys and the courts. Bidders try to make appeals directly to shareholders as they seek to have them accept their own terms, often against the recommendations of management. Target companies may go to great lengths to avoid the takeover. Sometimes this process can go on for months, such as in the 2004 Oracle and PeopleSoft takeover battle.

ECONOMIC CLASSIFICATIONS OF MERGERS AND ACQUISITIONS

Economic theory classifies mergers into three broad categories:

1. Horizontal
2. Vertical
3. Conglomerate

Horizontal mergers are combinations between two competitors. When Pfizer acquired Warner Lambert in 2000, the combination of these two pharmaceutical companies was a horizontal deal. The deal is an excellent example of the great value that can be derived from acquisitions, as Pfizer was able to acquire Lipitor as part of the package of products it gained when it acquired Warner Lambert. Lipitor, the leading anticholesterol drug, would become the top-selling drug in the world, with annual revenues in excess of \$11 billion by 2004. This helped Pfizer maintain its position as the number-one pharmaceutical company in the world. This transaction was actually part of a series of horizontal combinations in which we saw the pharmaceutical industry consolidate. Such consolidations often occur when

an industry is deregulated, although this was not the case for pharmaceuticals as it was for the banking industry. In banking this consolidation process has been going on for the past two decades. Regulatory strictures may prevent a combination that would otherwise occur among companies in an industry. Once deregulation happens, however, the artificial separations among companies may cease to exist, and the industry adjusts through a widespread combination of firms as they seek to move to a size and level of business activity that they believe is more efficient.

Increased horizontal mergers can affect the level of competition in an industry. Economic theory has shown us that competition normally benefits consumers. Competition usually results in lower prices and a greater output being put on the market relative to less competitive situations. As a result of this benefit to consumer welfare, most nations have laws that help prevent the domination of an industry by a few competitors. Such laws are referred to as *antitrust laws* in the United States. Outside the United States they are more clearly referred to as *competition policy*. Sometimes they may make exceptions to this policy if the regulators believe that special circumstances dictate it. We will discuss the laws that regulate the level of competition in an industry later in this chapter.

Sometimes industries consolidate in a series of horizontal transactions. An example has been the spate of horizontal M&As that has occurred in both the oil and pharmaceutical industries. Both industries have consolidated for somewhat different reasons. The mergers between oil companies, such as the merger between Exxon and Mobil in 1998, have provided some clear benefits in the form of economies of scale, which is a motive for M&As that we will discuss later in this chapter. The demonstration of such benefits, or even the suspicion that competitors who have pursued mergers are enjoying them, can set off a mini-wave of M&As in an industry. This was the case in the late 1990s and early 2000s as companies such as Conoco and Phillips, Texaco and Chevron merged following the Exxon-Mobil deal, which followed on the heels of the Amoco-BP merger and occurred at roughly the same time as the PetroFina-Total merger.

Vertical mergers are deals between companies that have a buyer and seller relationship with each other. In a vertical transaction, a

company might acquire a supplier or another company closer in the distribution chain to consumers. The oil industry, for example, features many large vertically integrated companies, which explore for and extract oil but also refine and distribute fuel directly to consumers.

An example of a vertical transaction occurred in 1993 with the \$6.6 billion merger between drug manufacturer Merck and Medco Containment Services—a company involved in the distribution of drugs. As with horizontal transactions, certain deals can set off a series of other copycat deals as competitors seek to respond to a perceived advantage that one company may have gotten by enhancing its distribution system. We already discussed this concept in the context of the oil industry. In the case of pharmaceuticals, Merck incorrectly thought it would acquire distribution-related advantages through its acquisition of Medco. Following the deal, competitors sought to do their own similar deals. In 1994 Eli Lilly bought PCS Health Systems for \$4.1 billion, while Roche Holdings acquired Syntex Corp. for \$5.3 billion. Merck was not good at foreseeing the ramifications of such vertical acquisitions in this industry and neither were the copycat competitors. They incorrectly believed that they would be able to enhance their distribution of drugs while gaining an advantage over competitors who might have reduced access to such distribution. The market and regulators did not accept such arrangements, so the deals were failures. The companies simply could not predict how their consumers and regulators in their own industry would react to such combinations.

Conglomerate deals are combinations of companies that do not have a business relationship with each other. That is, they do not have a buyer-seller relationship and they are not competitors. Conglomerates were popular in the 1960s, when antitrust enforcement prevented companies from easily engaging in horizontal or even vertical transactions. They still wanted to use M&As to facilitate their growth, and their own alternative was to buy companies with whom they did not have any business relationship. We will discuss this phenomena more when we review merger history. Also, we will discuss diversifying deals in general in Chapter 2 on merger strategies. We will find that while some types of diversifying mergers promote shareholder wealth, many do not. We will also see that even those

companies that have demonstrated a special prowess for doing successful diversifying deals also do big flops as well. General Electric (GE) is a well-known diversified company or conglomerate, but even it failed when it acquired Kidder Peabody. Acquiring a brokerage firm proved to be too big a stretch for this diversified corporation that was used to marketing very different products. The assets of brokerage firms are really their brokers, human beings who walk in and out of the company every day. This is different from capital-intensive businesses, which utilize equipment that tends to stay in the same place you put it. With a brokerage firm, if you do not give the “asset” a sufficient bonus, it takes off to one of your competitors at the end of the year. If you are not used to dealing with such human assets, this may not be the acquisition for you. It wasn’t for GE.

REGULATORY FRAMEWORK OF MERGERS AND ACQUISITIONS

In the United States, three sets of laws regulate M&As: securities, antitrust, and state corporation laws. The developments of these laws have been an ongoing process as the business of M&As has evolved over time. In this section we will cover the highlights of some of the major laws.

Securities Laws

In the United States, public companies—those that have sold shares to the public—are regulated by both federal and state securities laws. Although these laws regulate issuers of stock in many ways that are less relevant to M&As, they do contain specific sections that relate to such deals. Companies that engage in control transactions, of which an M&A would be considered such a transaction, have to make certain filings with the national governmental entity that regulates securities markets in the United States—the Securities and Exchange Commission (SEC). Securities laws require that with the occurrence of a significant event, including an M&A above a certain size, companies must file a Form 8K. This filing contains basic information on the transaction. In addition to this filing, when an entity is pursuing

a tender offer, it must make certain filings with the SEC pursuant to the Williams Act. This law is primarily directed at the activities of companies that are seeking to pursue hostile deals.

The two most important laws in the history of U.S. securities regulation are the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 Act required the registration of securities that were going to be offered to the public. This was passed in the wake of the stock market crash of 1929, when so many companies went bankrupt and their investors lost considerable sums. At this time investors had little access to relevant financial information on the companies that offered shares. The law was designed, in part, to provide greater disclosure, which small investors could use to assess the prospects for their investments in these public companies. The lawmakers' reasoning at that time was that individual investors would be better protected if companies were required to disclose such information with which the investors could make more informed decisions.

The Securities Act of 1934 added to the provisions of the 1933 Act but also established the federal enforcement agency that was charged with enforcing federal securities law—the Securities and Exchange Commission (SEC). Many of the securities and merger-related laws that have been enacted are amendments to the Securities Exchange Act. One major amendment to this law was the Williams Act, which regulated tender offers.

Tender Offer Regulation

Tender offers, which are made directly to shareholders of target companies, were relatively unregulated until the Williams Act was passed in 1968. This act contains two sections that are relevant to the conduct of tender offers. The first is Section 13(d), which requires that if an entity, corporation, partnership, or individuals acquire 5% or more of a company's outstanding shares, it must file a Schedule 13D within 10 days of reaching the 5% threshold. The schedule features various financial data that are to be provided by the acquirers of the shares. This information includes the identity of the acquirer, its intentions, and other information, of which shareholders of the target company might want to be aware. Such information requires the

acquirer to indicate the purpose of the transaction. If it intends to launch a hostile takeover of the company, it must say so. If the shares are being acquired for investment purposes, it must say so as well. This section of the law is important to shareholders who may not want to sell their shares if there is a bidder who is about to make an acquisition bid that would normally provide a takeover premium.

When a tender offer is made, the bidder must file a Schedule 14D, which also lists various information that the offerer must reveal. In addition to the identity of the bidder, the offerer must indicate the purpose of the transaction, the source of its financing, as well as other information that might be relevant to a target shareholder who wants to evaluate the transaction. Although the Williams Act regulates tender offers, ironically it actually does not define exactly what a tender offer is. This was done in court decisions that have interpreted that law. One such decision was rendered in *Wellman v. Dickinson*. In this case, the court set forth seven out of eight factors that later became known as the Eight Factor Test when another factor was added in a subsequent court decision. These are eight characteristics that an offer must have in order to be considered a tender offer requiring the filing of a Schedule 14D.¹ Hostile deals really become part of the fabric of corporate America in the 1980s, during a period that is known as the fourth merger wave. This time period and its characteristics will be discussed in detail in the next chapter.

Section 14(d) provides benefits to target company shareholders. It gives them more information that they can use to evaluate an offer. This is especially important in cases where the consideration is securities, such as shares in the bidder. Target company shareholders want to know that information so they can determine if the deal is in their interests. Section 14(d) requires that the bidder must wait 20 days before completing the purchase of the shares. During this time, shareholders may decide not to tender their shares to the bidder and may withdraw them even if they tendered them earlier in the 20-day time period. This time period is provided so that shareholders have time to fully consider the offer that has been presented to them and that is described in the materials submitted with the Schedule 14D. During that period, other bidders may come forward with competing bids, and this can have an effect on the length of the original

offer period as under certain circumstances, depending on when during the 20-day time period a second or even third bids come, the total waiting period may be extended. Such extensions are designed to give shareholders time to evaluate both offers together.

Insider Trading Laws

Various securities laws have been adopted to try to prevent insider trading. One is Rule 10b-5, which prohibits the use of fraud and deceit in the trading of securities. The passage of the Insider Trading Sanctions Act of 1984, however, specifically prevented the trading of securities based on insider information. Unfortunately, the exact definition of *inside information* was left murky by the law, and the process of coming up with a working definition of *inside information* and *insiders* evolved based on decisions in various cases brought alleging insider trading. However, the general concept behind the laws is that those who have access to inside information, which is not available to the average investors and which would affect the value of a security, should not be able to trade using such information unless it is first made available to the public. This does not mean that insiders, such as management and directors, cannot purchase shares in their own companies. Such purchases and sales have to be specifically disclosed, and there is a legal process for how such trading and disclosure should be conducted. Those who violate insider trading laws can face both criminal penalties and civil suits from investors.

In the 1980s, there were several prominent cases of corporate insiders, investment bankers, attorneys, and even newspaper reporters using inside information to trade for their own benefit. Information on a company that is about to be acquired can be valuable because takeover offers normally include a control premium, and shareholders may not want to sell shares in a company that is about to receive such an offer. Those who know about an impending but as-yet-undisclosed takeover offer may be tempted to buy shares from unsuspecting investors and gain this premium. This is why we have laws that try to prevent just that. Do the laws work? Laws never eliminate crime, but they raise the price of violating the rules. In doing

so, the laws help level the playing field between those investors who have a preferential access to information that others do not have.

ANTITRUST LAWS

In the United States, we call competition policy *antitrust policy*. This term was derived from the types of entities that were the focus of initial concerns about anticompetitive activity—trusts. These were the large business entities that came to dominate certain industries in the late 1800s. As part of this concern, the Sherman Antitrust Act was passed in 1890. This law has two main sections. Section One is designed to prevent the formation of monopolies and seeks to limit a company's ability to monopolize an industry. Section Two seeks to prevent combinations of companies from engaging in business activities that limit competition. The law was broad and initially had little impact on anticompetitive activities. It is ironic that the first great merger period, one that resulted in the formation of monopolies in various industries, took place after the passage of the law that was designed to prevent such actions. There are several reasons for the initial ineffectiveness of this law. One was that the law was so broad that many people did not think it was really enforceable. In addition, the Justice Department did not really have the resources to effectively enforce the law, especially since an unprecedented period of M&A activity took place soon after its passage, yet no additional resources were provided to the Justice Department to enable it to deal with the onslaught of new deals.

After this first merger wave came to an end, Congress sought to readdress competition policy in the United States. This led to the passage of some more laws regulating businesses. One of these was the Clayton Act of 1914. This law generally focused on competition policy, and it had a specific section, Section 7, which was designed to regulate anticompetitive mergers. At the same time, Congress also passed another law—the Federal Trade Commission Act, which established the Federal Trade Commission (FTC). The FTC was charged with enforcing the Federal Trade Commission Act but also is involved in enforcing our competition laws along with the Justice Department. Both governmental entities are involved in enforcing

antitrust laws, and they tend to work together to ensure that one governmental entity enforces the laws in each particular case. This often means that one entity, say the FTC, focuses on certain industries while the Justice department handles others. The FTC had previously handled the competitive software industry, but when the U.S. government decided it was going to pursue action against Microsoft, it was decided that the Justice Department, which could command greater resources, would step forward and take over the matter.

One antitrust law that is also relevant to M&A is the Hart-Scott-Rodino Antitrust Improvements Act, which was passed in 1976. This law requires that companies involved in M&A transactions file data on sales and shipments with the Justice Department and FTC. Companies must receive prior approval from one of these regulatory bodies before being able to complete a deal. The purpose of the law is to prevent deals that might be anticompetitive from being consummated and having to be disassembled after the fact. There has been criticism in recent years that the approval process is unnecessarily long and regulators have promised to work to eliminate unnecessary delays.

STATE CORPORATION LAWS

Corporations are chartered by specific states. Being incorporated in a particular state means that the company must follow the laws of that state. However, companies may also have to adhere to laws of other states in which they do business. The most common state for companies to be incorporated in is the State of Delaware, which has made a small industry out of incorporating businesses and processing their legal claims in the State's court system. There has been much debate about why Delaware is the state of preference for companies. It cannot be fully explained by just tax differences or even the state's highly developed legal code. Other states, such as Nevada, have tried to attract away some of this business by copying the Delaware corporation laws, but this attempt has not been successful. At this point, part of the explanation lies in the fact that Delaware has been established as the preferred state, and that is difficult to change.

With respect to M&As, one major difference among states is their antitakeover laws. Many states adopted different antitakeover laws that made it more difficult for hostile bidders, especially those from outside a given state, to take over companies in that state. This was very popular in the 1980s, when hostile takeovers were the rage. Delaware actually lagged behind some of the other states, which had passed aggressive antitakeover laws as a result of lobbying pressures by potential target companies on state legislatures. Eventually Delaware passed a law in the midst of a takeover battle between Carl Icahn and Texaco, which actually was made retroactive to a date when Icahn's shareholdings would later be sufficient to be bound by this law. This underscores the role of potential target companies in passing such laws.

There are various types of antitakeover laws, and many states have sets of laws that embody several of the different types of restrictions. These include:

- *Fair price laws.* These laws require that all shareholders in tender offers receive what the law defines to be a fair price. The law includes some definition of a fair price, such as the highest price paid by the bidder for shares.
- *Business combination statutes.* These laws were designed to make leveraged takeovers that are dependent on sales of a target company's assets more difficult to complete. They tried to prevent unwanted bidders from taking full control of the target company's assets unless it acquires a minimum number of shares, such as 85%. If the shareholders or the board members decide that they do not want to be bound by the law, they can elect not to do so.
- *Control share provisions.* These laws require bidders to receive approvals from target company shareholders before they can acquire shares or use the voting rights associated with those shares.
- *Cash-out statutes.* These statutes require a bidder to purchase the shares of the shareholders whose stock may not have been purchased by a bidder whose purchases of target company stock may have provided it with an element of control in the

company. This is designed to both prevent target shareholders from being unfairly treated by a controlling shareholder and to require that the bidder have sufficient financing to be able to afford to purchase these shares.

HOSTILE TAKEOVERS

Hostile takeovers refer to the taking control of a corporation against the will of its management and/or directors. Taking over a company without the support of management and directors does not necessarily mean it is against the will of its shareholders. The way the takeover process works, shareholders usually do not get to express their views directly during a takeover battle and rely on management to do this for them. This is why having managers and directors who will live up to their fiduciary responsibilities is very important for the growth of shareholder wealth.

The main reason why a bidder pursues a hostile as opposed to a friendly takeover is that the deal is opposed by the target. Bidders usually want to do friendly deals because hostile deals typically are more expensive to complete. The greater expense comes from the fact that the bidding process may result in a higher premium because it may involve other bidders bidding the price up. It will also include costs such as additional investment bankers' fees and legal fees. Hostile deals also have less assurance that a deal would go through compared to friendly deals, which have a much higher percentage of completion.

One of the main tools used to complete a hostile takeover is the tender offer. This topic was discussed briefly while reviewing tender offer regulation. Tender offers are bids made directly to shareholders, bypassing management and the board of directors. If a company were pursuing a friendly deal, the logical place to start would be to contact the target company management. If this contact is rejected, then there are two other alternatives: (1) go to the board of directors or (2) go directly to shareholders. When bidders make an offer to the board of directors, this is sometimes referred to as a *bear hug*. It is mainly a hostile tactic because it carries with it the implied, and sometimes stated, threat that if the offer is not favorably received, the bidder will go directly to shareholders next.

If a friendly overture or a bear hug is not favorably responded to, then one of the next alternatives is a tender offer. Here the bidder communicates the terms of its offer directly to shareholders, hoping they will accept the deal. As discussed earlier, the Williams Act provides for specific regulations to which tender offers must adhere. Bidders are somewhat limited following the submission of the offer because they have the aforementioned 20-day waiting period that they must wait out before actually purchasing the shares—assuming shareholders find the offer sufficiently appealing to want to sell. During the 20-day offer period, other bidders may make offers. The first bidder may have put the target company *in play* and may then find itself in a bidding contest. Target company shareholders then get to consider both offers and possibly even others. This usually works to their advantage because they tend to receive higher premiums when there are multiple bids.

For bidders, however, it usually means they either will have to pay a higher price for the target or will have to drop out of the process. Shrewd bidders know where to draw the line and step back. Others, sometimes consumed by hubris, will bid on in an attempt to “win” the contest. Often what they end up winning is the “winner’s curse,” where they pay more than the company is worth. This was the case in 1988 when Robert Campeau, having already acquired Allied Stores, went on to make an offer for Federated, which would give him the largest department store chain in the world. Unfortunately for him, Macy’s stepped into the bidding process, and Edward Finkelstein and Robert Campeau went head-to-head, increasing the premium until finally Campeau won out. The ultimate winning bid was \$8.17 billion (equity, debt, and total fees paid), and the acquisition saddled the combined company with billions of dollars in new debt. We will discuss this takeover more in Chapter 4, but it is a great example of a bidder incorrectly estimating the value of a target and taking on more debt than it could service. Campeau was forced to file for Chapter 11 bankruptcy not that long after the “successful” completion of the takeover.

Hostile bidders have tried different means to thwart the requirements of the Williams Act. One way they have done this was through two-tiered tender offers, which provide preferential compensation to

bidders who tender into the first tier of the offer—say the first 51% of all shares tendered. The 51% usually (but not always) gives the bidder control of the target, and the remaining 49% may be of less value. If this is the case, the bidder may seek to provide higher compensation for this percentage while offering lower compensation and maybe even different consideration for the remaining shares. Courts have found, however, that such offers are often “coercive” and work against the principles of the Williams Act. In such cases, they have been ruled illegal.

Another alternative to a tender offer is a proxy fight. This is where the bidder tries to use the corporate democracy process to garner enough votes to throw out the current board of directors and the managers they have selected. They would either try this at the next corporate election or call a special election. The *insurgent*, as such bidders are now called in this context, then presents its proposals and/or its slate of directors in opposition to the current group. This manner of taking over a company is costly and provides for an uncertain outcome. It is often unsuccessful, although success depends on how you define it. If the bidder is trying to bring about changes in the way the target company is run, this process often does accomplish that. If the goal, however, is to get shareholders to outright reject the current board and then go so far as to accept a bid for the company against management’s recommendation, then this process often does not work. Bidders also find themselves having to expend significant sums for an outcome that often does not work in their favor—at least in the short run.

TAKEOVER DEFENSE

The hostile takeover process is somewhat like a chess match, with the target company being pitted against the hostile bidder. During the fourth merger wave of the 1980s, the tactics and defenses deployed against hostile takeovers came to be greatly refined. Before the 1980s, the usual knee-jerk reaction of a target company when faced with an unwanted bid was to file a suit alleging antitrust violations. Today such a defense would usually be construed as weak and ineffective. However, in the 1960s and 1970s, when antitrust policy was

much more stringent, especially during the 1960s, this was a much more credible response. At such times, if the antitrust lawsuit was not successful, then the bidder tried to pursue more friendly suitors and prepare a list of *white knights*, as such friendly suitors are referred. By the 1980s, when hostile bidders were initiating tender offers with increasing aggressiveness, targets began to catch up to bidders, and the arms race between bidders and targets took force in earnest. Targets enlisted the services of adept attorneys and investment bankers, who devised increasingly sophisticated takeover defenses.

There are two types of takeover defenses. *Preventive takeover defenses* are put in place in advance of any specific takeover bid. They are installed so that a bidder will not attempt a takeover. *Active takeover defenses* are deployed in the midst of a takeover battle where a bidder has made an offer for the company. Although there are a variety of both types of defenses, many of them are less effective than when they were initially created.

The most effective preventive takeover defense is a *poison pill*. Poison pills are also called *shareholders' rights plans*. Rights are short-term versions of warrants. Like warrants, they allow the holder to purchase securities at some specific price and under certain circumstances. Poison pills usually allow the rightsholders to purchase shares at half-price. This is usually worded as saying the holder can purchase \$200 worth of stock for \$100.

Poison pills are an effective defense because they make the costs of a takeover very expensive. If the bidder were to buy 100% of the outstanding shares, it would still have to honor the warrants held by former shareholders, who would then be able to purchase shares at half-price. Because this usually makes an acquisition cost prohibitive, bidders seek to negotiate with the target to get it to dismantle this defense. Sometimes the bidder makes direct appeals to shareholders, requesting them to take action so they can enjoy the premium it is offering and which management and the board may be preventing them from receiving. Target management and directors, however, may be using the protection provided by the poison pill to extract a suitable premium from the bidder. Once a satisfactory offer is received, they may then dismantle this defense, which can usually be done easily and at low cost to the target company.

Other types of preventive takeover defenses involve different amendments of the corporate charter. One such defense is a staggered board, which alters the elections of directors so that only a limited number of directors, such as one-third, come up for election at one time. If only one-third of the board could be elected at one time, then new controlling shareholders would have to wait for two elections before winning control of the board. This hinders bidders who make an investment in the target and then cannot make changes in the company for a period of time. Such changes may be a merger with the bidding company or the sales of assets, which might be used to help pay off debt the bidder incurred to finance the acquisition of the target's stock.

Other common corporate charter amendments are supermajority provisions, which require not just a simple majority but a higher percentage, before certain types of changes can be approved. If a pocket of shareholders will not vote with the bidder, such as managers and some employees who are worried about their jobs, then a bidder may not be able to get enough shares to enact the changes that it needs to take full control of the company.

Still other corporate charter changes include fair price provisions. These work similarly to fair price state corporation laws, except they are installed in the corporation's own bylaws. They require that bidders pay what they define as fair compensation for all shares that are purchased. It is especially focused on two-tiered bids, which seek to pay lower compensation to the back end of an offer. Fair price provisions are not considered a strong takeover defense.

Other corporate charter changes include dual capitalizations. These feature different classes of stock, which afford different voting rights and dividend entitlements to holders of the shares. They often involve one class of super voting rights stock, which usually pay very low dividends. These shares are usually distributed to all shareholders, but those who are interested in augmenting their control, such as managers, may retain it while others may accept a follow-up offer by the company to exchange these shares for regular voting and dividend-paying stock. The end result of such a stock offering/dividend distribution is that increased control is concentrated in the hands of shareholders who typically are more "loyal" to the corporation and

who would be less likely to accept an offer from a hostile bidder. SEC and stock exchange rules limit the extent to which companies can issue and trade such shares.

Companies may also try to prevent a takeover by moving to a state that has stronger antitakeover laws than the state in which it may be incorporated. This often is not an effective defense. Many companies that have such concerns usually are already incorporated in a favorable state or are incorporated in Delaware, which has many attractive features in its antitakeover laws.

A target company can take several steps when it is the receipt of an unwanted bid. Drawing on the defense that has been used for many years, it could file a lawsuit. Unless there are important legal issues it could argue, this often is not enough to stop a takeover. It may, however, provide time, which may enable the target to mount other defenses. This may include selling to a more favored bidder — a white knight. It may also involve selling shares to a more friendly party. This can be done in advance of an offer or as an active defense. The buyer in such sales is referred to as a *white squire*.

During the 1980s, targets were more likely to try to greenmail the bidder to get it to go away and leave the company independent. *Greenmail*, which plays on the word *blackmail*, involves the payment to the bidder of a sufficient amount so that it retreats and does not continue with the takeover. Many changes have occurred since the mid-1980s, when this active defense was used more liberally. The changes include tax penalties on such payments as well as corporate charter amendments that companies have passed limiting their ability to pay greenmail. Greenmail is usually frowned on by shareholders who find their financial resources being used to prevent a bidder, who might be willing to pay a premium for their shares, from making a successful offer.

Greenmail is often accompanied by standstill agreements, whereby a bidder agrees to not purchase shares beyond some limit. In exchange for those agreements, the bidder receive certain compensation. We still see standstill agreements today for various reasons, and they are used independent of greenmail.

Targets may also restructure the company to make it less attractive to a bidder, or it may make some of the same changes that are

being suggested by a bidder, thereby taking this recommendation away from the bidder. Restructuring the company may involve both asset sales and purchases. The company may also restructure its capitalization to increase its debt, making it more leveraged. Capital structure changes may have some impact by making the company less attractive and by reducing the amount of debt that can be raised by a bidder to finance the target's own takeover.

LEVERAGED TRANSACTIONS

Leveraged deals are those that use debt to finance takeover. They are sometimes referred to as highly leveraged transactions (HLTs). One well-known version of HLTs is a leveraged buyout (LBO). An LBO is an acquisition that uses debt to buy the target's stock. When people refer to an LBO, however, they are often referring to a transaction in which a public company is bought using debt and then goes private. The largest LBO of all time was that of RJR Nabisco in 1988 for \$24.8 billion. The company was bought by the well-known buyout firm of Kohlberg Kravis and Roberts (KKR). Although many of KKR's deals have been successes, this buyout was not part of that notable group. One of the problems it had, which LBOs in general have, is that the buyer takes on substantial debt, which leaves the company with a high degree of financial leverage. This carries with it all of the risk that high financial leverage imposes. This comes in the form of fixed charges for the increased debt service. Buyers of companies in leveraged transactions often plan on reducing this leverage with asset sales where the proceeds from those sales can be used to pay down the debt and reduce the debt service. They also try to implement cost structure changes and increased efficiencies, which will lower the company's overall costs and enable it to service the debt.

Buyers of companies in LBOs usually have a plan to reduce the debt over a period of time while they make various changes at the company. Many of these deal makers plan on doing a *reverse LBO* some time after the original LBO. In a reverse LBO, the private company that was bought out in the LBO goes public again. This can be done all at once or in stages, as it was done in the case of RJR Nabisco. In the RJR Nabisco deal, KKR sold percentages of the company to the

public and used these proceeds to pay down the mountain of debt it had assumed. One of the reasons why this deal was not a success has to do with the budding contest that occurred as part of the buyout. RJR received a low-ball offer from a group led by then CEO Ross Johnson.² KKR entered the fray with its own offer, knowing that the Johnson group's offer was low. However, a bidding contest ensued, and KKR won, but it really bore the winner's curse.

Many LBOs are management buyouts (MBOs), which is what the Ross Johnson proposal was. As the name suggests, in a management buyout a management group acquires the company from the public shareholders. This is often an awkward situation because management are fiduciaries for shareholders and are charged with the responsibility of getting the best deal for them. However, it is in management's interests to pay the least amount for the company, which would mean a lower value for shareholders. Organizers of MBOs try to finesse this situation and seek to get outside opinions to substantiate the idea that shareholders are getting their full value for the company.

During the 1980s, there were many mega-LBOs featuring billion-dollar prices for public companies such as RJR Nabisco but also companies such as Seagate Technologies and Beatrice (see Exhibit 1.1). Many of these deals, as well as non-LBO acquisitions, were financed using funds raised through the sale of junk bonds. Marketers of junk bonds prefer to call them high-yield bonds. The bonds offer a high yield because they are more risky than other corporate bonds. The risk of the bond is assessed by rating agencies such as Standard & Poor's and Moody's. Under the Standard & Poor's system, AAA is the highest rating, AA is next, and so on. Bonds that receive a BB rating or worse are considered junk bonds. The name *junk bonds* is a poor one because these securities can pay attractive yields and be an important part of many investors' portfolios. Investors can combine them in diversified portfolios, thereby lowering their exposure to any one security, and enjoying impressive returns. However, because the agencies see greater risk in these corporate bonds as opposed to those to which they give a higher rating, the issuers have to offer a higher interest rate to investors to compensate them for assuming the relatively greater risk of these investments—hence the term *high yield*.

Exhibit 1.1 Top Ten LBO Deals

Year Announced	Company Name	Purchase Price (\$ millions)
1988	RJR Nabisco (tobacco and food giant)	24,561.60
2000	Seagate Technology Inc. (storage, retrieval, and data mgmt. products)	11,661.60
1985	Beatrice Cos. (diversified food and consumer products)	5,361.60
1986	Safeway Stores Inc. (supermarket chain)	4,198.40
1987	Borg-Warner Corp. (diversified manufacturing)	3,798.60
1987	Southland Corp. (convenience food stores)	3,723.30
1986	Owens-Illinois Inc. (packaging, financial services, nursing homes)	3,631.90
1988	Hospital Corp. of America (hospitals)	3,602.10
1988	Fort Howard Paper Corp. (paper products)	3,574.20
1989	NWA Inc. (airline)	3,524.50

Source: Mergerstat Review, 2004.

The high-yield bond market provided some of the fuel for many of the megamergers and LBOs that occurred in the 1980s. When this market collapsed at the end of that decade, it helped end the fourth merger wave. We will discuss this interesting merger time period in the following section. Many of the companies that took on large amounts of debt during this period came to regret it shortly afterward when the economy slowed. Some of these companies were forced to file for bankruptcy. This put a damper on the junk-bond-financed merger and LBO market—one that it has not recovered from to date.

Ironically, after a sharp decline at the end of the 1980s, the junk bond market recovered and remains an important part of corporate finance. Now smaller, less well-known companies can tap into the capital that is available in the junk bond market. Before investment

bankers such as Michael Milken helped pioneer the development of the original issue high-yield bond market, smaller companies did not have access to this huge capital market and were relegated to more restrictive financing sources such as bank loans. Although the junk bond market is alive and well in the 2000s, it does not play as prominent a role as it once did in the M&A market. Deals do not rely on this financing source as much, for reasons that will be discussed in the case study that follows the end of this chapter.

In the fifth merger wave of the 1990s and in the first half of the decade that followed, we still see many LBOs. However, they are different from the LBOs that were more common in the 1980s. One major difference is that they involve less debt and more equity. The companies that are bought in such deals tend to have less debt pressures and a greater likelihood of surviving the post-buyout period. A thriving *private equity market* has developed, and some of this capital finds its way into these types of deals. So we find that the whole LBO business has changed significantly over the past 20 years, but it is still very much alive, although in a different form.

RESTRUCTURINGS

Mergers and acquisitions are but one form of corporate restructuring. However, while this is the focus of this book, other forms of restructuring can be related to M&As. One form of restructuring that is the opposite of M&As is sell-offs. In a *sell-off* a company sells part of itself to another entity. This can be done in several ways. The most common way is a divestiture, where a company simply sells off part of itself to another entity. However, downsizing can be accomplished in other ways, such as through spin-offs, where parts of a company are separated from the parent. Shares in the spun-off entity are given to shareholders of the parent company, who then become shareholders in two, as opposed to one, company. We discuss these types of transactions in Chapter 6 because they can be a way of reversing the error. Another way that a division of a parent company, perhaps one that was acquired in a deal that is now being viewed as a failure, can be separated from the parent company is through an equity carve out. Here shares in the divisions are offered to the market in

a public offering. In Chapter 6 we discuss the shareholder wealth effects of these different types of transactions. However, we can point out now that, in general, the shareholder wealth effects of these various forms of downsizing tend to be positive. We will review the research, which convincingly shows this over an extended time period.

Another form of corporate restructuring on which we do not focus in this book but which is related to the world of M&As is restructuring in bankruptcy. Bankruptcy is not just an adverse event in a company's history that marks the end of the company. There are various forms of bankruptcy, and some of them are more of a tool of corporate finance where companies can make changes in their operations and financial structure and become a better company. Such restructurings can come through a Chapter 11 filing. The Chapter 11 filing refers to the part of the U.S. Bankruptcy Code that allows companies to receive protection from their creditors—an automatic stay. Other countries have bankruptcy laws that allow for restructuring, but many, such as Great Britain and Canada, are more restrictive on the debtor than the United States.

While operating under the protection of the bankruptcy court, the *debtor in possession*, as the company that did the Chapter 11 filing is called, prepares a reorganization plan, which may feature significant changes in the debtor company. These changes may provide for a different capital structure, one with less debt and more equity. It may also provide for asset sales, including sales of whole divisions, which supplies a cash infusion and which may be used to retire some of the debt that may have led to the bankruptcy.

In the 1990s, many of the companies that ate at the debt trough in the fourth merger wave, were forced to file for Chapter 11 protection. One of them was the Campeau Corporation which became a very different company after the company emerged from bankruptcy protection. As with most Chapter 11 reorganizations, the equity holders, which included the deal makers who dreamed up this highly leveraged acquisition, incurred significant losses as the market penalized them for their poor financial planning. Part of the focus of this book is to determine how such merger failures can be prevented. One of the options available for companies that have made poor deals is to proactively make some of the needed restructuring

changes without having to go down the bankruptcy road. Sometimes, however, the situation is such that the pressure of the laws of the bankruptcy court is needed to force all relevant parties, including different groups of creditors who have different interests and motivations, to agree to go along with the proposed changes.

REASONING FOR MERGERS AND ACQUISITIONS

Why do firms engage in M&As? There are many reasons, and the more often cited ones are reviewed in Chapter 2. The two most common ones are growth and synergy. That is, M&As are a way in which a company can grow at an accelerated rate. This type of growth is usually much faster than growth through internal development. So when a company sees an opportunity in the market that it could fulfill if it had the resources to do so, one way to reach this goal in some cases is to buy a company that can help meet this objective.

Synergy is also an often-cited motive for companies wanting to do deals. These synergies can come from reductions in costs as a result of a combination of two firms that have partially overlapping or redundant cost structures. Other sources of synergy can come from improved revenues that derive from the combination of the two companies. We will show that this source of synergy is often difficult to come by. It is much easier to talk about in advance of a deal than it is to actually make it come to pass.

Other motives or reasons for M&As include economic motives, such as the pursuit of economies of scale such as cost reductions from being a larger company. We will see that economies of scale are one of the more achievable forms of synergy, although even here many companies never achieve the synergistic gains talked about before the deal. Other economic motives include economies of scope, where a company may be able to offer a broader product line to its current customer base.

The reasons for M&As can be varied. We will review these motives and others that companies put forward to justify M&As. We will see that some types of deals are better than others for shareholders. For example, in many instances, mergers involving companies in different industries are often not well received in the market. However,

deals that enhance a company's focus tend to be better received. We will also see that the market's initial reaction—something that is studied extensively by academic researchers—is often telling about the long-term effects of the change that is being implemented. Although some managers may not learn from prior similar events, the market seems to have a longer memory. It is sometimes fooled, but it seems that it is more on target than managers who seem to quickly forget where other managers, or even themselves, have gone wrong in the past.

TRENDS IN MERGERS

Some volume of M&As always exist, but there have been several periods when a very high volume of deals was followed by a period of lower deal volume. These periods of intense M&A volume are referred to as *merger waves*. There have been five merger waves in the United States. The first merger wave occurred during the years 1897 to 1904. It featured many horizontal M&As. Many industries started the period in an unconcentrated state with many small firms operating. At the end of the period, many industries became much more concentrated, including some being near monopolies. This was ironic because the Sherman Act, as previously discussed, was specifically passed to prevent such an industry structure. The first wave ended when the economy and the market turned down. During the slow economy there was less pressure to do deals. This changed in the 1920s, when the economy started to boom. The vibrant economic conditions led to a second merger wave, which was concentrated during 1916 to 1929. This period featured many horizontal deals but also featured many vertical transactions. Deals were especially concentrated in specific industries. When the stock market collapsed in 1929 and the economy went into a prolonged and deep recession in the 1930s, the merger wave ended. We did not have another major merger period until the end of the 1960s.

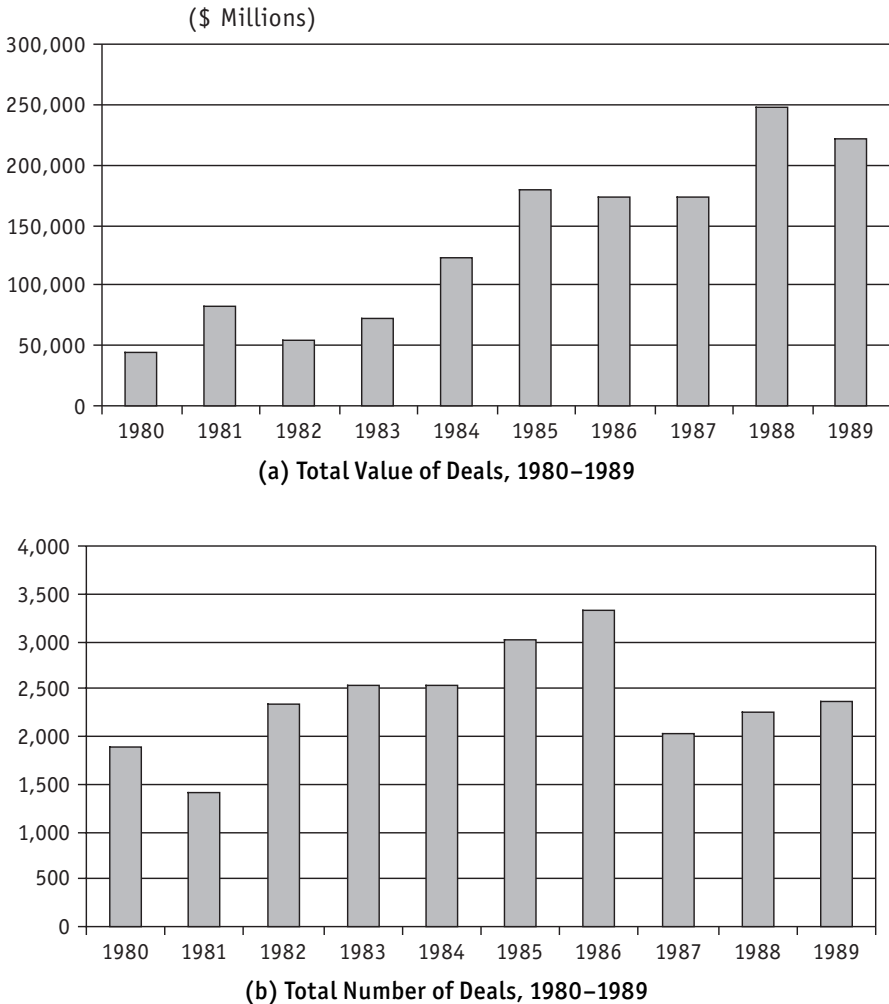
The third merger wave was an interesting period in that it featured many conglomerate M&As, because of the intense antitrust enforcement of that time period. The Justice Department was aggressive in its opposition to M&As and saw many deals that would be

immediately approved today as antitrust problems. For this reason, companies that were acquisition-minded were forced to do deals outside of their industry to avoid the wrath of the Justice Department and the FTC. Many large conglomerates, such as ITT, Gulf & Western, Teledyne, and Textron, were built during that period. While the 1960s featured a booming economy for much of the decade, the economy and the market turned down at the end of that period. Like the prior merger wave, it ended when the economic and financial pressures to expand subsided.

The 1970s featured a more modest number of M&As but did have many others forms of restructurings as companies, which may have been acquired during the third merger wave, were sold off as companies adjusted to the slower economic conditions and questioned some of the deals they had made when the economy was booming and their judgment may have been clouded by dreams of wealth that never materialized. As companies felt the economic pressures of a deep recession in the middle of the decade, they implemented management changes, and some of those changes helped bring about the various restructurings and sell-offs we saw during that period.

The 1980s proved to be the longest postwar economic expansion until we got to the following decade, which featured an even longer growth period. The 1980s provided the colorful fourth merger wave, which had many interested facets including the megamerger. This was the M&A in billion-dollar deals (see Exhibit 1.2). As noted earlier, some of these deals were highly levered and the fuel for these highly leveraged deals was provided by the junk bond market, which also boomed in response to the deal-related demand for this form of capital. The fourth wave also featured many hostile deals as companies, including major corporations, found themselves the target of unwanted suitors. Hostile deals certainly occurred before this period, but they were mainly bids by relatively smaller companies for other smaller companies. Before that period, it was unusual to hear of a hostile offer for large companies. It was even less common to have major reputable companies taking part in hostile takeovers. All of that changed in the late 1970s, and this set the stage for many of the hostile takeovers that occurred in the fourth merger wave.

Exhibit 1.2 Fourth Merger Wave



Source: *Mergerstat Review*, 2004.

The fourth merger wave ended when the economy slowed at the end of the decade and the junk bond market collapsed, in part as a function of weak economic conditions but also as a result of specific problems with that market, including the indictment of Michael Milken and his investment bank—Drexel Burnham Lambert.

In the period 1990 to 1991, there was a mild recession, and the economy recovered slowly initially and then the rebound picked up

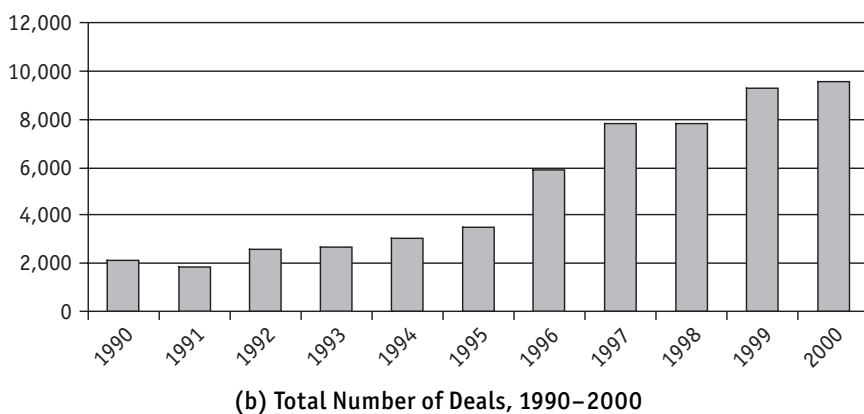
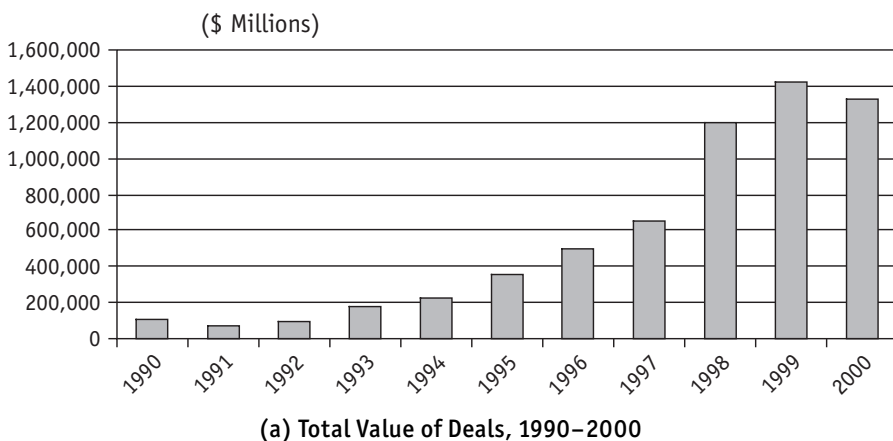
steam. As with many prior expansions, companies looked to grow, and the fastest way to expand is to buy whole companies as opposed to building such a business internally. To some extent, this makes sense as expanding economic conditions create market opportunities that companies may need to react to quickly to take full advantage of. The problem occurs when dreams of economic riches cloud the judgment of management and it does not make the most enlightened decisions. Another problem with booming economic conditions is that they can mask poor management. Increased demand can lead to higher sales and profits even for some companies that are not that well managed. When this occurs, shareholders and the board may credit management with gains that they did not bring about. This may lead them to go along with acquisition proposals that they may not scrutinize carefully enough. Management may get a pass, so to speak, until, for some of the less astute managers, their acquisition schemes blow up in their face. For those who made well-thought-out deals, they may be able to advance the company and take advantage of competitive opportunities in the marketplace.

The fifth merger wave was precedent setting in terms of the total volume of mergers as well as the size of the deals that took place (see Exhibits 1.3 and 1.4). While many megamergers took place in the fourth wave, some of the deals that took place in the fifth wave made the fourth wave deals seem ordinary. In this book we will look at some of these leading deals and see that many of them were simply flops. Deals such as the AOL-Time Warner “merger of equals” were failures that left certain shareholders incensed. Others, such as the Warner Lambert acquisition by Pfizer or the merger between Exxon and Mobil, clearly were successes. The difference between successful and failed deals is the topic we will discuss throughout the rest of this book.

CONCLUSION

The field of M&A is multifaceted with many different aspects. Companies engage in these deals for a variety of reasons, including to take advantage of synergies. These are situations where a combination of companies lead to a greater value than what would have occurred if the company remained independent. In addition to synergistic gains,

Exhibit 1.3 Fifth Merger Wave



Source: *Mergerstat Review*, 2004.

however, companies engage in M&A for other economic motives. These may come from the realization of economies of scale, such as what would occur in historical deals. Companies may also be able to lock up sources of supply to greater access to the market through vertical deals.

Mergers and acquisitions is just one form of restructuring. Other forms of restructuring include restructuring in bankruptcy. This is a more extreme situation where the company may not have performed well. Other forms of restructuring include sell-offs and spin-offs. There are various ways that a company can rid itself of a division in the business unit that no longer fits into its strategic plan. They may

Exhibit 1.4 Large Mergers and Acquisitions of the Fifth Merger Wave

Announced Year	Effective Year	Acquirer	Target	Transaction Value (\$ Billions)
Nov. 1999	Jun. 2000	Vodafone Air	Mannesman 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 Beechman 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

Source: Thomson Financial Securities Data.

do a divestiture or an equity carve-out or spin-off. We have devoted Chapter 6 to these types of restructurings because they often have positive shareholder wealth effects.

In the United States, M&As have occurred in waves or periods of intense activity. These waves have tended to occur in periods of economic expansion and have ended when the economy and the market have turned down. Each wave has distinct differences from the others. We have just completed the fifth merger wave—one that was truly international in its scope. The rest of this book is devoted to determining why many companies doing M&As do deals that are mistakes. In each of the major waves, mistakes were made. In some cases, it seems that we have learned from prior mistakes, but in others we seem to have forgotten our merger history and made some of the same mistakes. Some of the same companies, such as AT&T, have made major merger blunders in different merger waves.

ENDNOTES

1. Wellman v. Dickinson lists seven factors. A subsequent court decision added the eighth factor.
2. For an excellent description of this colorful deal, see Bryan Burrough and John Helyar, *Barbarians at the Gate: The Rise and Fall of RJR Nabisco* (New York: Harper Trade, 1990).

Case Study

Lessons from the Failures of the Fourth Merger Wave

The fifth merger wave that recently ended provides many lessons on what can go wrong with M&As. However, this merger wave came on the heels of another precedent-setting merger period. It is useful to look back on some of the failure lessons we can derive from that period and see if we learned our lesson. Did we make some of the same mistakes in the 1990s that we made in the 1980s, or did we learn from them and make different mistakes? In this case study, we will review some of the more prominent merger failures from the 1980s and see what lessons still have to be learned from those mistakes and which ones have helped us avoid errors.

FOURTH MERGER WAVE FAILURE LESSONS

Each wave has its set of failures and successes. Sometimes we focus too much on the failures because they tend to generate losses for shareholders and can create a big outcry regarding who is to blame. The fourth wave was notable for certain types of deals. We saw more hostile deals, particularly megamergers by large reputable companies.

Many of the deals gave rise to bidding contests, and the winners sometimes got stuck with the winner's curse, having overpaid for the target companies. This was the case in the infamous takeover of Federated Stores by Campeau. Campeau made two major mistakes in that takeover. First and most fundamentally, he overpaid for the target. He got into a bidding contest and would not back out when the price got too high. He stayed in the contest and ended up overpaying. He was not the first corporate buyer to overpay for an asset. However, the fact that he did so on such a grand scale, combined with the fact that he had to declare bankruptcy so soon after the takeover makes him and his takeover a leading failure from that period. The second mistake that Campeau made and that we also hope to learn from is that he borrowed heavily to finance a pricey acquisition. His heavy borrowing put great pressure on the company's cash flows, and this pressure could not be alleviated by asset sales. The high leverage of the deal raised its risk level. He did not have an equity cushion to give him some breathing room in case the markets weakened, as they did. So with the Campeau deal, we had two major lessons:

1. Beware of overpaying, especially if you are in a bidding contest.
2. Beware of using too much debt to finance a pricey acquisition.

Did the markets learn from not just this particular case of overpaying and taking on too much debt but many others that occurred during that heady period? The answer appears that they did—at least at the beginning of the fifth merger wave. When the merger business started to heat up in 1994 and the economic expansion of the 1990s started to pick up steam, companies were leery of relying on debt to finance their acquisitions. Many capital providers were burned by some of the highly leveraged transactions of the fourth merger wave, and they were reluctant to duplicate prior mistakes. In that sense, a learning process had occurred, and the recently learned lessons from the fourth merger wave were not lost on capital providers and deal makers.

SHORT-TERM ORIENTATION OF FINANCIAL, NOT STRATEGIC, DEALS

Another lesson that was painfully taught to some corporations was to be leery of overly aggressive deal makers who are seeking quick

gains and have a short-term focus. Many of the deals, for example, that Drexel Burnham Lambert, but also other major investment banks, were involved in were motivated by the pursuit of high profits from deal making without sufficient care for the long-term health of their investment banking clients. The money from such deal work was so good that it was too hard to resist. Deal makers promoted some transactions purely with a short-term focus to realize fees and having little strategic purpose. Where did the companies go wrong? There was plenty of blame to go around, but much of it has to be laid at the feet of the management and directors of the companies that willingly went along with these proposals. It is not unusual for management to receive deal proposals from bankers, but management has to critically analyze the strategic purpose of the proposed deals and reject those that do not fit its strategy. Management has to have a strategy and should only do deals if they fit their plans, not change the strategy as deals come along. Here again, investment bankers may have appealed to CEO hubris, and this may have led management to make decisions that were not in shareholders' best interests.

Investment bankers had a prominent role in the 1980s, and there were many "Masters of the Universe" running around. Some were arrogant and had an all-knowing air about them. In some cases, they clearly intimidated management of client companies. Given the prominence of hostile deals, certain companies went along with investment bankers, promoting hostile takeovers lest they become the target of their own banker's hostile ambitions. When many of these deals came with mountains of high-yield debt, companies and their shareholders were left holding the bag, for management and their advisors' takeover schemes.

Many corporations were burned from doing deals that were so eagerly recommended by investment bankers. As many companies rebounded from some of their failed deals of the fourth merger wave, they sought to regain full control of their growth strategy. In the fifth merger wave, management assumed the driving role for deals—as should be their normal place. Investment bankers were brought in to assist in specific aspects of deals and were sometimes asked to leave M&A meetings when their presentations on the financing and other aspects of their work were finished. This was an important and needed change in order for the corporate governance process to work properly.

Our discussion of management losing control of the process in the fourth merger wave and investment bankers assuming too large a role is a generalization and applies more to the small percentage of failed deals than it applies to corporations in general. For many corporations, management being in charge of the process was always the norm. However, as we consider that our discussion is on the subset of deals that failed, not a discussion of all types of takeovers of the fourth wave, we can see how those deals that involved management losing control of the process will more often fall into the merger failure category.

In the fifth merger wave, there seemed to be fewer instances of failures because of management's loss of control of the deal-making process and investment bankers being too aggressive in promoting short-term-oriented deals. This is not to say that we did not have an overabundance of failures in the fifth wave. We did, but fewer of them can be blamed on investment bankers. In the fifth wave, we seem to have had more cases of overaggressive and hubris-filled managers making mistakes than overaggressive investment bankers.

AGGRESSIVE USE OF LEVERAGE

When the fifth merger wave took hold, we saw a very different management orientation at play. The failure of many of the highly leveraged takeovers of the fourth wave in the recessionary economy that followed left many deal makers with "black eyes." It is truly ironic that many of the deal makers quickly switched into doing bankruptcy work as opposed to doing acquisitions. During the post-fourth wave period, many deal makers helped finance sales of acquisitions as companies needed to downsize to relieve the combined pressure of weak economic demand with high debt service pressures. Money could now be made with asset sales and other restructuring-related work as well as securities sales to try to arrange different capital structures for companies that found themselves too highly leveraged from the fourth wave period. Investment bankers made money by helping companies load up on debt in the fourth merger wave and later helped them restructure this debt and have a less leveraged capital structure in the 1990s. Many helped companies acquire other businesses in leveraged acquisitions and then other, or sometimes the

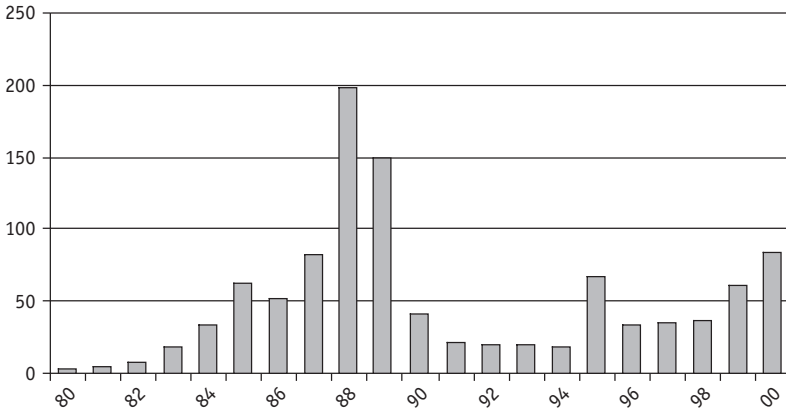
same, investment bankers helped them sell off the prior acquisitions that brought with them debt that they could not service.

A related change in the fifth merger wave that was based on lessons of the fourth wave was that the mega-LBO disappeared. Gone from the landscape was the RJR-Nabisco-type deal. This \$24.8 billion buyout of a food and tobacco giant did not do well for its chief architect—Kohlberg Kravis and Roberts. The deal came toward the end of the fourth merger wave and followed some other mega-LBOs such as the Beatrice buyout. However, RJR Nabisco was far larger than any other LBO, and it was a problem for the buyers for years to come. When the markets turned down as we moved into the 1990–1991 recession, the demand for debt issued by acquirers greatly declined. Investment banks had trouble financing highly leveraged transactions (HLTs) of all types as the market worried about the ability of companies to service high debt levels. Such companies were ill prepared to handle a weak economic climate such as what ensued right after the end of the fourth wave. The lesson, which was underscored by the bankruptcy of many of these debt-laden companies, was not lost both on corporations that would contemplate deals as well as on capital providers and their middlemen—investment bankers. There was an all-around reluctance on the part of both demanders and suppliers of capital to assume or provide high debt levels to finance deals. This was the case for the megadeals as mega-LBOs disappeared from the landscape. However, this did not mean that the LBO disappeared. In fact, after a short hiatus, we started to see an increased number of LBOs, but they were clearly different from many of the LBOs in the 1980s. The LBOs of the fifth merger wave featured more equity and less debt. Gone were the megabuyouts, but there were still plenty of LBOs. They just were smaller deals and often were less debt laden (see Exhibit A).

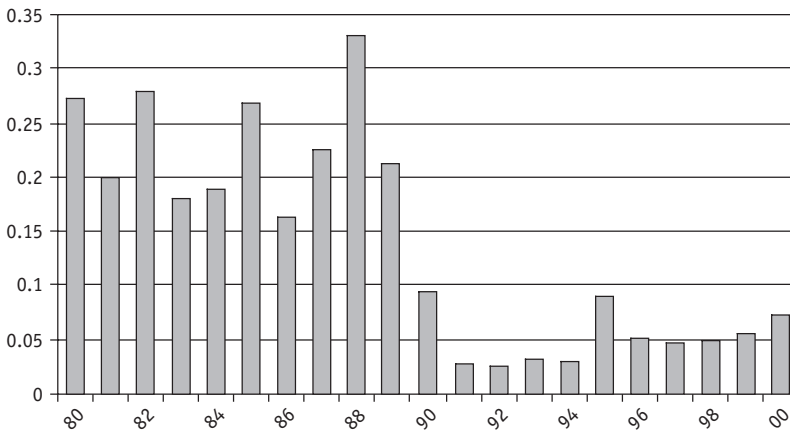
CORPORATE GOVERNANCE AND USE OF ANTITAKEOVER DEFENSES

Another major change from the fourth merger wave was that there was a greater focus on the importance of corporate governance. The role of the board of directors became more important in ensuring

Exhibit A



(a) Value of Worldwide LBOs, 1980–2000



(b) Average Value of Worldwide LBOs, 1980–2000

Source: Thomson Financial Securities Data.

that shareholder rights were protected and that management ran the company in a manner that promoted gains in their stock values. There were more instances of antitakeover defenses being challenged. Unfortunately, the heightened corporate governance did not become pronounced until the end of the fifth wave, and even then was more focused on the prevention of accounting fraud than on the optimal growth and acquisition strategy. From a governance perspective, we learned from the fourth merger wave that the

indiscriminant use of antitakeover defenses, especially when deployed by underperforming and entrenched managers, should be avoided. However, directors have not really gone so far as to become sufficiently active in their scrutiny of proposed deals as they should be. Perhaps by the sixth merger wave we will be sufficiently aware to make sure that we do not repeat the mistakes of the fifth wave, while also sufficiently mindful of the errors of prior waves so that we do not repeat those either.

