Raising capital and creating Wealth: Conflicts in the modern corporation*

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July 1990

I. Introduction

The public corporation has become an important institution in virtually all societies outside the Communist world. Indeed, even in Eastern Europe, recent political upheavals portend a promising future for the corporate form of business organization. Economists have long recognized the advantages of the corporate organization: limited liability, transferability of ownership, and unlimited life. Finance theory would add that the corporate form also allows diversification of risks by investors and thereby provides for efficient risk bearing. These advantages make the corporate form a superior organization for raising capital, and the corporation has become virtually synonymous with modern business. In the U.S., for example, nearly two-thirds of the GNP is accounted for by nonfinancial corporations.

Notwithstanding the economic success of the modern corporation, it is being questioned as a wealth generator. That is to say, its economic efficiency is being questioned. While this line of criticism is not new, it has increased in intensity in the last 10 years or so.

The root of the criticism is that the modern corporation often suffers from conflicts of interest between managers and widely dispersed shareholders. The conflicts of interest lead to inefficiencies such as excessive expenditures or investments with low returns that reduce managers' risks — and loss of shareholder wealth. The firm is less efficient and the shareholders are poorer than would be the case if the conflicting interests were aligned.

While separation of ownership and management is typical in the modern firm, certainly not all are inefficient or poorly managed. Nonetheless, there is evidence from various sources to suggest that opportunities for improvement in performance are not rare. Anecdotal evidence of lavish operating expenditures can be found in the business press. Gains to shareholders from take over attempts and recapitalizations have been reported in numerous academic studies. And in significant numbers, firms are giving up the advantages of public ownership and going private.

This paper examines the problem of separation of ownership and control in the modern corporation. The issue is intimately linked to corporate finance and corporate financial policy, since corporate finance is concerned with the acquisition and use of funds by the firm. The value os the firm in a wellfunctioning market will reflect the effects of inefficiencies caused by separation of ownership and management, and resolution of conflicts between managers and shareholders can be expected to increase the value of the firm. That increased value represents increased wealth to society as a whole.

*Prepared for the 1990 International Symposium, Instituto Politecnico Nacional, Mexico City, Mexico. Helpful comments from Robert Clark, Jack Grinnell, Jane Haugh, and Lyn Laber are gratefully acknowledged.

First, the issue of separation of ownership and control in the modern corporation is examined. While academic research on the subject has grown rapidly in recent years, evidence of the problem dates from the 17th century.

Next, control mechanisms that operate to reduce conflicts between managers and shareholders are examined. In theory, the board of directors should monitor managers on behalf of shareholders and mitigate or eliminate conflicts of interest. In practice, the performance of the board as a monitor of management has been questioned.

Third, the paper reviews how an external market for corporate control exists in the form of takeovers. Operating through tender offers for the firm's shares and proxy contests for the election of board members, takeovers provide a competitive market for corporate control. Evidence from numerous studies indicates that shareholders benefit from these activities in the form of abnormally high returns on their shares. The stock market must see efficiency gains from these activities.

Section V of the paper examines financial policy issues. In addition to the over-all monitoring activities of the board of directors and the external market for corporate control, managers may adopt financial policies designed to reduce conflicts caused by separation of ownership and management. Dividend policy and capital structure policy can be used to constrain managerial discretion and thereby reduce opportunities for conflicts between managers and owners. Leveraged buyouts and leveraged recapitalizations are innovative forms of such financial policy decisions.

II. Ownership and control in the modern corporation

The "firm" of economic theory is assumed to be seeking maximum wealth for its owners. In their classic work on agency theory, Jensen and Meckling [9] point out, however, that the theory of the firm in economics is really not a theory of the firm, but rather a theory of markets. Economic theory does not explain the behavior of managers of the firm, but rather, the behavior of markets in which the firm operates.

Therefore, we must look elsewhere for insight into managerial behavior. Berle and Means [1] are widely recognized for initiating a discussion of the problem associated with separation of ownership and management in the corporation, and their work has stimulated research in accounting, finance, and economics. The essence of the problem is that the corporation's sucess in raising capital from diverse sources leads to widely dispersed ownership of the firm, while management and control are vested in a small group. The management group often owns only a small fraction of the firm's shares. Actions of managers to increase their perquisites and reduce personal risks at the expense of maximizing the value of the firm are spread over many shareholders, most of whom own too few shares to undertake extensive monitoring of management. In theory the board of directors is charged with looking after shareholders' interests, but often they too have small ownership positions in the firm and possess less information than managers.

Jensen and Meckling [9] placed the issue of separation of ownershipe and control in a broader theoretical context in their work on agency theory. The modern corporation is viewed in that model as a set of contractual relationships among owners of resources and the firms' customers. Conflicts between owners and managers are seen as part of the general problem of costly contracting between principals and agents.

It is significant that agency theory does not depend on non-maximizing behavior on the part of managers. Managers are assumed to maximize their utility, which depends on value of the firm and non-pecuniary benefits. If the managers own 100% of the firm, consumption of non-pecuniary benefits reduces the value of the firm — and thus their wealth — in a one-to-one relationship. As outside shareholders are added to the ownership group, managers can enjoy non-pecuniary benefits and have the effects of that consumption on the value of the firm spread across many shareholders. As ownership becomes more and more dispersed, those incentives grow stronger, since the effects are spread over more outsiders, while the difficulty of shareholder monitoring increases. Nonetheless, consumption of non-pecuniary benefits does have a cost to managers in the form of lost value of the firm, and these wealth losses temper the willingness of managers to increase their non-pecuniary benefits.

Although Berle and Means are widely recognized as initiating the modern discussions of separation of ownership and control, the issue did not escape earlier notice. Adam Smith saw the problem in the *Wealth of Nations* [17, p. 700]:

> The directors of such [joint-stock] companies, however, being the managers of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with wich the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

And while Smith was observing a relatively new institution the joint stock company, or corporation – there is evidence of conflict between managers and shareholders even earlier. The Dutch East India Company, one of first major joint stock companies, was organized in 1602, as a successor to a partnership arrangement that preceded it [18]. By 1623, conflicts between managers (*bewindhebbers*) and shareholders resulted in modifications of the firm's charter [18, p. 244].

Anecdotal evidence suggests that the concern over separation of ownership and control is not without modern foundation. For example, in 1986 the board of directors of Allegheny International finally replaced its chairman. Net income had been declining for 5 years, along with the stock price. The firm had been spending lavishly on corporate jets, executive benefits, jobs for relatives of executives, investments in troubled real estate projects after executives had made personal investments in those projects, and low interest loans to executives [2]. The board of directors included the CEO of a large food products firm, a retired general with extensive high-level government experience, and the president of a major university. Ironically, the university president is also a well-known economist who was written on the theory of the firm.

A similar story emerged about RJR Nabisco after its leveraged buyout [16]. Executives enjoyed liberal allowances for club dues, luxury automobiles, and elegant furnishings for their offices. The firm had 10 airplanes and 36 pilots, and paid various sports stars over $2 million a year for "appearances" at RJR Nabisco events. The chairman was quoted as saying, "a few million dollars. . . are lost in the sands of time."

It is important to note in both of these examples that we are not describing situations of bad judgments on investments or investment decisions that might be challenged with the benefit of hindsight. Rather, the behavior was that of lavish spending that exceeded amounts necessary to run the firm. And the boards of directors either did not curb the behavior or moved slowly to do so.

III. Board of Directors

In theory, problems caused by separation of ownership and control in modern corporation should be mitigate by the monitoring of management by the board of directors. In practice, many observers question whether such monitoring is effective. Anecdotal evidence such a the Allegheny International example can be found in other firms. Management consultant and author Peter Drucker claims that although boards are changing, they work well only "in the case of a catastrophe" [19].

Critics charge that boards become dependent on incumbent management for fat directors' fees, and are therefore reeluctant to rock the boat. During a recent takeover attempt of Lockheed, a large institutional investor complained that stock ownership by outside board members is minuscule. Their financial links to the firm are therefore like those of paid managers, not those of investors.

There is evidence, however, to indicate that boards are not oblivious to the performance of the firm. Poor stock market performance tends to increase the likelihood of removal of a chief executive officer (CEO) [25]. However, removal is much more likely when the board is dominated by outsiders, defined as directors who do not work for the company. Research by Morck, Shleifer, and Vishny [14] on Fortune 500 companies found that removal of top managers is more likely to occur when the firm underperforms relative to other firms in the industry, as opposed simply to poor performance. In other words, poor performance of the entire industry does not seem to cause boards of directors to remove managers, but poor performance of the firm relative to the industry does.

By contrast, poor industry performance seems to stimulate hostile takeovers. While boards of directors may be reluctant to replace top managers of a firm that is matching the performance of a poorly performing industry, that firm is likely to become a target of a hostile takeover. The implication is that the market for takeovers is providing stronger discipline for management than internal discipline from the board of directors.

IV. External market for control

While the efficacy of the board of directors to reduce conflicts between managers and owners may be subject to debate, the growth of hostile attempts to takeover firms is beyond dispute. These takeover activities consist of two forms - tender offers and proxy contests — and represent a market for corporate control.

Tender offers. — From levels of fewer than 30 offers a year in the early 1960's, tender offers in the U.S. were running in excess of 100 a year by the mid-1980's [5]. Tender offers represent attempts to pruchase a controlling interest in the firm by offering to buy shares in the market, typically at a substantial premium above the market price. Accompanying this increased popularity of the tender offer as a means of corporate control has been a growing outcry from corporate executives, who are not anxious to see themselves displaced. Corporate managers have been joined in their concern by politicians, who have responded from time to time with legislative proposals to curb takeover activity. On balance one can say rather clearly that tender offer takeovers have not been highly regarded in some circles.

Financial economists, on the other hand, see the tender offer as an effective market force to counter the power of entrenched managers. Moreover, evidence suggests that tender offers are wealth-creating activities. Shareholders of target firms enjoy abnormal returns of 30% or more as a result of tender offers, while shareholders of the bidding firms experience abnormal returns that about zero. Thus, while the distribution of the gains from these takeovers tend to be skewed toward the shareholders of the target firms, on balance the gains are positive. Takeovers by tender offers create wealth.

At this juncture it is wirth digressing for a moment to review the methods being used in modern financial research to assess economic effects of financial decisions. The essence of the method is to assess stock market reaction to corporate events, such as mergers, takeovers, or other policy decisions. A positive market reaction to an event is said to generate a positive abnormal return, which is a return over and above what would be expected on the company's shares. More specifically,

$$AR_{jt} = R_{jt} - E(R_{jt}),$$

where AR_{jt} is the abnormal return on the stock of company j at time t;

R_{jt} = the rate of return — dividends and capital gains — on the stock of company j at time t;

$E(R_{jt})$ = the expected rate of return on the stock of company j at time t. (The expected return on company j's shares typically would be estimated by relating its historical retruns to returns on the stock market as a whole: $E(R_{jt}) = a + b R_{mt} + c_{jt}$, where R_{mt} is the return on the entire stock market, c_{jt} is an error term, and a and b are estimated from historical data. The b term is the stock's beta coeficient.)

If the stock market is efficient — that is, if the market quickly reflects all relevant information — then positive abnormal returns reflect increases in the value of assests. There is abundant evidence in modern literature on accounting and finance that stock markets are indeed sophisticated processors of information. Thus, financial economists are inclined to view the positive abnormal returns that accompany tender offers as evidence of wealth creation.

The specific causes of the gains from tender offers cannot be discerned from the abnormal stock returns themselves. But some causes are suggested: companies subject to hostile tender offers are often forced to sell off assets and abandon diversification efforts. Sir James Goldsmith's attempted takeover of Goodyear had this result, causing financial analysts and competitiors to observe that Goodyear was a stronger company after its divestiture of assets in the oil industry [22]. A new president of Phillips Petroleum admitted that attemped takeovers of the firm had caused it to divest assets and focus on its "basic" business, and that the firm had previously been "wasting money" in its diversification efforts [25].

It is noteworthy that neither of these examples resulted in an actual takeover of the target company. The threat of a takeover, however, affected important policy decisions within the firm. Hostile takeovers provide a market mechanism — a competitive mechanism — to change management's behavior.

Another potential source of wealth creation caused by takeovers relates to operating efficiencies. Two large food retailers in the U.S. — Kroger and Safeway avoided takeovers by major restructurings. Kroger did a leveraged recapitalization and Safeway was taken private through a leveraged buyout (LBO). In both cases, staffs were cut and expenses reduced. The takeover attempts put pressures on these firms to take steps to be more efficient than they otherwise would have been.

Critics of takeovers often cite a third source of abnormal returns to shareholders—redistribution of wealth away from other stakeholders, such as bondholders and labor. Support for this source of gain is not convincing. Studies of bondholder impacts resulting from mergers and acquisitions and from leveraged buyouts do not show significant losses to bondholders [6]. With respect to wage reductions, there is a lack of systematic evidence on the effects of takeovers. However, anecdotal evidence suggests that takeovers and restructuring reactions to takeovers are accompanied by attempts of management to obtain wage concessions. Whether such attempts represent some form of social loss is not unequivocally clear.

These potential sources of shareholder gain provide an answer to critics of takeovers who question how a firm can be worth more to an acquirer than it sells for in a stock market that is supposedly efficient [22]. The firm is worth more to the acquirer because new control of the firm can improve the productivity of its assets. The fair or efficient price of a share reflects future cash flows associated with that share, and those cash flows depend on the investments made by the firm and the expenses it incurs. Eliminating poor investments and trimming lavish expenses create value to shareholders by improving the efficiency of the firm.

Proxy Contests. A proxy contest involves an attempt by dissident shareholders to elect members to the board of directors. In extreme form, the entire board may be displaced in the election. While proxy contests are less popular than tender offers and thought to be a less effective mechanism for corporate takeovers, stock market reaction to such events is positive. Shareholders experience positive abnormal returns, even when the dissident shareholders are unsuccessful. As with unsuccessful takeovers, the challenge o incumbent management appears to portend favorable changes for shareholders.

A basic problem with proxy contests as a mechanism for control relates to the difficulty and cost of mobilizing widely dispersed shareholders to the cause. Also, institutional investors in the past allegedly have tended to side with incumbent management, although tendency may be changing [20].

An illustration of the potential impact of a proxy contest is seen in the case of GAF. After unsuccesfully challenging management of GAF, Samuel Heyman launched a proxy contest and won control of the company. Within his first year as CEO, Heyman cut operating expenses by 23% and fired 15% of the firm's employees. Bond ratings of the firm improved somewhat, and the stock price increased sharply [21]. The same firm became more valuable because of increased efficiencies.

V. Financial Policies

Just as the board of directors represents an internal control device to mitigate agency problems and takeovers represent an external market for control, managers and directors may adopt financial policies to reduce the costs of separation of ownership and control. Financial policy decisions related to dividend payout and capital structure affect the monitoring of the monitoring of the firm by capital markets and the discretion of managers to undertake investments and incur expenses.

Internal sources typically represent 75-85% of the funds raised by U.S. corporations. Aside from the fact that internal sources reduce transaction costs, they also insulate the firm from the monitoring and scrutiny that accompany trips to the external capital market. Managers and directors attempting to reduce conflicts of interest between owners and managers can reduce managerial discretion and increase external monitoring of the firm by paying out cash flows in the form of dividends and by issuing debt.

Dividend Policy. Financial economists regard the decision to pay dividends as something of a puzzle. Dividends are taxable to investors, sometimes at rates that are unfavorable compared with capital gains that accrue to reinvested earnings. Even in the face of equal tax rates, taxes on capital gains associated with reinvestment of earnings can be deferred. Yet firms pay dividends, often while raising capital in external capital markets.

The simultaneous payment of dividends and the raising of external capital can be viewed as a way of reducing conflicts between managers and owners. Trips to the external capital market result in the monitoring of the firm by investment bankers or other financial intermediaries [3]. Subjecting managers to this form of monitoring assists the widely dispersed owners in these attempts to monitor management.

In addition, dividend payout reduces the tendency for the firms's debt ratio to fall as retained earnings build up. Managers have personal interests in reducing the bankruptcy risk of the firm by reducing the debt ratio, but such reductions serve to enhance the well-being of the debtholders. Paying dividends reduces the likelihood that bondholders will gain at the expense of shareholders.

There is some empirical evidence to support the agency theory of dividends. A study of 1,000 U.S. firms [15] found that dividend payout ratios increase with the number of shareholders. This finding is consistent with and agency-cost motivation for dividends. Increased numbers of shareholders means widely dispersed ownership, and dividend payout reduces monitoring costs in that environment.

Increased holdings of shares by insiders reduced dividend payout ratios in the study. That finding is also consistent with agency theory. As insiders own more of the firm, problems associated with separation of ownership and control are reduced.

While agency theory explanations for dividend payout are a relatively recent development in financial theory, evidence of shareholder concern over the issue is not. As noted earlier, the Dutch East India Company experienced conflicts between managers and shareholders in the early 1600's. A principal source of those conflicts was dividend policy. Shareholders claimed in a formal protest that dividend payout was too low, and that management had wasted resources by acts of war [18, p. 247]. It appears that earnings were reinvested in the firm in excess of the levels contemplated in the company's charter. The propensity of management to reinvest earnings, even in unprofitable ventures, is not a 20th century development.

Capital Structure. —Conflicts between managers and shareholders can be reduced if managers' discretion to take actions inimical to shareholders' interests is reduced. Substitution of debt for equity capital is one method to reduce that discretion.

Use of debt capital creates contractual obligations for the firm. A capital structure with much debt can be said to result in a governance structure characterized by rules, whereas equity capital creates a governance structure characterized by discretion [27]. The contractual nature of debt forces payout of cash flows. Jensen [8] describes the substitution of debt for equity capital as a process of "bonding" dividend payments. Managers' discretion to use funds for poor investments is thus curtailed and conflicts between managers and shareholders are reduced.

At very high levels, the contractual obligations of debt force managers to look for opportunities to cut costs. Accounts in the financial press often recount the "backs-to-the-wall" sentiments of managers operating in highly leveraged firms. Managers are thus severely limited in their abilities to engage in lavish expenditures.

Two recent financial innovations are an extension of the use of debt to reduce conflicts between managers and stockholders. These are leveraged buyouts and leveraged recapitalizations. Both involve substitution of debt for equity capital in the firm's financial structure. The leveraged recapitalization typically inolves the issuance of debt which is used to pay a large extraordinary dividend. Sometimes the book value of the firm's equity becomes negative. Managers and sometimes employees receive additional shares of stock in lieu of the dividend. The result is a highly leveraged capital structure and increased ownership of shares by managers and perhaps employees. The firm remains public.

The leveraged buyout (LBO) also uses large amounts of debt. In this case, the public shares are repurchased with the proceeds of the debt issue. The firm goes private, where ownership is concentrated in relatively few hands. Typically, the former managers of the public firm end up with significant ownership of shares. The wide dispersion of ownership that is typical in the modern corporation is eliminated, and ownership and control are closely aligned. Firms that undergo LBO's sometimes return to public status after several years.

Evidence suggests that thsese reorganizations do produce efficiency gains. A study of companies that underwent LBO's shows that operating earnings and operating margins (as a percentage of sales) of the sample companies rose relative to earnings of control companies operating in the same industries [10]. These changes are indicate of operating efficiencies caused by the LBO.

Comments of the chief executive of Safeway tell a similar story about that LBO [13]. Interestingly, the substitution of debt for equity and the resulting elimination of "income" strengthened the bargaining power of the firm in its wage negotiations. High levels of net income were viewed as surpluses by the union, whereas interest was viewed as an expense. The CEO observed that the high debt levels forced operating efficiencies that would not have been possible when the firm was showing high net income.

Market reaction to leveraged recapitalizations has been favorable. Shareholders in a smal sample of firms undergoing this form of restructuring experienced abnormal returns of 33% [11]. Some of the gains may arise form the tax benefits of debt, as apposed to efficiency gains. Nonetheless, shareholders have benefited from the recapitalizations.

Decisions to engage in LBO's and leveraged recapitalizations frequently follow takeover attempts. Thus, the external market for control is playing an important role in stimulating internal financial policy decisions. Again, the importance of competitive market forces for disciplining managers cannot be overstated.

VI. Summary

The corporate form of organization typifies the modern business firm, and its success as a vehicle for raising capital is beyond dispute. The success of the corporation in raising capital, however, results in widely dispersed ownership. Long ago it was recognized that the separation of ownership and management could lead to inefficiencies that reduce the value of the firm.

Conflicts between shareholders and managers can be reduced by monitoring activities of boards of directors, by the external market for control of the corporation, and by financial policies.

There is evidence to suggest that, while boards of directors are not oblivious to shareholders interests, the board as an institution is not sufficiently rigorous as a monitor to eliminate inefficiencies in the modern firm. Firms can adopt financial policies that reduce opportunities for managers to take actions inimical to shareholder interest. Payment of dividends and use of debt reduce managerial discretion. Recent financial innovations, such as leveraged buyouts and leveraged recapitalizations, are strong examples such policies.

The most rigorous monitoring device is found in takeover attempts. Such events are an external market force that has been shown to create wealth for shareholders and to change firm behavior, even when not successful. Curtailing these activities through legal restraints would reduce the pressure on firms to be more efficient. It is not clear that a good substitute exists for discipline that is enforced by takeover attempts, and thus successful attempts to prevent take overs will carry the cost of reduced economic efficiency.

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